BROKER WORLD

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How To Battle Rising Taxes:

Seven Ideas Using Life Insurance

Don't overlook the power of permanent life insurance in financial and retirement planning

Rising Taxes — and New Taxes — in the Years Ahead

There are compelling reasons why permanent life insurance should not be overlooked in retirement and financial plans that use income tax-efficient techniques.

The retirement and financial planning concept is simple enough—to accumulate and preserve asset values for sustainable retirement income, and to provide a potential legacy for loved ones. Yet, the simplest of planning concepts can be a challenge in an environment of changing taxes.

No one can truly predict whether their total tax burden will rise or fall over the next decade or two. But unless Congress intervenes with different tax laws, clients and planners alike are seeing clear signs in 2010 that federal income taxes will increase for some, once the Bush tax cuts expire.

Many believe the direction of federal tax policy necessarily points to higher income taxes. After all, federal spending has reached historically high levels and current revenues have plummeted—with skyrocketing federal deficits.

As the needle seems to move toward higher taxes, here is what experts are predicting for 2011:

- The top long term capital gain rate will increase from 15 to 20 percent.
- The top federal gift tax rate will jump from 35 to 55 percent.
- The top federal estate tax rate (zero percent today) will return to 55 percent (with a 5 percent surtax on larger estates).
- For some, the tax rate on dividends will increase to 39.6 percent, from the current 15 percent.
- Under the new Patient Protection and Affordable Care Act, married couples with adjusted gross income of more than $250,000 (and single taxpayers with AGI of more than $200,000) will be subject to an expanded 3.8 percent Medicare tax on so-called "net investment income" (covering various sources of investment income, including distributions from nonqualified annuities). This would start in 2013.
- Many state legislatures, beset with their own well-publicized budget dilemmas, have their eyes set on raising state revenues.

How Increasing Income Tax Rates Impacts Retirement Income

After adding up these assumed higher taxes—39.6 percent federal income plus 3.8 percent Medicare tax plus 7 percent assumed state tax—some presumably will face combined top rates approaching or exceeding 50 percent.

Organization of the client's assets to

help avoid the "rising tax cost predicament" should be an important focus of any financial plan. A person now subject to a 35 percent combined rate and seeking to spend $10,000 requires before-tax income of $15,384. If his combined rate climbs to 50 percent, the amount of before-tax income needed to produce $10,000 in spending money jumps sharply to $20,000.

Looking at the situation today, most tax increases can only be viewed as reasonable possibilities—not firm predictions. Nevertheless, if tax rates actually do rise while clients are building their retirement funds or entering their retirement years, there exists a risk of some serious erosion of the retirement nest egg, retirement income and family wealth legacy. Accordingly, prudence suggests that long range financial plans should build in some projected increases in federal and state income taxes.

The time has arrived for successful individuals, entrepreneurs and small business owners to consider income tax planning ideas as they plan their financial future.

Cardinal Principle of Tax Planning: Timing the Tax

The outcome of any financial plan can be dramatically influenced by various costs, and *costs include taxes.* Advisors who understand this are in a better position to design an income-tax-efficient financial or retirement strategy. Another important consideration is the *time when tax costs are incurred.* Consequently, an income-tax-efficient plan will focus on:

• Identifying and managing assets by *income type* (taxable, tax-exempt, or tax-deferred).

• Allocating assets by class and *income characteristics.*

• Determining or managing the *time when income is received.*

As a very basic template, fact-finding would begin with an inventory of client assets, to identify the sources of potential losses and costs into the future of the financial plan. A quick inventory, on page 14, shows a client with investment assets of $2 million, broken down by tax treatment.

Taxable		
Mutual Funds	$300,000	
Cash	$100,000	
CDs	$100,000	
Subtotal	**$500,000**	**(25%)**
Tax-Exempt		
Muni-Bonds	$100,000	
Muni-Bonds	$100,000	
Muni-Bonds	$100,000	
Subtotal	**$300,000**	**(15%)**
Tax-Deferred		
Traditional IRA	$400,000	
Annuities	$200,000	
401(k)/403(b)	$200,000	
Subtotal	**$800,000**	**(40%)**
Tax-Free		
Roth IRA	$100,000	
529 Plan	$100,000	
Life Insurance	$200,000	
Subtotal	**$400,000**	**(20%)**

Having a grasp of the allocation of assets by tax treatment is great, but neglecting to consider the time when income streams are received may lead to an underperforming plan—less net income for the client and less legacy for the client's heirs. The idea of developing a plan that begins by allocating assets by tax treatment can be sobering to clients. But when it's done, the client can better anticipate the timing of known tax costs—as well as the expected size of those costs.

One example of using tax-efficient assets is a high-income taxpayer acquiring municipal bonds to enjoy tax-exempt income. Qualified distributions from Roth IRAs are similarly not subject to income tax.

Tax deferral can be achieved with traditional IRAs; workplace vehicles like 401(k), simplified employee pensions (SEPs), SIMPLE IRA, and 403(b) plans, as well as Roth IRAs. Other examples include 529 plans, buy-and-hold strategies, and nonqualified deferred annuities (fixed and variable). Depending on income and other conditions, contributions to some (but not all) of these are deductible, and distributions from them (except Roth IRAs) are subject to ordinary income taxes—with special tax rules for distributions from annuities.

Consequently, if tax rates associated with a distribution may be projected to increase, the net after-tax income may be expected to drop, depending on a client's particular circumstances. The point is that clients who expect tax rates to rise should factor in the potentially reduced net income as distributions are received for certain retirement assets.

Current or Accelerated Tax Payment. While the thought of paying any tax is distasteful, paying income taxes early may be a smart move if rates rise appreciably in the future. A great example of accelerating the income tax on personal assets is the conversion from a traditional IRA to a Roth IRA. That decision has many moving parts, but one of the key motivators supporting the decision to convert may be the client's expectation that he will encounter higher taxes in later years.

Life Insurance Strategies for Rising Income Taxes

As you develop planning ideas for clients anxious about rising income taxes and new taxes, permanent life insurance should not be overlooked as an essential element of a well-designed financial plan to mitigate the potential costs of higher taxes.

Why use permanent insurance inside a tax-advantaged financial strategy?

Many understand that the primary mission of permanent life insurance is to provide financial support for an insured's loved ones at the time of need—replacing income lost on the insured's death and enabling the survivors to pay off the taxes and debts of the insured.

Ownership of permanent life insurance offers certain other powerful benefits—secondary to the primary mission—that flow from modern life insurance contracts under current tax laws. Arguably, no other

Table 1
Seven Life Insurance Ideas To Battle Rising Taxes

	Idea	Description of Strategy	Purpose	Tax Impact
1	**Fundamental Protection**	Client buys permanent life insurance policy to provide funds at death.	Financial security for loved ones, replace income of bread-winner, and provide funds to pay taxes and debts upon death.	Tax deferral of any gains in policy cash values, income-tax-free withdrawals of cash values up to owner's basis in the policy, tax-free policy loans, and income tax-free death benefits received by beneficiaries.
2	**Portfolio Diversification**	High-net-worth client buys guaranteed UL as part of overall portfolio strategy.	Portfolio diversification and greater predictability of legacy assets.	Death benefits received income tax-free and free of death taxes in a well-designed estate plan.
3	**Supplemental Income**	Client buys permanent insurance policy suitable to client's risk tolerance and other factors, in force for sufficient time to build policy cash values for retirement distributions.	Tax-advantaged income stream for policy owner during retirement years, with pre-retirement death benefits for beneficiaries in the event of insured's pre-retirement death.	Tax deferral of any gains in policy cash values, income tax-free withdrawals of cash values up to owner's basis in the policy, tax-free policy loans, and income tax-free death benefits received by beneficiaries.
4	**Capital Transfer**	Client withdraws all or portion of tax-deferred accounts (annuity, IRA, retirement plan, 401(k), SEP, SIMPLE IRA) to buy permanent life insurance.	Client seeks to avoid tax-inefficiency of unneeded assets in tax-deferred vehicles, to enhance net legacy to beneficiaries.	Ordinary income tax liability on withdrawals from the tax-deferred vehicle, but death benefits of new life insurance policy can be passed to heirs, income and estate tax-free (with a properly designed plan).
5	**Roth IRA Conversion after Death of Traditional IRA Owner**	Married owner of traditional IRA buys permanent life insurance policy on owner's life, naming spouse as beneficiary. Face amount is equal to estimated tax cost associated with IRA at insured's life expectancy.	After the IRA owner's death, the surviving spouse inherits the traditional IRA and proceeds to convert it to a Roth IRA—death benefits of policy help income tax due on the conversion.	Income tax due on surviving spouse's conversion of inherited traditional IRA is paid with income tax-free proceeds of permanent policy on IRA owner's life. Enables surviving spouse to continue deferral with Roth IRA and income tax-free distributions over remaining lifetime.
6	**Blended Roth Conversion**	Systematically convert traditional IRA over multiple years and split the after-tax distributions into Roth IRA *and* new life insurance policy.	To redeploy assets from traditional IRA to more income tax-efficient assets (a blend of Roth IRA and permanent life insurance).	Converting funds from a traditional IRA to Roth IRA and new life insurance policy results in income tax on withdrawals.
7	**Charitable Remainder Trust with Wealth Replacement ILIT**	Client transfers appreciated assets to charitable remainder trust using retained income to buy new life insurance policy inside wealth replacement trust.	To remove appreciated assets from taxable estate, enjoying an income stream from the CRT, and gift remainder to the client's favorite charity.	Donor may obtain charitable income tax deductions on transfer to CRT. Income from CRT may be used to buy new policy held in ILIT (death benefits excluded from donor's taxable estate).

product provides as much security and flexibility:

• Income-tax-free death benefits for policy beneficiaries.

• Tax deferral on any gains in policy cash values.

• Income-tax-free access to policy cash values through withdrawals up to tax basis in the contract or policy loans (subject to the limits or conditions specified in a particular contract).

These benefits, uniquely combined in a single product, should not be overlooked by anyone seeking to develop a financial or retirement plan that seeks to soften the impact of rising income taxes.

Seven Life Insurance Ideas to Battle Rising Taxes

At a tactical level, financial planners and insurance advisors may want to consider the seven life insurance ideas to battle rising taxes, described in Table 1.

Unmistakable signs point to higher income tax rates and new taxes. As these tax changes unfold, building income tax strategies into financial and retirement plans will gain greater importance. As client expectations about rising taxes take hold, advisors will be asked to step up with more creative and comprehensive solutions. A wide variety of financial products, strategies and decisions come into play. These are decisions that shouldn't be left to guesswork and intuition. Powerful planning tools to assess varying tax scenarios are available to help advisors create a finished product.

Has there been enough done to introduce clients to the role that permanent life insurance can play in an income-tax-efficient financial strategy?

For successful individuals, now is the time to understand tax strategies that can be implemented today to anticipate whatever new and higher taxes may be lurking around the corner. When sifting through the many retirement planning ideas that come your way, don't overlook the security and tax-efficiency of permanent life insurance. Together with other product choices and strategies, permanent life insurance can be a critical tool in the battle against rising taxes.

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