

Roth 401(k) catch up alternative

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Hello everyone and welcome to another AuguStar financial podcast. I'm Jim Barbee, your host for today with the Advanced Planning Team. And today I'd like to talk about some very recent tax law changes and two related sales concepts. The first concept applies to a very specific type of client. And the second concept really you can apply to most clients broadly.

So, let's start with the tax law changes. Up until 2025, an employee who participated in an employer 401(k) plan could make elective deferrals using pretax or Roth dollars. So, what is pretax? That just means the contribution amount is not going to appear on box one of the employees W-2, and they're not going to have to pay taxes on it.

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The Roth contribution after tax dollars is going to be taxed in the year that it was made. But as we know, earnings are growing tax free and can be withdrawn with certain penalties that we're going to get to in a few minutes. That employee could also make if there are 50 or over a catch-up contribution using pretax or after tax dollars to the plan.

So, starting January 1st, 2026, if the employee is 50 or over and they made \$150,000 of FICA wages in 2025, that catchup contribution, which is \$8,000 for people over 50, can only be made with Roth dollars. So, what does that mean? Well, it means some of those clients might not want to make that contribution if the whole reason they were contributing to the plan in the first place was to save on taxes, because they're still going to be taxed on that contribution amount.

So, what do we do with that client? Well, that client might want to put some or all of that \$8,000 contribution into life insurance instead of making Roth contributions to a 401(k), for example, maybe that client already has a traditional Roth IRA, which you could have with a 401(k) as well. Or maybe they've made their elective deferral of up to \$24,500 using Roth dollars or some combination of them, and they simply don't want to make a Roth contribution further to the plan of up to \$8,000.

So, in order to figure out whether this is a good idea for this client, let's analyze some of the differences and similarities between a Roth 401(k) and life insurance. The first and primary difference is the purpose of these financial vehicles. Roth 401(k) is designed for supplementing income during retirement. It's not really planned as a legacy tool.

It's not really designed to pass on to heirs, although you can. But there are certain IRS rules regarding distributions, which we'll get to in a minute. It's just simply not a great tool for leaving to beneficiaries. Life insurance's primary purpose, on the other hand, is the death benefit and protection providing for your beneficiaries your heirs, your spouse, estate liquidity, paying taxes ...

It's really not designed, to take care of you during your lifetime. Now, that said, life insurance can be used as a retirement supplement just like a 401(k); in some instances, all the for one case have some limitations. And let me get into those a little bit so we can decide whether this is good for your client.

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With the 401(k) Roth contributions, it is true that the earnings grow income tax-free. However, if you try to withdraw those earnings and you haven't had a Roth account open for at least five years, the IRS actually taxes the earnings. And further, if you withdraw those earnings before you're 59.5 and still working, the IRS might, assess a 10% penalty, subject to a few exceptions.

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Now, I've had some clients say, well, can't I just withdraw the contributions? Yes or no? You can withdraw contributions. However, the IRS applies a pro-rata rule. So let's say I have a \$100,000 account and \$80,000 of it is from traditional deferrals and their earnings, and \$20,000 of it is from Roth contributions in earnings. So there's an 80/20 percentage.

Now let's say I withdraw \$30,000. The IRS is going to say \$24,000 of that, which is 80% is subject to taxes. And the other \$6,000 of contributions. Well, the earnings portion of that \$6,000 is going to be subject to taxes. If I haven't had the account open for five years and a 10% penalty on the earnings portion, if I'm under 59.5, there is an exception to the 59.5 rule, if I've ceased working for the employer and I'm 55 or over. But, let's face it, most people are going to be looking at the 59.5, year rule.

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Life insurance, on the other hand, doesn't have these same types of limitations. You can access cash value, without worrying about the pro-rata rule, without worrying about taxation on earnings as long as the policy is structured correctly. It's not a macro example. There aren't certain gains in the policy. And I can also do this in a few ways.

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First, you can surrender the basis, which means I can take out just my contributions. I can take out the money I've taken out of premiums, this is not a policy loan, I get my that money back income tax free. I can also take policy loans and as long as this policy's not lapsing, I'm not going to be paying any taxes on those policy loans.

So you can see how life insurance in some cases is a wonderful retirement supplement without the limitations of a Roth 401(k), there's also cash value accumulation to consider. As we know, with a Roth 401(k), the account can go up or down from year to year based on the holdings in the account. Although it's tax-advantaged, it's not immune from market declines.

Life insurance specifically, some of the products at AuguStar, aren't subject to the same types of declines in the cash value in a bad market. For example, with our IUL, we have certain guaranteed non forfeiture rates. And if you want to get into that, it's a little beyond the scope of this podcast please give me a call. But the bottom line is there are certain guarantees with that IWL.

The IUL for example has a 0% floor on the cash value crediting or movement every year. So let's say I've chosen the S&P 500 as my index, and it's down 20% in 2026. AuguStar will not subtract 20% from the cash value. Instead, it'll just have a 0% floor. Now every insurance product will have

cost of insurance, administrative fees, loads. Those are going to detract from the cash value, but there won't be any additional, subtraction from cash value based on the market decline.

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Now, given that fact, you can see how life insurance is going to work. It's a great volatility buffer with a 401(k). Let me explain what that means. So let's say I have a client who's retired and they're primarily using their Roth 401(k) to pay for living expenses. And whatever it happens to be. And they're making withdrawals every year from that account.

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But in my, hypothetical, let's say the accounts down 20%, the client might not want to make withdrawals from their 401(k), essentially locking in losses, not giving the account time to appreciate and value. Well, with life insurance in those negative years, the client could either surrender the basis or take policy loans to pay for their living expenses and give the Roth 401(k) account some time to recover.

This is how we would use life insurance as a volatility buffer. And by the way, I'm a big believer in Roth accounts and life insurance working together this way. There's also been some recent tax law changes that make leaving that 401(k) to beneficiaries less advantaged than life insurance. For example, if you leave your Roth 401(k) to a beneficiary other than your spouse, with only a few exceptions, the IRS requires that beneficiary to distribute the account funds within ten years of the original account owner's death, regardless of whether the beneficiary needs the money or has any use for it, which is essentially cutting off any future growth in that account income tax-free. Now, I've had some clients say, well, can't you get around that by making a trust the beneficiary and saying that the trustee can distribute this based perhaps on the beneficiaries lifetime? Well, actually, you can't draft around the tax law, the Secure act. And so you can't get around those rules just by drafting a trust.

By the way, here, let me put a plug in here for our document or use service if you haven't used it. We have a lot of agents send us their clients trusts and wills. And we look for things like this to see if those documents are still in compliance with the Secure Act and other tax law changes. Now, we're not going to draft documents for your client. We're not their attorney. We're not going to recommend amendments. But we can certainly spot these issues for you, which you can pass on to your client, helping you stand out as a trusted advisor who's going the extra mile.

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So let's get back to life insurance here. Life insurance is not subject to the Secure Act. It's not a qualified account, and the beneficiaries of your account can do anything with that. Those funds and spend them whenever they want or not at all. And you can also use a trust. Let's say I want to, leave money to my child, but I'm concerned about them spending it too early.

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I can leave the death benefit to a trust, with instructions to the trustee to only make distributions to the beneficiary at certain time periods, or ages. For example, maybe the beneficiary gets 25% when the beneficiaries 25 and more money is the beneficiary is 30 and 35, etc. I can also put provisions in the trust that say no distributions to the beneficiary.

If that beneficiary has creditors at the time we call the suspend preferred clause, essentially, protecting some of that death benefit from creditors. Now, with all this said, you can see how for some clients, especially the 50-year-old who doesn't want to make a Roth contribution, the 401(k) might want to use that \$8,000 to buy life insurance and hopefully supplement an existing Roth account that they have.

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That's one sales idea. The other sales idea is just to apply this concept of using a Roth account and life insurance together for all of your clients in their financial planning needs. The Roth account has a lot of tax advantages and can really benefit clients in certain ways, and supplementing it with life insurance policy can provide the volatility buffer, access to cash value before the client's 55, if they're if they've separated from service or 59.5, we don't have to worry about the five year rule for taking out earnings that might be subject to taxes and or penalties based on the person's age, and it's really a great protection device for anyone with beneficiaries, heirs, spouses, anyone who needs protection. Please give us a call in Advanced Planning to get into more depth. These podcasts are meant to be short and just pique your interest in the issue. We love to talk to you about this or any other advanced planning case you may have. Thanks for tuning in today and we hope to speak with you soon.

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