

Tax Diversification and Retirement

What You Need to Know

Optimizing your income strategies for tax-deferred accounts with efficient tax mitigants



The Importance of Tax Diversification in Retirement

Learn what you can do to help reduce your future taxation and protect the longevity of your retirement income

**“In this world
nothing can be
certain, except
death and taxes.”**

— Benjamin Franklin

Taxes are part of Americans’ financial lives and help afford much of what makes this country great. Yet, for those entering and in retirement — when preserving and protecting every penny becomes a priority — minimizing tax liabilities can be especially important.

What is Tax Risk?

Tax risk can be defined as the possibility of decreasing retirement income because of increasing future tax rates.

Many Americans will owe some form of tax in retirement from income sources such as Social Security benefits, pensions, individual retirement accounts, 401(k)s, as well as other accounts where capital gains and dividends are taxed. This can equate to 15, 20 or even 30 years of future tax liabilities during post-working years. Tax risk can work against retirees in several ways, including tax increases, reduced tax deductions, and placement in a higher than anticipated tax bracket.

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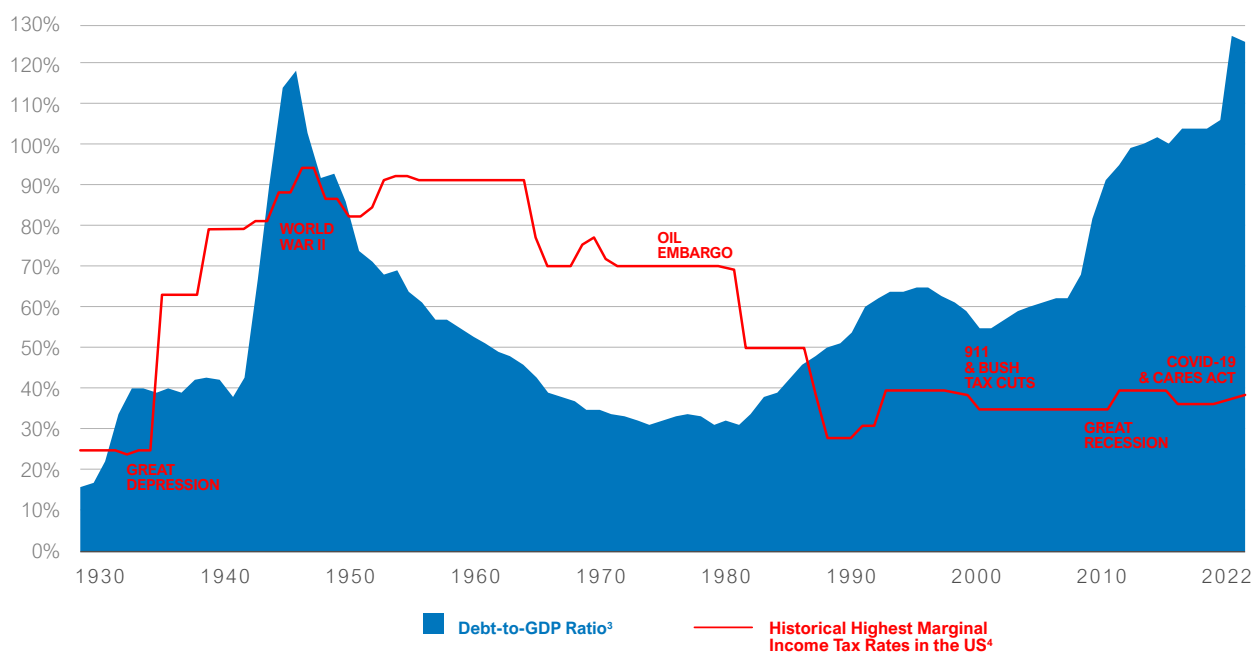
Tax Increases

The first way that tax risk can work to erode retirement income is an increase to income tax rates; but what is the likelihood of tax increases over the next few decades?

In the U.S., we have observed a correlation between national public debt-to-Gross Domestic Product (GDP) as a leading indicator of income tax increases. Higher debt-to-GDP ratio implies that as a country, we are less likely to pay back our debt, and one of the ways to help reduce this risk is to increase taxes so that these debts may be eliminated.¹ Figure 1.1 illustrates the fluctuation of our debt-to-GDP from 1930 to 2022 and the correlating highest marginal tax rate.

What is particularly interesting about our recent debt-to-GDP history, is that in 2007, pre-Great Recession, the U.S. National Debt reached \$8 Trillion with the highest marginal tax rate at 35%. Today, we are experiencing unprecedented debt levels at \$31.4 trillion (and growing).² This is a 250%+ increase in debt, generated in only 15 years. It is no surprise that this uptick in spending is causing many Americans to anticipate tax increases will follow.

FIGURE 1.1: Debt-to-GDP: A Leading Indicator of Tax Increases



Reduced Tax Deductions

In addition to possible income tax rate increases, the reduction of tax deductions can also impact the longevity of a retiree's income. Common deductions that are often lost in retirement include those associated with 401(k) or traditional IRA contributions. In retirement, the account owner is withdrawing from these accounts as opposed to contributing, which means they no longer benefit from the reduced taxable income. Additionally, in many cases, retirees can no longer claim dependents, as their children have likely reached adulthood. Lastly, if the retiree's home is paid off, there is loss of the mortgage interest deduction as well.

Higher Than Expected Tax Bracket

In retirement, individuals may find themselves in a higher than anticipated tax bracket due to increased income needs and/or required distributions. Many retirees will spend time doing the things they love while maintaining or enhancing their existing lifestyle. This can result in them needing to withdraw taxable income to accommodate their additional spending and potentially bumping them into a higher tax bracket. Even if retirees don't enhance their lifestyle, they are still required to take minimum distributions from their tax-qualified plans at a certain age; couple this with their Social Security benefit, and they too could find themselves in a higher tax bracket.⁵



A Possible Solution to Tax Risk: Tax Diversification

To help counteract tax risk, individuals can strategically allocate taxable assets among multiple accounts with varying taxation (tax-now, tax-later and tax-free vehicles). This process is also known as tax diversification.

Tax-Now Vehicles

Tax-now strategies include accounts where income is taxed on any earnings (capital gains and dividends) received each year. Examples of these financial vehicles include:

- ✓ Savings
- ✓ Checking
- ✓ Certificates of Deposit
- ✓ Stocks
- ✓ Corporate Bonds
- ✓ Mutual Funds

Tax-now strategies provide minimal tax risk reduction as the account owner is subject to tax each year earnings are received. If taxes increase over time, then there is a likelihood that the owner's tax obligation will increase as well.





Tax-Later Vehicles

Tax-later strategies can be considered a “traditional approach” that allows the account owner to defer taxes today, but then requires them to pay taxes on the entire amount withdrawn in the future. Examples of tax-later accounts include:

- ✓ Traditional IRA
- ✓ SEP IRA
- ✓ Simple IRA
- ✓ 401(k)
- ✓ 403(b)
- ✓ Pensions
- ✓ Qualified Annuities
- ✓ Savings Bonds

Tax-later vehicles can be an ideal diversification strategy for those earning an income who want to offset their present tax obligations. However, if there are concerns about tax rate increases while in retirement, it may make sense to consider planning strategies that will allow the owner to transfer assets in order to lock-in today’s tax rates for some retirement income sources.

Tax-Free Vehicles

Lastly, are the tax-free diversification strategies. These strategies can help the account owner accumulate tax-deferred, income-tax free, and penalty free earnings. Examples of tax-free account types include:

- ✓ Universal Life Insurance (Death Benefit with Cash Accumulation)
- ✓ Roth IRA
- ✓ Municipal Bonds
- ✓ 529 Plans

Tax-free diversification strategies are ideal for those who are concerned about increases in tax rates and/or potentially find themselves in a higher tax bracket in retirement. Additionally, if the account owner is already maximizing their traditional retirement savings vehicles, tax-free strategies can help them bolster their savings while reducing their tax risk on future retirement income.

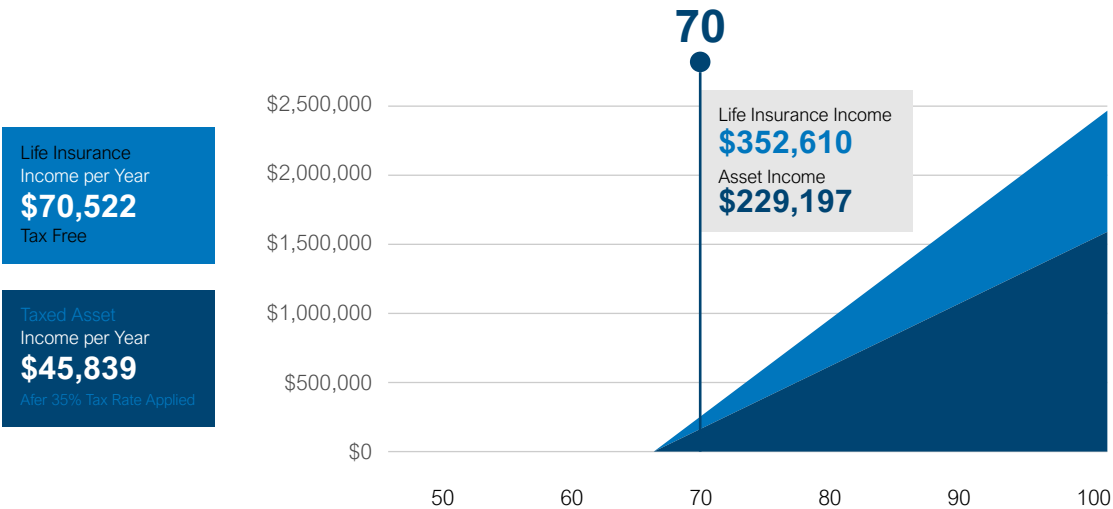




How Taxes Can Potentially Impact the Growth of a Retirement Asset

While taxes can reduce the longevity of retirement assets, they can also hinder the potential growth of an asset as well. Take for example Figure 1.2, which demonstrates a hypothetical situation where the retiree receives \$70,522 of income each year through a tax-free vehicle, versus \$45,839 of a taxed asset. By age 70, the retiree will see a difference in the total accumulation amounts of more than \$120,000 (assuming a tax rate of 35%). Drawing the same amount from a taxable asset could provide less income after taxes compared to the advantages of a tax-free vehicle.

FIGURE 1.2 Tax-Free Income Versus Taxed Asset Income



This hypothetical example is designed to provide general information on the subject covered. Pursuant to IRS Circular 230, it is not intended to provide specific legal or tax advice and cannot be used to avoid penalties or to promote, market, or recommend any tax plan or arrangement. Consumers are encouraged to consult with their personal tax advisor or attorney. Results are not guaranteed and will vary depending on the client.

Strategies for Helping Achieve Tax Diversification in Retirement

There are a multitude of strategies for helping individuals work towards a tax-diversified retirement. Many of these include re-allocating a portion of tax-later assets to tax-free vehicles. These strategies can help the account owner accumulate tax-deferred, income-tax free and penalty free earnings.

Roth IRA Conversion

One strategy that pre-retirees may consider utilizing is a Roth Conversion. In this strategy, the account owner transitions assets from a tax-deferred individual retirement account such as an IRA or 401(k) to an after-tax Roth IRA account.

The key to this strategy is that the account owner pays taxes at the current tax rate on the total amount of the conversion versus paying taxes on the distribution of the tax-deferred account when tax rates are unknown. Additionally, if an individual would like to contribute to a Roth directly but earns more than the income limit (the income limit for Roth IRA contributions in 2023 is \$218,000⁶), a Roth IRA Conversion can help them legally circumvent this technicality to secure this tax-diversification strategy for retirement.

There are a few different methods for executing a Roth Conversion. The first is an indirect rollover, where the account owner receives a distribution from their traditional IRA and allocates it to a Roth IRA within 60 days. The second is a trustee-to-trustee rollover, where the account owner asks the traditional IRA provider to transfer funds directly to the Roth IRA provider. Lastly, is the same trustee transfer, which can occur if the traditional IRA provider will maintain the Roth IRA account as well.⁷

Leveraging Life Insurance

One tax-planning strategy that is growing in popularity is leveraging Index Universal Life Insurance (IUL), sometimes known as a 702(j) plan.⁸ An IUL is a form of permanent life insurance that provides the potential for strong cash accumulation, tax-free income, accelerated living benefit riders, and an income tax-free death benefit.

Under current tax code, specifically section 7702, permanent life insurance is permitted to provide a source of income in retirement that is not counted as income or taxed as income because this income is technically a loan against the cash value of the life insurance policy.

In summary, the policyholder pays premiums that go toward purchasing the base life insurance policy with a portion of those premiums allocated to the cash value of the policy. During this time, the cash value of the policy is invested in an index (based on the policyholder's desired risk tolerance) so that it may benefit from market gains, tax-free, without the risk of loss during a market downturn. Taxes are deferred on any earnings until borrowed from the policy and distributed to the policy owner.

The key to an IUL is that the policy owner can elect to withdraw funds from the policy basis tax-free (until depleted) and take a loan against the taxable earnings (those above basis) tax-free. As for the death benefit, any remaining value left in the policy (once loans have been repaid) can be transferred to your beneficiary, income tax-free. It is important to note that for an IUL to help protect against tax risk, you must ensure that the policy is in good standing.

Policy loans and withdrawals will reduce available cash values and death benefits and may cause the policy to lapse or affect any guarantees against lapse. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. Withdrawals are generally income tax-free, unless the withdrawal amount exceeds the amount of premium paid.

Steps Toward Tax Diversification in Retirement

As you approach and enter retirement, there's no better time to explore tax-free diversification strategies that may be able to help reduce your tax risk and increase the longevity of your assets in retirement. Consider taking the first steps to see if you could benefit.

1. Identify your taxable income sources in retirement.
2. Determine what income tax bracket you will be in retirement.
3. Explore tax-diversification strategies and your financial goals.
4. Meet with a qualified financial professional to identify possible strategies for potentially reducing your tax liabilities in retirement.

While tax rates may be unpredictable, Americans can strive to learn from the past and work to navigate the ever-evolving, complex, tax rules and regulations, and extend their wealth's longevity to help provide income for what is needed and wanted in retirement.

Guarantees are backed by the financial strength and claims-paying ability of the issuing insurance company.

If you have questions regarding how to incorporate tax-diversification strategies in your retirement income plan, please contact:



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