Tax Diversification in Retirement Planning

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Introduction

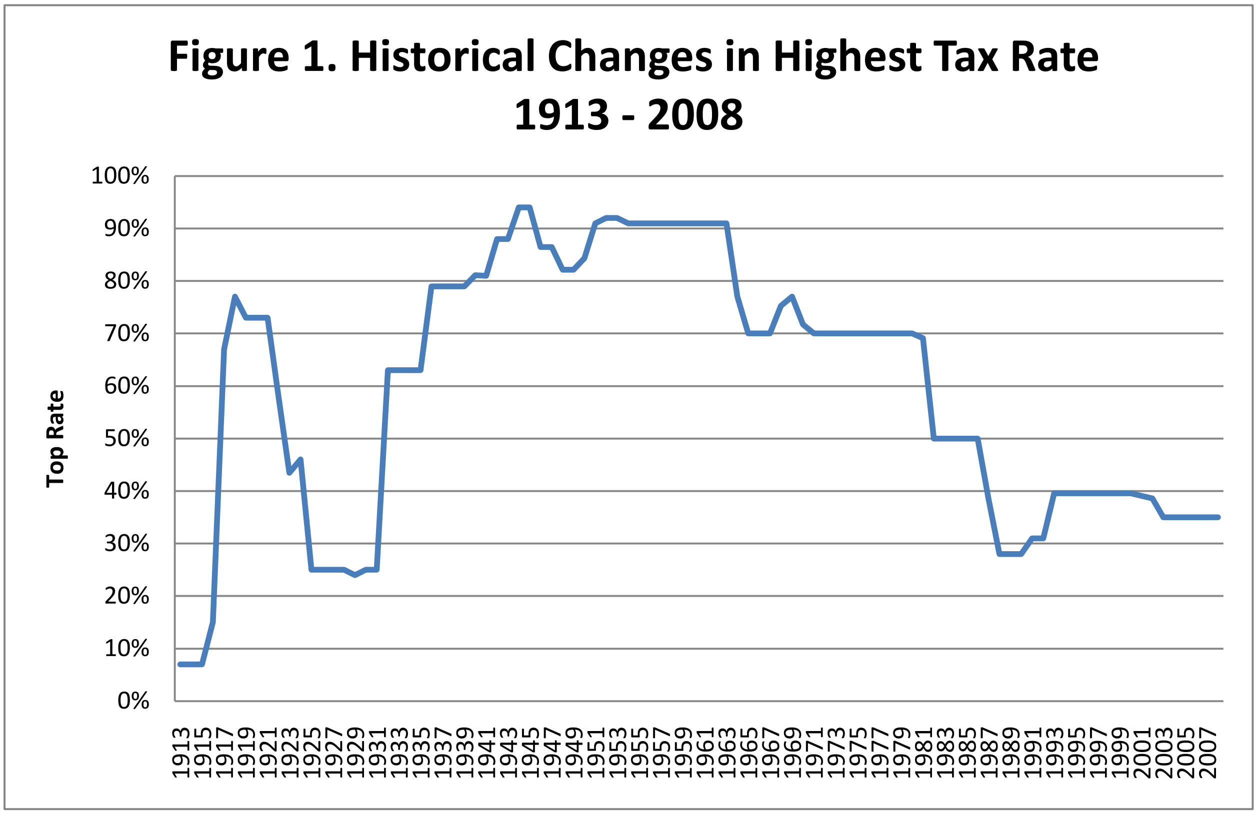
Much has changed in the past five years from predictions that the baby boom generation will begin retiring in mass in 2010 to questions of whether this generation will have enough resources to fund its retirement years. We have seen poor stock market performance since 2000 placing enormous pressure on retirement savings, projected higher medical and long-term health care costs, a Social Security system that seems tenuous, and longer life expectancies. This presents serious challenges for retirement and for tax planners and their clients trying to accumulate a retirement nest egg and protect those assets from threats of greater taxation and possible inflation. In addition, planners are increasingly being asked to reliably predict or create viable assumptions about what the federal tax system will be like in 10, 20 or even 50 years. The emerging importance of tax planning was recently reported in a study by Lincoln Financial Group. Its October, 2009 survey of retirees with annual household incomes greater than $100,000 (ages 62 to 75) revealed that taxes made up more than 31 percent of overall spending in retirement.[1]

To accommodate these changes and demands, a paradigm shift is needed among retirement and tax planners from the traditional strategy of making the most of tax-deductible savings today, with the assumption of lower applicable tax rates during future retirement years, to strategically planning for future tax treatment of investment accounts and retirement income. This approach accepts the premise that how investment accounts and retirement income will be taxed in the future is no longer predictable, and advocates trying to maximize the diversification of investment portfolios based on creating multiple sources of income, each taxed in a different way.[2] As a result, clients may be better positioned for a more financially secure retirement by leveraging current tax laws to help improve retirement income, while protecting investments and income from being overtaxed. Of course, clients with low retirement objectives (maybe under $60,000 retirement spending per year), or clients who do not have significant savings or the ability to save, may be unlikely to benefit from this type of planning, but circumstances can change (inheritance, sale of business, settlement of a lawsuit, etc.). For this reason, I would not underestimate the impact taxes could have on all of us in the future.

Taxes Make a Difference

Tax considerations impact many financial and investment decisions; for example, clients may accept lower returns of municipal bonds just to avoid income taxes. Some may hold investments longer than might otherwise be prudent in order to qualify for long-term capital gains treatment. Others will pay insurance charges to gain tax protections offered by annuities and life insurance. Under recent tax changes, investors have paid extra taxes currently just to be able to convert their regular Individual Retirement Accounts (IRAs) to Roth IRAs.[3] These examples illustrate the myriad of decisions clients must make as a result of a complex and unpredictable federal tax system. And, of course, we have no indication that there will be any more stability in rates in the future, especially given the sharp differences that exist between the positions being taken by political parties today. Our experience has been that the political process used to determine tax rates is quite complicated, with unrelated and unpredictable political considerations often impacting the final result.

Using data from the U.S. Internal Revenue Service, Figure 1 illustrates changes in the top income tax bracket since 1913. Analysis of this chart clearly shows no clear pattern, and answers the question of whether taxes will go up or down in the future with a simple "yes." Going forward, many clients strongly expect that tax increases are a virtual certainty in the face of the mounting federal debt, changes in the national health care system, and looming funding challenges with Social Security and Medicare.



To further complicate matters, retirement and tax planners must also consider other unpredictable factors that may impact their clients, including the inconsistent patchwork of state taxes; how future capital gains, dividends and interest will be taxed; the alternative minimum tax; or possible new taxes, such as a value added tax (VAT), higher Social Security and Medicare taxes, or any number of creative "fees and charges" that for practical purposes amount to nothing more than another tax. There also may be additional taxes driven by the loss of deductions and exemptions that can occur when client incomes increase.

Consequently, higher income retirees will benefit from positioning their assets to allow a blending of suitable income after taxes from different sources. In fact, the higher the amount of retirement income goal, the greater the need for an allocation strategy that helps maximize the diversification of multiple sources of income, with each taxed in a different way. If clients are planning for a very modest retirement income, however, diversified tax planning will not be as important. In fact, clients in lower tax brackets and with a reasonable expectation of staying in the lower brackets during retirement could be adversely affected by some of the strategies discussed in this paper. The application of the ideas presented must be tempered with the retirement planner's best judgment and will be unique to each individual client's financial status and goals.

Tax Buckets: Key Characteristics

The tax diversification for retirement planning approach presented in this paper relies on the concept of "tax buckets," which is simply another way of defining how a particular investment account is taxed and provides a different perspective of the various investments clients typically use to save for retirement, including:

- Personally owned certificates of deposit and money market funds
- Defined benefit pensions
- IRA, 401(k), 403(b) and profit sharing plans
- Corporate nonqualified plans
- Personally owned annuities (not immediate)
- Personally owned bonds or bond funds
- Personally owned stocks or stock funds
- Personally owned alternative investments
- Cash value life insurance
- Roth IRA

Each type of investment is a tax bucket, and for illustrative purposes, each bucket has five key characteristics, as shown in Figure 2. The center segments represent the three most common tax issues, including:

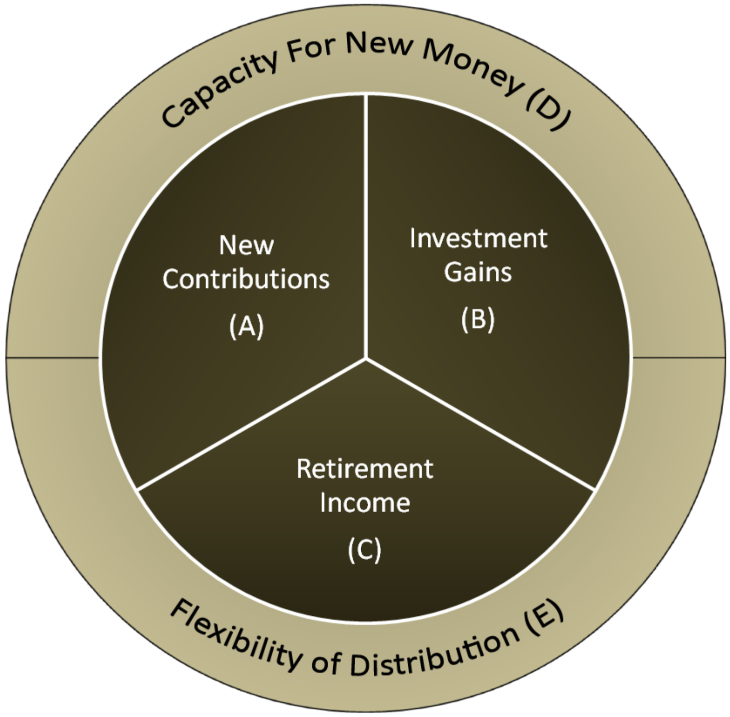
A. Deductibility of new funds (New Contributions)
B. Taxation of accounts during accumulation (Investment Gains)
C. Taxation of income taken during retirement (Retirement Income)

The outer ring contains two segments that represent additional issues that are very important to planners for creating a successful retirement plan:

A. How much additional funds, if any, can be added to each investment vehicle or tax bucket (Capacity for New Money)
B. How much flexibility will clients have during retirement, including the ability to turn income on or off from a particular bucket and the ability to access principal for unexpected or larger spending needs (Flexibility of Distribution)

Figure 2

Tax Buckets: Five Key Characteristics for Retirement Planning



Using an analogy of a stop light, with red meaning stop or proceed with extreme caution, yellow meaning proceed with caution, and green meaning proceed as planned, choices within the five issues may be color coded, as follows:

A) New Contributions

1 – Deductible (Green)

2 – Non-deductible (Yellow)

B) Investment Gains

1 – Tax-free or deferred (Green)

2 – Low tax rates, such as capital gains (Yellow)

3 – Ordinary or higher rates (Red)

Retirement Income

1 – Tax-free or sheltered (Green)

2 – Low tax rates (Yellow)

3 – Ordinary Income (Red)

C) Capacity for Additions

1 – No limits (Green)

2 – Some limits (Yellow)

3 – Tight rules (Red)

D) Flexibility of Distributions

1 – Full ability to control income (Green)

2 – Some limits (Yellow)

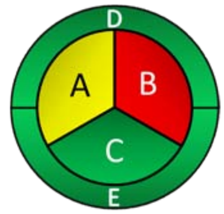
3 – Fixed income, no access to principal (Red)

Note: The above scale is for demonstration purposes, and when used in real life may include additional characteristics and choices. A good example of an additional consideration is the availability of employer matches or other employer contributions. The goal here is not to address every possibility but rather to explain the basic differences between different types of retirement funding accounts based on tax diversification planning. Obviously, the perfect tax bucket is all green, but in this illustration and in real life there are no all-green buckets. Retirement planners, therefore, can use this approach to compare investment vehicles and how they may be taxed differently and make responsible recommendations based on individual client goals, needs and ability to invest.

The top outer ring (Segment D. Capacity for New Money), for example, helps retirement planners understand that certain buckets may achieve all their clients goals from a tax and investment perspective, but are so restricted in the amounts that can be invested that they are of little practical use. The best example of this is the Roth IRA. It may have great tax features and flexibility, but the opportunity to place funds into a Roth IRA is very limited or possibly very expensive, as in the case of a conversion from a regular IRA.

Conversely, there is the requirement for Required Minimum Distributions from most qualified defined contribution plans (IRAs, 401(k)s, etc.). The requirement that certain levels of income must be taken from accounts that produce ordinary income is an impediment to applying optimal tax strategy after age 70 ½, and it must be accounted for. Of course, if the retirement income goal is under $60,000, and qualified plan balances are minimal, the RMD issue will not be material. However, clients anticipating higher retirement incomes should consider their RMD strategy at the earliest stages possible, including the years prior to retirement. If RMDs are likely to be a problem, then clients should consider diverting their current savings away from accounts that have RMDs.

The following series of graphics show recommended characterizations of each of the tax buckets listed above, based on the stop light color-code analogy:



Personally Owned Certificates of Deposit and Money Market Funds[4]

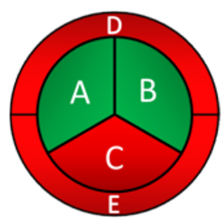
A – Contributions are not deductible

B – Ongoing income is taxed as interest at high rates

C – Distributions are not taxable except for unrealized income

D – No limits on the amounts that may be invested

E – Full flexibility to spend as needed



Defined Benefit Pensions

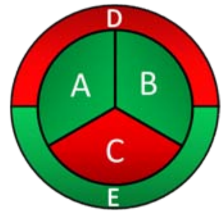
A – Contributions are deductible

B – Investment earnings in all forms are tax deferred

C – Income paid out is ordinary income

D – Strict limits on amounts that may be contributed

E – Retirement income usually very inflexible with no access to principal



IRA, 401(k), 403(b) and Profit Sharing Plans

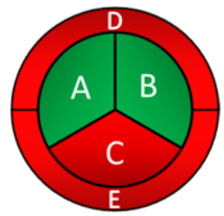
A – Most contributions are fully deductible

B – Investment earnings in all forms are tax deferred

C – Income paid out is ordinary

D – Strict limits on amounts that may be contributed

E – Retirement income is usually very flexible with full access to principal; however, RMDs may prematurely force out unwanted income



Corporate Nonqualified Plans

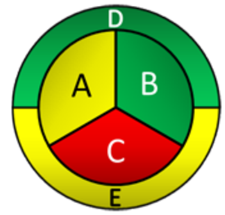
A – Most contributions are effectively tax deductible, such as with deferred compensation or they are not reported as income in the case of employer funding

B – Investment earnings are tax deferred

C – Income paid out is ordinary

D – Few clients have access to these plans and employers control amounts

E – Due to IRS Code Section 409A, payouts are generally a lump sum or fixed, with little ability to change the originally designed income stream



Personally Owned Annuities (not immediate)

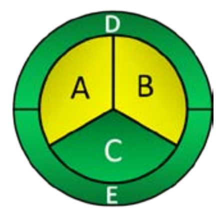
A – Investments in these contracts are made with after-tax funds

B – Investment earnings are tax deferred

C – On withdrawals, all gains come out first as ordinary income, but on annuitization, the ordinary income and return of basis are blended (exclusion ratio)

D – No real limits on the amount that may go into annuities

E – Money withdrawn prior to annuitization is generally unlimited, but if annuitization is elected, access to principal is lost and payments are fixed



Personally Owned Bonds or Bond Funds

A – Funds placed into bonds do not create tax deductions

B – Various tax treatments, depending on taxable bonds or tax-free or zero coupon; plus, potential capital gains or losses if traded

C – Since taxes paid on an ongoing basis, taking income out of this bucket should not generate additional taxes unless bonds are sold to produce the income

D – No limits on how much can be invested

E – No limits on taking income or principal at any time

Personally Owned Stocks or Stock Funds

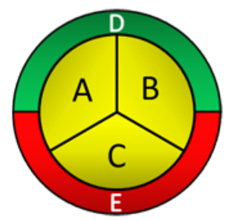
A – Funds used to purchase stocks do not create tax deductions

B – Taxation occurs on an ongoing basis, but can be managed and minimized, given varying capital gains and dividend treatments

C – Given the ongoing taxation, withdrawals for retirement income should not generate additional taxes unless additional sales of appreciated stock are required

D – No limits on how much can be invested

E – No limits on taking income or principal at any time



Personally Owned Alternative Investments

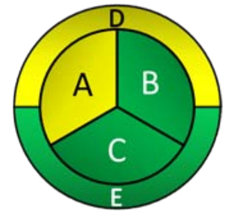
A – Investments are not generally deductible, but there may be some deductions

B – Ongoing taxation is unique to the asset, with depreciation or depletion and other items often sheltering the income generated

C – Payouts may be treated multiple ways, depending on the program

D – No limits on the amounts that may be invested in alternative investments

E – Usually, the investor has little control over the timing or character of distributions from real estate, oil or equipment leasing programs, for example



Cash Value Life Insurance

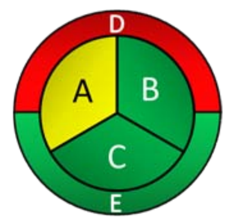
A – Life insurance premiums are not deductible outside of qualified plans

B – Increases in the cash value are tax deferred

C – Distributions at retirement may be managed to be tax-free

D – Modest limits on the amount that may bought based on financial profile, but health requirements must be satisfied

E – A regular amount or larger portions of the cash value may be withdrawn at any time[6] (within the economic limits of the policy)



Roth IRA

A – Contributions are not deductible

B – All gains and income in the account are tax-free

C – If you meet minimal requirements, all withdrawals are tax-free

D – Severe limitations on the amount of funds that can be added to a Roth IRA

E – After a waiting period, any amount may be withdrawn at any time, but note: early withdrawal penalties apply to contributions, not to increases in the value of the account

Using this approach, the primary focus is not only on Segment A, looking for deductible savings opportunities—the traditional approach—but also on Segment C, the way the resulting retirement income will be taxed. The goal is to find a variety of tax buckets that can generate the most flexibility in tax planning during retirement, rather than focusing solely on how to shelter income now from taxes while clients are in a higher tax bracket and might pay presumably lower taxes during retirement on the deferred income. Closely related to Segment

C is Segment E, which defines how much flexibility there will be for increasing or decreasing distributions from a particular tax bucket. Remember, we can't predict where Congress will be taking our tax law in the years ahead, but we can position our clients with multiple options to improve their ability to draw income in a tax-efficient manner.

The short take on this is that Segments A (New Contributions) and D (Capacity for New Money) highlight the aspects of a tax bucket as it relates to how well funds can be accumulated. Segments C (Retirement Income) and E (Flexibility of Distribution) are more critical when crafting a retirement income plan blended from the available buckets. Segment B (Investment Gains) applies to both the impact of taxes on accumulations and at retirement, since some assets will drive tax obligations during both periods of time.

Example 1. Applying Tax Buckets in Retirement Planning

Creation and funding of the various tax buckets can be implemented both before and during retirement. Some buckets cannot be created or filled in a short period of time. For example, clients using life insurance or annuities will typically benefit from funding those accounts over a period of years. Life insurance policies can lose their tax benefits if overfunded or funded too quickly (modified endowment contracts), and some annuities offer guaranteed income streams only after funds have been on deposit for some period of time, often in the range of 10 years. Also, because tax benefits are subject to change at any time, it may be wise to capture those approaches that offer good tax advantages now. By capturing tax advantages today, we could be setting up the client with a "grandfathered" product, preserving the tax advantages on the products we select today while losing any opportunity to acquire the same products in the future. For example, we can still convert traditional IRAs to Roth IRAs, but the opportunity could be taken away at any time.

Other bucket creation or funding can be done later, even during retirement. Reallocations between stocks and bonds and alternative assets may be advantageous at any time, but would be generally subject to the recognition of gains, which might be offset by loss harvesting. In low tax years, clients might take extra income or gains from those accounts that generate taxable income, pay taxes at the lower rates, and then reposition the funds into accounts that would deliver tax-free or tax-advantaged income in future years when rates might be higher.

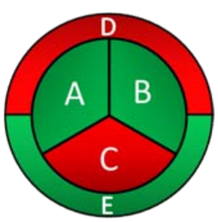
Understanding that the timing considerations just discussed could cause changes in a particular situation, here is an illustration of how a planner might approach the building of a client's retirement strategy. We would suggest that the planner consider the following seven steps in adding the tax bucket approach to a client's overall retirement planning:

1) Establish the client's spendable income goal, including the number of years the client (and spouse) wants to fund, based on life expectancy plus an element of margin
2) Apply an inflation factor
3) Make appropriate investment and tax-impact assumptions
4) Project the total funding that can accomplish the client's goal
5) Establish sufficiency of current funding in the current tax buckets (investment vehicles)
6) Determine additional savings needed and agree on whether additional funding can be accomplished or whether retirement income goal needs to be reduced
7) Build the buckets, adding new buckets if needed for tax diversity and funding the buckets with current assets or new money

The array of tax buckets depends on tax assumptions and the desired spendable income.

Consider how applying tax buckets to retirement planning greatly improves one client's (Client B) tax situation and enhances financial security as compared with another client (Client A):

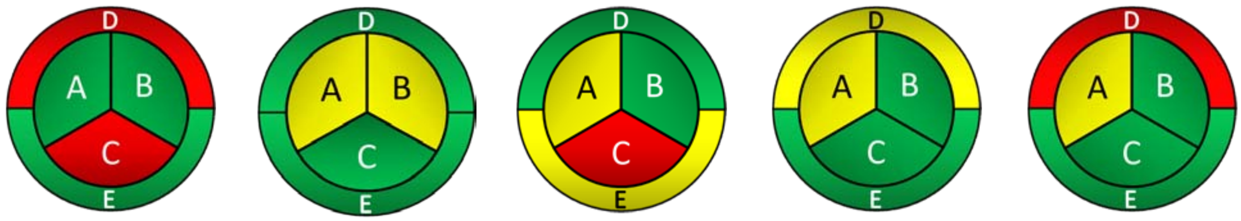
Client A has accumulated $4 million of retirement assets and would like to spend $180,000 per year for the next 30 years, with a 3 percent increase every year to cover assumed inflation.



$4,000,000 – IRA

His assets were created in his company retirement plan with little outside savings and were later converted to an IRA. The graphic illustrates Client A's retirement plan, using the color-coded tax bucket, as explained above. Assuming 2010 tax rates, this client will need to draw approximately $277,000 of income from the IRA and pay taxes of $97,000 state and federal to net the needed $180,000 per year. The rate of spending represents just less than 7 percent of the $4 million account. This rate of drawdown over 30 years is likely unsustainable, particularly if the client wants to allow for scheduled 3 percent spending increases every year.

Client B has also accumulated $4 million of retirement assets, but holds those assets in a wide range of tax buckets, including an IRA, mutual funds, annuities, cash value life insurance, and some funds that were converted earlier to a Roth IRA when the client was in a low tax bracket. The graphics also illustrate Client B's retirement plan, using the color-coded tax buckets as described above:



1,000,000 – IRA | $1,600,000 – Mutual funds | $300,000 – Personally owned annuities | $600,000 – Cash value life insurance | $500,000 – Roth IRA

This client has a greater chance of drawing his income in a way that is far less costly in taxes, possibly only requiring an annual withdrawal of $224,000, to reach an after-tax spendable income of $180,000 at today's tax rates. Notice by placing investments in different tax buckets, Client B may be paying $53,000 less in taxes, and only 5.6 percent of his investment capital will be withdrawn each year, which is a much more sustainable rate of withdrawal.

Admittedly, this comparison is not perfect. Client A, for example, enjoyed tax deductions while he was accumulating his retirement funds, while Client B paid taxes for his Roth IRA conversion, and some of his investments were made with after-tax funds. Client A avoided all taxes on capital gains, as did Client B for most of his investments, but Client B also paid insurance charges on his variable annuities and on his life insurance. The question is whether Client B's diligence in creating multiple tax buckets cost him more or less than the ultimate tax savings he enjoyed in retirement. See *Tax Benefits Come With a Cost* for further discussion of this question.

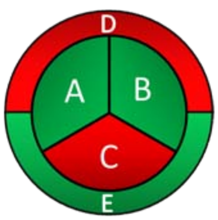
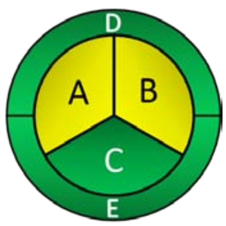
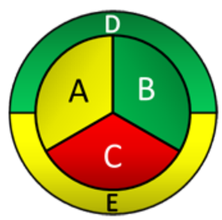
Note: If a client has a retirement goal of $68,000 plus deductions and personal exemptions, little tax planning may be needed under the 2010 tax tables, because the 2010 federal income tax marginal rate is 15 percent on taxable income up to $68,000 for a married couple. All ordinary income above this threshold, however, likely will be subject to higher taxes. So, for clients who have a greater than $68,000 income goal, it then becomes advantageous to draw the additional income from sources that do not involve ordinary income, which may be taxed at much lower rates or not at all, such as personally owned capital gains assets, cash value life insurance, municipal bonds and Roth IRA accounts.

Will the federal income tax marginal rate remain at 15 percent on taxable income up to $68,000 for a married couple? That is a good question, and one that is not possible to answer with any certainty. In the future, even clients requiring $68,000 per year at retirement may not find themselves in the lowest brackets. Projected changes in how dividends will be taxed and the new application of the Medicare tax to future investment income already have been unveiled. This is why creating a broad mix of tax buckets today may be a tremendous advantage to clients during their retirement years, especially tax buckets that create tax-free income.

Example 2. Postretirement Tax Planning

This next example presents a scenario that illustrates how planners can use tax buckets to help clients manage their assets during retirement to optimize income and minimize taxes. In this instance, the client has three tax buckets, a 401(k), stocks and a variable annuity. It also offers a series of steps planners can use, as follows:

I. Inventory the funds available for retirement

401(k) or IRA	**Stocks**	**Variable Annuity**	**TOTAL**
			
$3,000,000	$1,000,000	$450,000	$4,450,000

II. Determine spending needs for the year

Annual Goal: $180,000

III. Identify predetermined cash flow and taxable income

Item	Cash Flow	Taxable
Social Security	$24,000	$24,000
Dividends (reinvested)		$15,000
Required Minimum Distributions:		0
Cap Gains (reinvested)		$35,000
Deductions		($20,000)
	$24,000	$54,000

IV. Select the optimal tax bracket based on distribution of tax buckets

$137,300 is the beginning of the 28% bracket (Selected by planner*)

$26,687 is the tax on $137,300
$ 7,000 is the tax on $ 35,000 of capital gains

* *Selection of a targeted tax bracket is a purely subjective determination based on the planner's view of long-term tax rates and the client's particular mix of tax buckets. In general, withdrawals from the various buckets should be somewhat proportional, or some buckets will be exhausted early (but that may be intentional). Note also: state income taxes are not included in the above illustration, but are an important factor in many states, including the definition of income, how municipal bonds are treated, and how capital gains are treated.*

V. Adjust the total amount needed from the buckets

Goal	$180,000
Social Security	($ 24,000)
Fed Taxes	$ 33,687
Shortfall	$189,687

VI. Determine how much cash flow from the buckets can be taxable

$137,300	Taxable target
$20,000	Deductions and personal exemptions
($39,000)	Predetermined ordinary income from Social Security and investments
$118,300	Target for ordinary income from buckets

VII. Summary of the plan

$189,687	Amount to be taken from buckets
$118,300	Amount that can be ordinary income

VIII. Apply to the Buckets

$118,300	Amount to be taken from the IRA or annuity (ordinary income)
$71,387	Amount to be taken from the stock fund (assumes no additional cap gains impact)

IX. Resulting Cash Flow and Taxable Income

	TAX CALCULATION
$ 24,000	Social Security income
$ 15,000	Dividend income
$118,300	IRA or annuity income
($ 20,000)	Personal deductions and exemptions
$ 137,300	Taxable Income
$ 26,687	Ordinary income tax
$ 7,000	Capital gains tax
$33,687	Federal income taxes

	CASH FLOW CALCULATION
$24,000	Social Security income
$118,300	IRA or annuity withdrawals
$71,387	Withdrawals from stock fund
($33,687)	Federal taxes
$180,000	**Spendable Income**

The client in this example did not do a very good job of creating multiple tax-friendly buckets, which required the planner to work just under the 28 percent tax bracket. By taking $118,300 from the IRA or annuity (3.4 percent of the total) and $71,387 from the stocks (7.1 percent of the total), the client was able to stay below the 28 percent tax bracket. But this required drawing down the stock fund in excess of 5 percent of the total fund, which may not be sustainable over a long period of time.

The stock fund was taxed on the basis of an assumed dividend and capital gains results, not on the basis of how much will be withdrawn. Unless the variable annuity was purchased to deliver some element of guaranteed income, an alternative strategy might have been to build up a cash value life insurance policy similar to a corporate owned life insurance policy (COLI) in place of the annuity. The income from this tax bucket would have been tax-free, resulting in less of a need to rely solely on stocks to supply the tax-free ordinary income.

Should the client have considered a Roth IRA conversion for a portion of his IRA? That would have helped also, but it would have depended on the tax impact at the time of conversion versus the tax impact at retirement. The client's hypothetical tax bracket at retirement is only 25 percent, so conversion to a Roth IRA may have cost more taxes up front than would be paid during retirement with no conversion.

However, it is worth noting that the tax impact of a Roth conversion may be reduced by some excellent planning strategies. For example, a traditional IRA might be converted to maybe two to four Roth IRAs, for discussion purposes. The new Roth IRAs might be invested in very different noncorrelated or negatively correlated investments, creating very different investment results. Within certain time frames, a client can reverse the Roth conversion on the investments that decline and keep the successful investments in their new Roth status. Thus, taxes are paid only on the conversion(s) that resulted in gains. Even more interesting is the fact that the *gains* on a Roth could be withdrawn during the first five years of the Roth and used to pay the income taxes on the conversion. I don't mean to divert from the primary topic of this article, but the cost of a Roth conversion is a factor in retirement planning and requires attentive planning.

This example underscores why considering the appropriate way to optimize retirement income while minimizing tax obligations when structuring retirement accumulation strategies is important. No longer can planners just reach for deductible savings with deferred taxation and assume the tax payback can be worked out sometime in the future. Some tax buckets can take decades to fund, and if they are not properly structured to maximize retirement income while minimizing taxes on that income, clients may end up less financially secure, with an unsustainable pattern of withdrawals coupled with unnecessarily large tax liabilities.

Other Considerations

Tax diversification encourages tax and retirement planners to consider how income withdrawn from investment vehicles (tax buckets) during retirement may be taxed as a fundamental part of an overall strategy for saving for retirement. The examples above demonstrate its benefits and how to apply the tax buckets to retirement planning and in managing withdrawals of retirement income to help minimize clients' tax burdens. In addition to following this approach, planners must still address several other considerations.

Tax Benefits Come With a Cost

As complex as the federal tax code may be, virtually every provision offering tax relief has been written with some purpose in mind, often a behavioral purpose. For example, a tax deduction for mortgage interest encourages home ownership. Retirement and tax planners often search out the new tax opportunities and use them to whatever advantage they can, whether this is what the U.S. Congress intended or not. This is the root of various tax arbitrage strategies and the occasional "loophole." Going back to the green segments in the various tax buckets, it seems that every good tax benefit has a cost. The following are some examples:

1) Tax deductibility of contributions usually results in future taxation when the funds are withdrawn (pensions, IRAs, 401(k), 403(b) and nonqualified plans)
2) Lower tax rates on municipal bonds are part of the formula in determining the yield, thus resulting in lower yields
3) The benefits of tax deferral offered by annuities are offset by insurance charges paid for the "tax wrapper" and by converting all gains into ordinary income when withdrawn
4) The benefits of tax deferral offered by cash value life insurance are also offset by insurance charges, but the income and death benefit can avoid future income taxes
5) The tax-free growth and income of a Roth IRA or cash value life insurance are created only with assets that have been taxed previously

Paying for certain features is not uncommon. Retirement and tax planners and investment advisors know that a familiar but unrelated "cost" of many investments is the price of safety. Higher quality bonds, for example, offer lower yields. Money market funds generally regarded as safe and certificates of deposit deliver very low yields, which is the cost for safety and liquidity. Annuity contracts offer guarantees, but at a cost normally applied as an annual charge against the assets in the contact.[5]

Ultimately, planners must assess the costs associated with tax strategies. Recall in Example 1 that Client B used several tax buckets to fund retirement, including an IRA, mutual fund, cash value life insurance, annuities and some funds, including municipal bonds, which were converted to a Roth IRA. Whether to invest in municipal or other types of bonds is a question of evaluating whether the higher yield offered by a taxable bond nets the same or better result than that which could be obtained by a municipal bond with similar investment risk. The decision to convert to a Roth IRA, however, is usually more complex, since it must assess the projected immediate income tax cost versus the future tax savings, tied to life expectancy, estate planning goals, and presumed retirement income withdrawal patterns. Likewise, the selection of cash value life insurance or annuities must take into account all insurance charges. This will enable the planner in this example to determine whether those charges are less than the value of the income tax benefits offered by the various insurance products.

Treatment of New Money in the Model

The addition of new savings for retirement presents a great opportunity to balance out the tax buckets, which can come from existing savings plans as well as funds not yet selected for a particular destination. Assuming some connection with income, the first question is whether to direct the funds to deductible or nondeductible buckets. If the decision is made to go with deductible options, it may be just a matter of which options are open (capacity). It may be difficult to find an appropriate bucket due to all of the limitations on qualified plans, in which case, planners may have to look at the nondeductible buckets. Alternatively, it may become evident that there are not enough funds going into the nondeductible buckets, especially if the end game is to create multiple sources of income with different tax consequences. In today's tax environment, clients with higher income goals (above the $68,000 taxable income threshold for married couples) should be lining up funds in the tax-preferred and tax-free buckets, primarily personally owned investments and life insurance products. Selection of the best products goes beyond the scope of this article, but it should be clear by now that while nondeductible savings may appear to be less attractive, because they require after-tax dollars, a much bigger payback could come later due to future tax savings.

Treatment of Existing Money in the Model

Clients may have accumulated funds in multiple tax buckets already. The nondeductible buckets are easier to transfer among themselves, and some consideration should be made as to whether this is wise in order to improve the potential tax savings or payout flexibility in the future. For clients with large accumulations in tax-qualified buckets, some thought should be given as to whether a Roth IRA conversion is wise. If funds are coming from a qualified plan that is not an IRA, there is the additional step of converting those funds first to a regular IRA before converting to a Roth IRA, if that is even possible.

Another consideration for planners is the withdrawal of funds from qualified plans by clients who are not yet retired but who are presently in low brackets due to low incomes resulting from the recent economy. This will be tempered with potential penalties for withdrawals prior to age 59 ½. Similarly, there may be clients with high incomes whose personal tax brackets will be even higher in the future. For these clients, especially clients over age 59 ½, there may be good reason to go ahead and withdraw some portion of their funds out of a qualified plan now and reposition those funds to be prepared for potential future high tax rates. This is an important consideration that planners should evaluate and discuss with their clients.

Do Insurance Products Make Sense?

Even though planners may not have recommended variable annuities, this tax bucket may now be an excellent option, especially in a Roth IRA. A variable annuity allows clients to establish and insure an income stream for life, setting up a known minimum income and avoiding any risk of outliving that income stream. It does come with a cost of insurance, but more often than not the cost of insurance is reasonable, especially for more risk-adverse clients.

There are some advisors who take pause at the idea of placing tax-sheltered funds into a product that itself has tax protection. They see this as a redundant aspect of annuities inside qualified plans. Yes, that is true, but the use of annuities inside qualified plans is done for other purposes. Specifically, annuities allow the owner to purchase income guarantees, principal guarantees, and death benefit guarantees. These are not normally available in other financial products. The fact that the annuity has certain tax advantages is just part of the package, which is granted by tax law and not necessarily used by the life insurance company to drive up the cost of the annuity, any more than a life insurance company charges more for the fact that a death benefit is tax-free. There are a large number of analogies for this. For example, doctors may prescribe drugs that address a certain medical condition not due to their primary use but because of their secondary use (i.e., Tums may be a good source of calcium even if that is not its primary purpose, which is as an antacid).

The downside to annuities is that the tax aspects are not especially favorable during retirement, since gains are taxed at ordinary rates and are paid out before basis unless the contract has been annuitized. And even with annuitization, gains may be spread out, but they still remain in the ordinary income category. Interestingly, we have recently encountered situations where the taxable income of annuities can be reduced by the way they are initially funded. Specifically, where clients have decided to surrender life insurance policies in which basis exceeds the surrender value, those clients may want to consider exchanging their life insurance under IRC Section 1035 for an annuity. The surrender value will now be invested inside the annuity, and the original basis will also carry into the annuity. Thus, any gains in the annuity will initially be offset by the excess basis that had been created inside the life insurance contract. Otherwise, upon surrender of the life insurance policy at a loss, there is no deduction against other gains nor is there any retention of the lost basis.

Perhaps the more exciting insurance product from a tax standpoint is the cash value life insurance policy built like a corporate owned life insurance policy (COLI). These products have been used for years by corporations seeking a way to fund future nonqualified retirement benefits without paying ongoing taxes on the growth of the investments. When structured correctly, these life insurance policies can pay out retirement income streams free from taxation and ultimately pay out a death benefit that is also income tax-free. To make these products perform well as tax buckets, the death benefit needs to be minimized to a level just above the point where the contract would become a modified endowment contract (MEC). In effect, the COLI-type of life insurance policy behaves much like a "Roth alternative." It is funded with after-tax dollars, grows tax-free and delivers retirement income free of taxation. The two major differences are that the Roth IRA has no insurance charges, but the Roth IRA also has no death benefit other than its remaining balance.

Retirement and tax planners should consider all forms of cash value life insurance, including whole life, universal life, variable life and the relatively new equity-index life, which is really a universal life policy with a unique participation in selected stock market indexes. Whole life products, however, tend to be less flexible than may be preferred, and the variable life can place clients on a stock market roller coaster that they would rather avoid. Equity-index products are becoming a preferred platform for many advisors, but client profiles will ultimately control which type of insurance is the best option to become a tax bucket.

Conclusion

Retirement planning may span more than 50 years of accumulation and distribution. During those 50 years, dramatic changes may occur in the tax code. Prudent investing must take taxes into account and maintain flexibility to respond to changing client needs in an environment where change is the norm. Tax and retirement planners must strive to enable clients to draw their retirement income in the most tax efficient way possible.

The historical development of the federal tax code should lead planners to move more assets into investment vehicles (tax buckets) that will generate tax advantaged income in greater amounts as clients retirement objectives increase. That could divert more contributions from tax-qualified plans toward more capital gains or insurance oriented funding. Because there is no assurance that the tax code will not change in the years ahead, prudence demands that planners create as wide a stance among as many diverse tax buckets as possible. This makes the idea of tax diversification an important consideration when also addressing investment diversification. Tax diversification may present the most effective way to address the uncertainties of the tax code and its impact on future spendable retirement income.

Footnotes

1 Lincoln Financial Group, “The underrated impact of taxes on retirement – Research Study,” 2010; Order code: LFG-TAX-WPR001.

2 Using diversification as part of your investment strategy neither assures nor guarantees better performance and cannot protect against loss of principal due to changing market conditions.

3 Converting a traditional IRA to a Roth IRA is a taxable event and could result in additional impacts to your personal tax situation, including the taxation of current social security benefit payments. Be sure to consult with a qualified tax advisor before making any decisions regarding an IRA.

It is generally preferable that funds are available to pay the taxes due upon conversion from funds outside of an IRA. If you elect to take a distribution from your IRA to pay the conversion taxes, please keep in mind the potential consequences, such as an assessment of product surrender charges or additional Internal Revenue Service penalties for premature distributions.

4 An investment in the Money Market Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the Fund.

5 Guarantees are subject to the claims paying ability of the insurance company.

6 Loans or withdrawals may generate an income tax liability, reduce available cash value, reduce the death benefit, or cause the policy to lapse or incur surrender charges.

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