Planning Retirement in a Rising Tax Environment

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One-sentence Synopsis

Inflation, heath care costs and market volatility are just some of the challenges with which retirement planners must contend.

If your clients are among the many planning to leverage their retirement accounts or proceeds from the value of their business for retirement income, the challenges and obstacles in today's uncertain environment can be overwhelming. More often, it adds complexity to one of the most important financial issues your clients will face in their lifetimes: Will their money outlive them or will they outlive their money?

To seriously address this issue and take proper planning steps, we must first fully understand the other challenges retirees already face:

- **Inflation** – Even at a low 3 percent rate, living costs could increase by approximately 150 percent over the next three decades. In addition, if real inflation rates increase to as much as 7 percent, not only would living costs double in just one decade, they could easily increase by more than 650 percent over three decades! Given that the Federal Reserve printed over 1 trillion dollars each year from 2009 through 2012, and interest rates have been kept at historically low levels (much like holding a beach ball under water), it will always be important to determine if your clients are protected against a future rise in living costs.
- **Health care costs** – Fidelity Investments updated its annual calculation in May 2013 and estimated that a typical 65-year-old couple will need $220,000 today to pay health care costs in retirement. In addition, according to the U.S. Government Accountability Office, Medicare spending, which had grown to more than $400 billion in 2009, is also on pace to exceed $600 billion by 2018. When you also consider the uncertainly surrounding the Affordable Care Act and its potential expansion to Medicaid, it appears these costs could rise significantly, requiring advisors to seriously consider if their clients are prepared to handle rising health care costs throughout retirement.
- **Market volatility** – Despite the historical success of properly diversified equities over long-term market cycles (i.e., based on Ibbotson study from 1926 – 2012, the S&P 500 averaged a positive 4.7 percent after taxes and inflation), the sequence of returns during the initial retirement phase has shown a potentially negative impact on many clients' invested retirement assets. This is true even when their average long-term returns exceeded their withdrawals. According to a recent Dalbar Study from 1992 – 2012, average investors performed 4.25 percent on their actual investments compared to the

> S&P 500 Index, which performed 8.21 percent over the same period. This gap is further evidence of typical investor behavior, which is to more often buy when the market is higher and more comfortable and to sell when the market is lower and less comfortable. Therefore, advisors must also determine if their clients' investment allocations are carefully positioned to avoid overreacting to market volatility.

If your clients are fortunate to have a proper plan to address these challenges, you may very well be better positioned to prepare for what many reliable financial experts today consider the most dangerous challenge of all: A Rising Tax Environment.

Doug Endorf, director of the Congressional Budget Office (CBO), recently conceded, "Taxes will have to be raised (including the middle class) substantially if we are to have any chance of successfully addressing our budget deficits." In addition, renowned industry retirement tax expert, Ed Slott, CPA, states, "Future tax increases will represent the greatest detriment to people's retirement dream!"

Consider this: Approximately 10,000 boomers will retire each day over the next 15 years. 119 million people currently receive government benefits, while there are only 104 million full-time workers. Government entitlements now represent 62 percent of the federal budget, and the future increases along with interest on debt will likely consume our entire budget by the end of the decade! More than likely, we will see increasing debt levels, more people receiving government benefits and more people paying higher taxes. Indeed, your clients may be faced with an increasing tax burden throughout their lifetimes. (*Sources: U.S. Department of Labor, U.S. Government Accountability Office, U.S. Congressional Budget Office, The Heritage Foundation (2013)*

While the U.S. financial climate can initially appear grim for many of your clients, I believe these problems will only be devastating to those who take no action to mitigate the challenges now.

The following five basic steps could prove very valuable for both your clients and your professional practice:

Step 1: Prepare for changes to come sooner rather than later

Among the list of tax breaks already considered for reduction or elimination include: tax exclusions for health insurance, capital gains, state and local tax deductions, mortgage interest, reduced charitable deductions, pension caps and reduced qualified plan contribution levels. Also being discussed on Capitol Hill and addressed with our top professional associations is how to potentially tax or reduce some of the benefits associated with many of the financial industry's most tax-advantaged vehicles and solutions, including:

- Limits on 401k balances
- Limited deductible 401k contribution (e.g., only 28 percent of contributions would be deductible for anyone in a tax bracket higher than 28 percent)
- Elimination of inherited IRAs for nonspouses
- Limits on Roth IRA contributions and conversions

- Tax on portion of future tax-deferred buildup of nonqualified annuities
- Partial tax on portion of future paid life insurance death benefit

While these issues are currently being discussed, it's important for advisors to be aware our lawmakers will consider any possibilities in order to raise more revenue, and changes could happen sooner rather than later.

Step 2: Consider taxable income distributions in relation to their current tax tables

For a couple over the age of 65, in 2014, their standard deduction will be $14,800, and they will each receive a $3,950 personal exemption. This means they can make $22,700 in addition to their Social Security before they pay any taxes. Their next bracket is the 10 percent bracket. That is $18,150. If you add $18,150 and $22,700, that is $40,850 of taxable income. Tax on that is $1,815. If you divide $1,815 of tax by $40,850, that is 4.4 percent.

Finally, the 15 percent tax bracket adds up to $96,500. The tax on $96,500 is $10,163. That is 10.5 percent.

A thorough understanding of each client's lower tax rates for each year is extremely important to properly manage the taxable and nontaxable portions of your client's distributions, which could otherwise be exposed to higher marginal tax rates.

Step 3: Consider combining Annuities

Retiring clients with especially large amounts of taxable assets sitting in CDs or savings accounts may need to consider strategically combining the most appropriate tax-deferred and immediate lifetime annuities as additional asset classes**.** Doing so also offers some of the following tax advantages:

- Under the regular annuity rules of IRC Section 72(b), higher guaranteed withdrawals are typically available from lifetime annuities, which often use an exclusion ratio and treat a larger portion of withdrawal as tax-free return of principal, up to the age of a client's life expectancy.
- Depending on which tax-deferred annuity is best for your client, you may have the ability to reposition, exchange or transfer any balance and deferred gains for other opportunities potentially inside the deferred annuity.
- The ability to target a specific period for withdrawal from the deferred annuity in any chosen taxable year.
- You may further reduce your client's taxable estate using immediate annuities and possibly leverage higher withdrawals as gifts or even purchase additional tax-free life insurance.
- Gains from deferral are not factored in calculation of actual tax on Social Security benefits.

Any advisor who may need to safeguard their clients' overall portfolio in response to a rising tax environment should give serious consideration to properly designing the most appropriate deferred and immediate annuities for even greater retirement and tax optimization!

Step 4: Consider a Roth IRA

For clients with a higher portion of holdings in qualified retirement accounts, consider converting all or a portion of their balance into a Roth IRA. Doing so may reap some of the following advantages:

- Taxes are still temporarily at historically low rates.
- Creates a tax-free environment with potential growth of tax-free gains.
- Helps remove some of the uncertainty of future tax rates.
- Can reduce exposure to the new investment income and health care taxes.
- There are no required minimal distribution requirements for the original account owner.
- It may provide a tax-free legacy to future generations who are even more likely to experience the effects of rising taxes.

Clients also have flexibility to recharacterize their Roth IRAs by the tax due date of the year they converted. This can be helpful if investment returns were negative after conversions, or if the client had a sudden need for the liquid assets used to pay their original taxes for the conversion.

Moreover, if your clients are disciplined and properly allocated based on longer-term goals, they will likely face higher tax rates and have a longer life expectancy—converting to a Roth IRA could potentially be the opportunity of your client's retirement lifetime!

Step 5: Consider leveraging permanent Cash Value Life Insurance as an additional asset class to your clients' retirement and estate plan

Cash value life insurance can be positioned safely with higher long-term returns and more liquidity—all while providing a leveraged death benefit and potentially additional financial and estate benefits such as:

- Increased credit worthiness
- Confidential beneficiary designations
- Creditor protection
- Probate avoidance
- Long-term care
- Critical illness and terminally ill benefits prior to death

In addition, cash value life insurance (treated under IRC section 7702) can also potentially provide even more amazing tax benefits to clients, including:

- Death benefit for family as income replacement or a wealth bequest
- Transfer of business ownership among other owners, employees or family members
- Charitable bequests
- Liquidity of cash values, including any gains

- No IRS reporting requirements as long as the policy stays within modified endowment limits
- Retirement income generation with potential to customize policy and reduce major retirement risks including market risk and negative sequence of return risk.
- May pledge as collateral as opposed to any IRA or defined contribution plan, which is normally taxed as a withdrawal when pledged to a lender for a loan.
- Easier ability to move death benefit outside client's taxable estate
- May reallocate cash values for potentially higher tax-free earnings, depending on type of policy.

With so many of the aforementioned benefits, it should be no surprise that Ed Slott, CPA, also states, "The tax exemption for life insurance is the single biggest benefit in the tax code." In a time when some clients may have a limited amount of money for protection, savings or retirement, a leveraged product like life insurance can still fit the bill—it is one dollar that can do the work of many tax-free dollars.

Lastly, based on the aforementioned challenges, uncertainties, as well as potential opportunities – careful attention should still be given to each client's unique circumstance. In addition, consideration of any changes or purchase of a specific tax favored financial product should always be carefully examined in detail based on the product features, charges, internal expenses, and actual goals of your client. Advisors should also become further specialized and proactively team with other professionals with unique knowledge, training and extensive experience in such areas as: IRA/401k tax and distribution rules, strategic asset allocation, lifetime income planning, business continuation and exit planning, and customized design and review of life insurance policies – providing such additional levels of expertise can easily elevate an advisor's role from being important to significant!

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Frank specializes in tax favored lifetime planning, IRA/401k distribution and customized wealth transfer strategies. He enjoys helping goal minded individuals protect, preserve, and grow income streams which can offset rising taxes, living costs, health care costs, and market volatility – while safely transferring their wealth within their family or business.