Centering the Assets
Stay On Balance

How do we stay centered on the potter's wheel of retirement income planning?"

Centering the clay on the potter's wheel is the first step in throwing pottery and is the one that determines the success of your finished piece. The reason is simple: if the clay is not in the center of the wheel the centrifugal force will make it lean to one side as the wheel turns. You will not be able to mold the clay properly between your hands unless it is standing straight up on the wheel.

Do you feel like your retirement plan is "off-center?" Is it time to scoop it up and "throw" it back on the wheel and begin again, as many potters often do?

Retirement isn't what it used to be. Once, retirement typically lasted about 10 years. Social Security, a pension plan, and some personal savings covered basic expenses in retirement.

Now, retirement may last longer. Many key sources of income have been reduced, leading to increased reliance on personal assets. The result is that the traditional three-legged stool of employer pensions, Social Security, and personal savings needs to be retooled. We must look beyond simply increasing retirement assets. **And the one issue that is too often overlooked is taxes.**

Taxes are an unavoidable part of retirement income planning. Most of us are familiar with the phrase "don't put all your eggs in one basket."

Investment diversification has been the classic mold for individuals as they plan for retirement. Many people consciously purchase complementary investments to protect against stock market fluctuations. However, they focus all their energy on the accumulation stage and ignore the fact that there are two stages in retirement planning: the accumulation stage and the distribution stage.

Consequently, many may find themselves disappointed with their standard of living in retirement, even though they have saved and carefully diversified their investments. When the time comes to convert retirement savings into income, they may be shocked to find they have substantially less spending money than expected.

It's important to remember that while investment diversification may protect from some market risk, it does not protect from loss in investment value due to taxes – *the tax risk*. This means a greater percentage of the retirement nest egg may be lost to taxes. To prevent this, another kind of diversification you should consider is tax diversification.

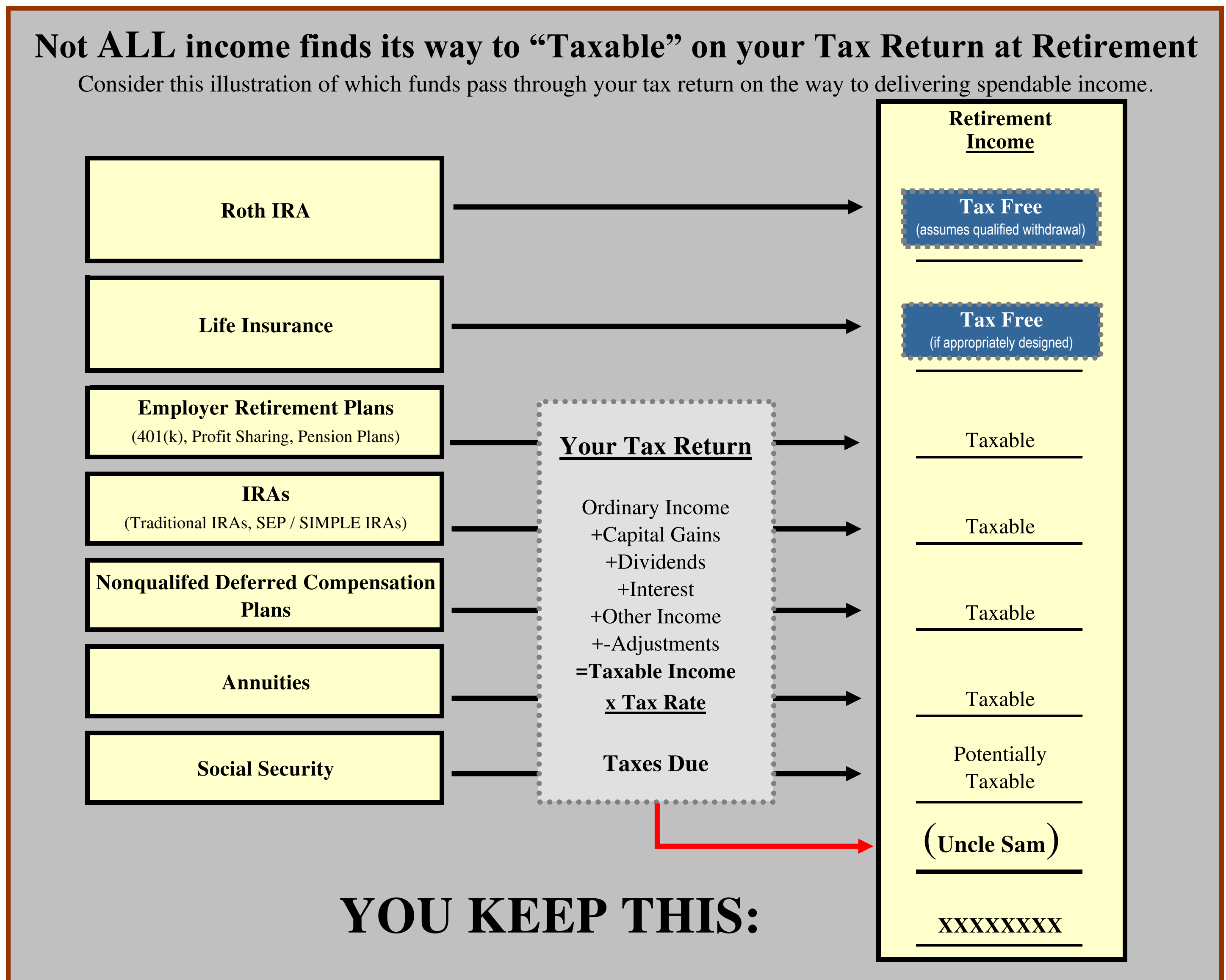
Tax Diversification

In simple terms, tax diversification refers to keeping assets in a variety of accounts that are treated differently at tax time – when you retire. You hedge against uncertainties in the federal tax system by allocating your investments across a diverse range of accounts that are taxed differently—from tax-deferred vehicles such as traditional individual retirement accounts and 401(k) plans, to taxable accounts such as bank and brokerage accounts, to tax-free accounts such as Roth IRAs, Roth 401(k)s, and life insurance. By having greater income tax diversification, you may have more control over your potential income tax liabilities.

Tax **D**iversification for retirement planning begins by understanding:

1) How retirement savings are taxed at accumulation;
2) How the assets are taxed as they grow; and
3) How they are taxed at distribution.

Managing these variables effectively may help minimize the tax erosion and also help optimize the value of retirement benefits over the longer life expectancy today's retirees are most likely to enjoy.



Tax-Preferred Retirement Planning

A tax-preferred retirement plan would be one in which:

- **Contributions are tax deductible**
- **Accumulation is tax deferred**
- **Distributions are tax free**

All Assets Have Unique Tax Consequences

Let's consider the optimal mix of "tax structuring" in preparing for and executing retirement income streams by examining the three major income types:

- **taxable income**
- **tax-deferred income**
- **tax-free income**

It's important to remember that not all income finds its way to "Taxable" on your tax return.

TAXABLE ACCOUNTS – Income generated within the account is taxed each year to the account owner.

- Examples include bank interest, corporate bond interest, rental real estate, limited partnership income, oil and gas income, royalties, and gain from the sale of investment assets.

TAX-DEFERRED ACCOUNTS – Income generated within the account is not taxed until distributions are taken from the account.

- **Fully taxable defined contribution assets**
  Accounts such as 401(k) plans, profit sharing plans and 403(b) plans fit this category. These plans are most often funded with tax-deductible dollars and may contain employer contributions.

You are generally required to make sure the funds last as long as needed. The risk of outliving your retirement funds is known as longevity risk.

- **Fully taxable defined benefit assets**
  These are often referred to as "pension plans." Generally speaking this is an ongoing fully taxable income stream during retirement, but offers no access to principal. The income stream may be fixed or slightly increasing, and it typically will last for the lifetime of the owner, and possibly spouse.

- **Fully taxable corporate nonqualified accounts**
  Often referred to as top-hat plans, salary continuation, or deferred compensation, these plans involve assets that have been retained on a company's balance sheet but which are promised to a selected employee in a lump sum or as an income stream at retirement. Amounts received are generally fully taxable when paid, there may be little access to principal, and there is an ongoing risk of a company's financial ability to complete such promises.

TAX-FREE ACCOUNTS – Assuming certain qualifications are met, income generated within the account is not taxed when distributions are made.

- **Roth Accounts**
  Roth IRAs and Roth 401(k)s offer the potential for both tax-free growth and tax-free distributions, assuming distributions are deemed "qualified withdrawals", but many may not qualify due to income limitations.

- **Life Insurance**
  Life insurance has not been a traditional retirement tool in recent years, but for tax diversification purposes you may find it a very important one to consider. It may grow in value without current income taxation, and provide tax-free income through loans or withdrawals if certain conditions are met.

Cash Value Life Insurance

The Non-Traditional Solution

Upon your death, when many other investments are taxed, your beneficiaries also receive the death benefit income tax free.

- **If you live…**
  You enjoy all the "living benefits" of life insurance, including the potential for supplemental tax-free retirement income.
- **If you become disabled…**
  With the purchase of the Disability Waiver of Premium Rider, your premiums are waived, and all the benefits of your policy stay in force.
- **If you die…**
  Your family receives the full value of the policy, less any unpaid loans and loan interest, income tax free.

In addition to protecting your family, cash value life insurance may provide an ideal way to tax-diversify your retirement savings.

- Premiums are paid with after-tax dollars
- Generates cash value that generally accumulates on a tax-deferred basis
- Allows you access to policy values – before or during retirement – generally on a tax-free basis
- No funding limits based on income
- No 10% penalty tax on cash value distributions prior to age 59½
- No required minimum distribution rules
- Potential creditor protection *(varies by state)*

Life insurance has not been a traditional retirement tool, but for tax diversification purposes you may find it an important one to consider.

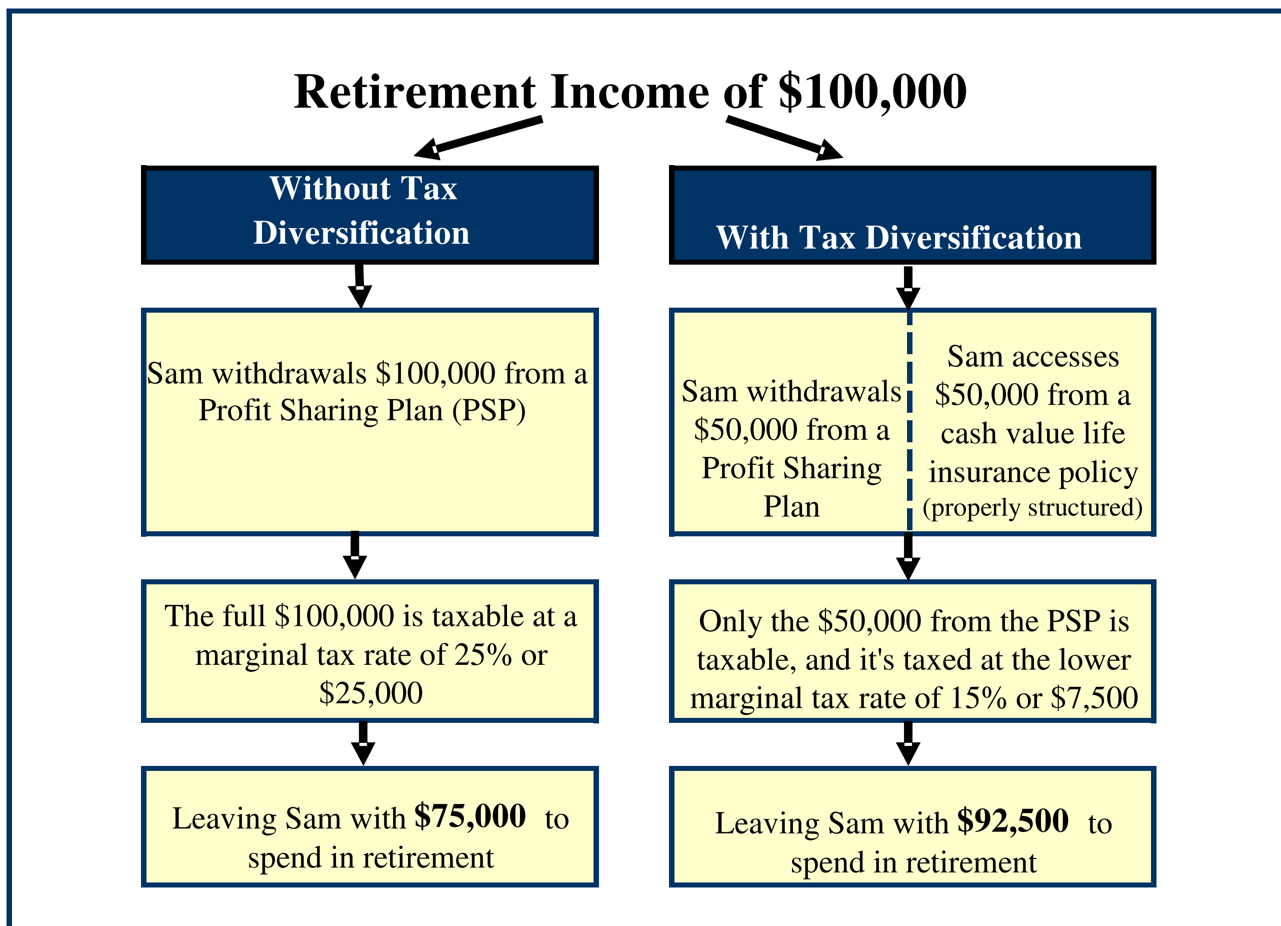
Tax-free distributions assume that the life insurance policy is properly funded and is not a Modified Endowment Contract (MEC). Distributions are generally treated first as tax-free recovery of basis and then as taxable income, assuming the policy is not a MEC. However, different rules apply in the first fifteen policy years, when distributions accompanied by benefit reductions may be taxable prior to basis recovery. Non-MEC loans are generally not subject to tax but may be taxable if the policy lapses, is surrendered, exchanged or otherwise terminated. In the case of a MEC, loans and withdrawals are taxable to the extent of policy gain and a 10% penalty may apply if taken prior to age 59 ½. Always confirm the status of a particular loan or withdrawal with a qualified tax advisor. Cash value accumulation may not be guaranteed depending on the type of product selected. Income tax-free death benefits, withdrawals and loans apply to Federal taxes only. State income taxes may apply.

Tax Diversification with Life Insurance

Kick Start Your Retirement Plan

Many individuals are more focused on building their assets and have traditionally viewed life insurance as just a necessary expense. While life insurance is primarily purchased for death benefit protection, it may be an important part of your retirement and legacy plan. Cash value life insurance has the potential to offer far more when you consider its advantages as an asset.

Let's look at how life insurance may be used in retirement. Sam, age 66, is retired and plans to access $100,000 of retirement savings this year. Assume he is married, and filing jointly with a spouse also age 65, with no additional income this year. Whether or not Sam tax diversifies in advance of retirement may have a significant impact on how much money Sam will have to spend in retirement.



Using the Right Tools for Today's Environment

Given the instability of Social Security, dwindling company-sponsored pension plans, uncertainty of tax rates and increasing longevity, it's clear that those planning for retirement need to tax diversify and may do so by making permanent cash value life insurance a part of their retirement plan.

Considerations of Working with Life Insurance

Handle Distributions Properly

Cash value life insurance may offer tax-free distributions, but the policy must be properly funded and certain criteria must be met.

Modified Endowment Contract (MEC)
If a policy is, or becomes, a Modified Endowment Contract (MEC), distributions may become taxable and a 10% penalty assessed if taken prior to age 59 ½.

While cash value life insurance may provide you with income distributions that are tax free, you should be careful to ensure your policy is properly structured and funded.

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Always confirm the status of a particular loan or withdrawal with a qualified tax advisor. Cash value accumulation may not be guaranteed depending on the type of product selected.

Investments in variable life insurance are subject to market risk, including loss of principal. Withdrawals will reduce cash value and death benefit.