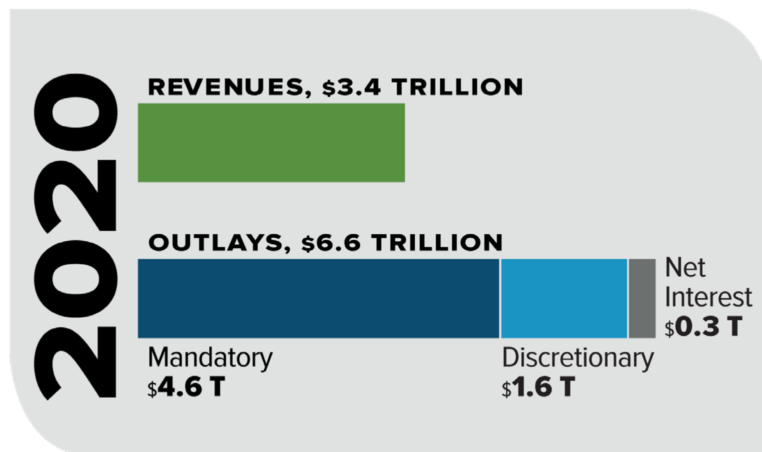
PAS PRODUCT & ADVANCED STRATEGIES

Tax Uncertainty Equals Income Uncertainty

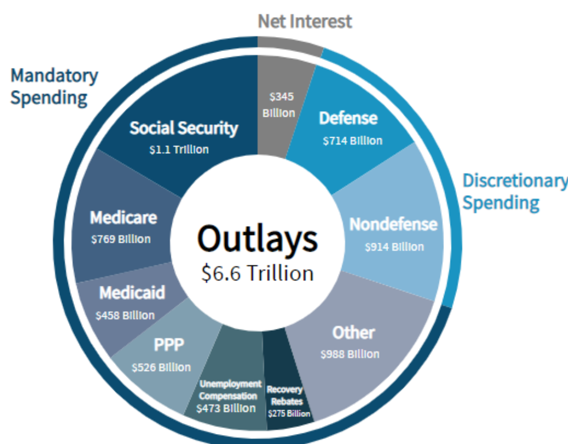
It has been said that there are only two certainties in life: death and taxes. While only our maker knows when we will die, we know that every April 15, Uncle Sam will require us to pay our taxes. Yet, with a proper strategy, we can take steps to help minimize the impact taxes will have on our after-tax income in retirement. Tax allocation is an approach that many nearing retirement or already in early retirement may wish to consider to help prepare for a changing tax environment.

WILL INCOME TAXES INCREASE?

To understand the future of taxes, it is important to understand where the U.S. sits today. As of this writing, the U.S. national debt is roughly $29 trillion.[1] During the fiscal year 2020, the U.S. federal government spent approximately $6.6 trillion. Meanwhile, tax revenues during that same period were $3.4 trillion. This resulted in a net deficit of nearly $3.2 trillion.[2]



Federal spending on mandatory government programs, such as Social Security and Medicare, account for just over 60% of total federal spending. When interest payments are added to the total, nearly 70% of federal spending is fixed every year.[3]



Fiscal Year 2020

At the same time, individual income taxes generate nearly half of all federal revenue.[4]

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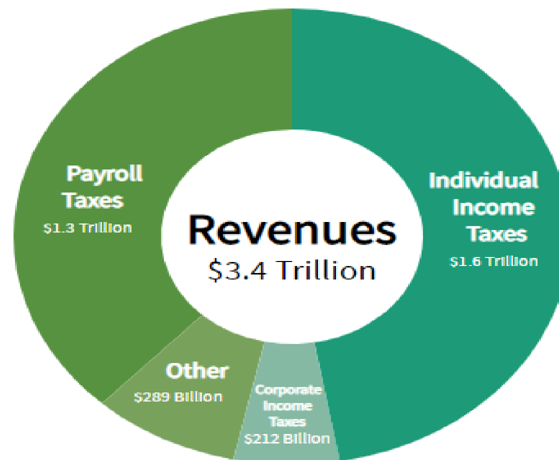
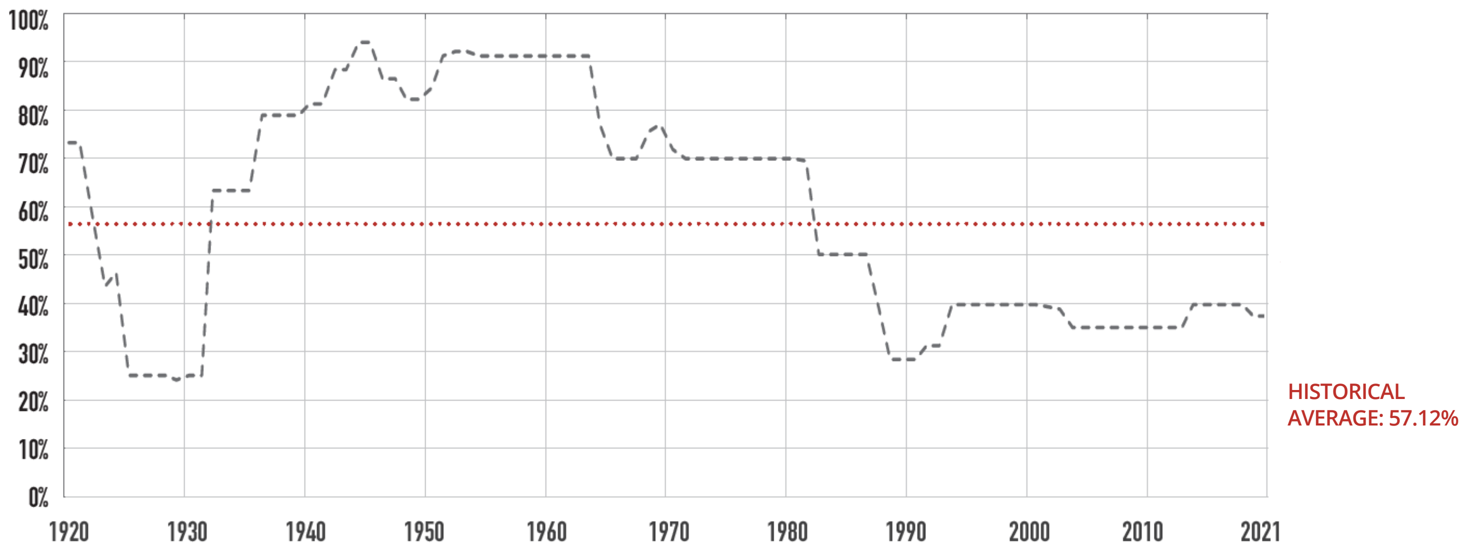
Fiscal Year 2020



US tax rates remain at relatively low levels. Today, the top marginal tax rate sits at 37%. This is substantially lower than the historical average of 57.31%. While previous periods did allow for substantially more deductions and tax loopholes, today, many of those deductions and loopholes have been reduced or eliminated. As an example, today, state and local tax deductions are capped at $10,000. Additionally, personal exemption deductions are no longer available. So, while marginal tax rates are relatively low, individuals may be experiencing higher effective tax rates.

HISTORICAL TOP MARGINAL TAX RATES[5]



Combining a historically high national debt with our currently favorable tax rates and tax brackets, a reasonable conclusion points to the potential for increased taxes. And even if tax rates do not increase, tax brackets, deductions, phase-outs, etc., can all be changed so that more income is taxed at higher levels.

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TAX TREATMENT OF RETIREMENT ASSETS

Retirement savings vehicles generally fall into one of three categories: taxable, tax-deferred, and tax-free.

Taxable Sources of Retirement Income

Taxable vehicles can take many forms. Mutual funds, stocks, bonds, and certificates of deposit are just a few examples. It should be noted that these vehicles can also be found within tax-deferred and tax-free vehicles, such as an IRA. Therefore, our analysis here will be limited to those that are held in brokerage or non-qualified accounts. Those held in such accounts generally fall into two sub-categories of tax treatment: ordinary income and capital gains.

Ordinary Income

Interest-bearing instruments such as corporate bonds, savings accounts, money markets, and certificates of deposits are all taxed as ordinary income. Interest, whether received or delayed, is recognized in the year that it is earned. Keep in mind that bonds or any instrument sold on the secondary market can also be subject to capital gains tax on any appreciation that the taxpayer may experience from the sale.

Capital Gains

Capital gains tax can take the form of either long-term or short-term gain. Such assets will be subject to capital gains treatment when the asset is sold. Whether the asset will receive favorable long-term capital gain treatment will be determined by whether it was held for the requisite time period, currently 12 months. Long-term capital gain rates begin at 0% and can be as high as 20%. If an asset was held for less than the requisite time period, the gain will be treated as a short-term gain and be taxed at ordinary income tax rates.

It should also be noted that certain vehicles, such as mutual funds, can generate capital gains even if the taxpayer has not sold the mutual fund shares. Internal trading of the mutual fund can result in gains independent of whether the taxpayer took any action. The capital gain treatment, either long- or short-term gain, will be determined by how long the mutual fund owned the sold asset.

Few taxpayers today own mutual funds, stocks, bonds, etc., outside of their 401(k)s and IRAs. As a result, the potential for lower tax rates on long-term capital gains will benefit few taxpayers. Therefore, changes in ordinary income tax rates will have a significantly disproportionate impact on the after-tax income many retirees will receive in retirement.[6]

Tax-Deferred Sources of Retirement Income

Today, the bulk of taxpayer retirement assets reside in tax-deferred vehicles, such as 401(k)s and traditional IRAs. By the end of 2020, defined contribution plans and IRAs held approximately $21.8 trillion. During that same time period, non-qualified annuities held another $2.5 trillion. Finally, defined benefit pension plans managed another $10.5 trillion. The taxable portion of all these retirement vehicles is treated as ordinary income, and therefore subject to ordinary income tax rates.[7]

Tax-Free Sources of Retirement Income

The ownership of tax-free retirement vehicles trails the ownership of tax-deferred vehicles. Today, about 20% of US households own a Roth IRA, significantly lower than traditional IRA ownership.[8] Additionally, ownership of all forms of life insurance continues to decline. Today, just over half of Americans own any form of life insurance. And among those that do, approximately a third only have coverage through a group policy.[9]

And although the list of tax-free retirement vehicles is short, any portion of income tax-free retirement income reduces the effective overall tax rate for that client and allows more after-tax spending money.

Municipal Bonds

Income from municipal bonds is received free from ordinary federal income taxes and is one staple of a tax-diversified portfolio. Although they maintain stable value if held to maturity, their underlying value can fluctuate in times of interest rate volatility. In times of rising interest rates, the bond value can diminish. In addition, large amounts of municipal bond interest can trigger the federal Alternative Minimum Tax, which could be 26% or more.

Another factor to consider is that the calculation to determine the amount of Social Security income that is taxable is based upon Modified Adjusted Gross Income, which includes municipal bond interest. A tax advisor should be consulted on these issues.

Roth IRAs and 401(k)s

Roth IRAs and 401(k)s are another fundamental piece of a tax-diversified portfolio. The good news is that retirement income from a Roth is received income tax-free, thus reducing the overall effective income tax rate on retirement income. The bad news is that there are restrictions on Roth contributions. Both Roth IRAs and 401(k)s are subject to contribution limits. Additionally, Roth IRAs have income eligibility restrictions. As a result, higher-earning taxpayers may not be able to contribute to a Roth IRA.

However, taxpayers can choose to do a Roth conversion as an opportunity to create tax-free retirement income. Although a Roth conversion triggers taxation in the transfer year, the future retirement income stream is received tax-free. In times of potential income tax increases, it may make sense to pay tax at current levels on a Roth conversion, thus locking in tax-free future retirement income.

Cash Value Life Insurance

One of the most tax-favored financial instruments is life insurance. Not only is the death benefit generally received income tax-free, but the cash value inside can also be accessed income tax-free. Cash withdrawn from a life insurance policy is deemed a return of principal to the extent of premium payments. And policy loans are not taxable at all if the policy stays in force. Additionally, the income limits applied to annual Roth contributions do not apply to fund a cash value life insurance policy. However, Modified Endowment Contract status must be avoided to ensure that cash value withdrawals and policy loans can provide supplemental tax-free retirement income.

WHAT IS TAX ALLOCATION?

Just as an investment portfolio may diversify to minimize market volatility, tax allocation can reduce the risk of all retirement income being taxed at the same, potentially increased, rate. As stated previously, the bulk of retirement assets sit in tax-deferred vehicles. As a result, a substantial portion of a retiree's income will be subject to potential future increases in tax rates, effectively reducing their spendable income.

Consider the hypothetical example of Angelo and Mary.* Both are 70 years old and retired. They currently derive their retirement income from a variety of sources and take the standard deduction.

Traditional IRA	$50,000
Long-Term Capital Gains	$10,000
Short-Term Capital Gains	$5,000
Social Security	$45,000
Total Income	$110,000

Based on January 2022 tax rates and law, Angelo and Mary will pay federal income taxes of $8,999. While they find themselves in the 12% marginal tax bracket, their effective tax rate is 8.18%. After federal income taxes are paid, they will have $101,001 of after-tax spendable income.

However, had Angelo and Mary made a few changes to how they saved for retirement, their outcome could have looked different.

Traditional IRA	$30,000
Roth IRA or Cash Value Life Insurance	$20,000
Long-Term Capital Gains	$10,000
Short-Term Capital Gains	$5,000
Social Security	$45,000
Total Income	$110,000

Based on the same January 2022 tax rates and law, Angelo and Mary would pay federal income taxes of $4,158, or less than half of the other scenario. Their after-tax spendable income would be $105,842. Additionally, and perhaps more importantly, Angelo and Mary have taken steps to mitigate the effects that future tax rates would have on their after-tax income.

Additionally, the benefits of tax allocation become more apparent upon the death of Angelo. Upon Angelo's death, Mary will see a reduction in her Social Security benefit. If she wishes to maintain the same pre-tax income of $110,000, she may need to increase the withdrawals from her traditional IRA.

Traditional IRA	$65,000
Long-Term Capital Gains	$10,000
Short-Term Capital Gains	$5,000
Social Security	$30,000
Total Income	$110,000

Since Mary is now a single taxpayer, based on the January 2022 tax rates and law, she will pay $18,106 in federal income tax. Her effective rate has increased from 8.18% to 16.46%! Her after-tax spendable income has dropped to $91,894 versus $101,001 when Angelo was still alive.

However, had Angelo and Mary utilized a tax allocation approach that incorporated life insurance or Roth IRAs, Mary could have reduced her traditional IRA withdrawals while still maintaining her after-tax income.

**This hypothetical example is shown for illustrative purposes only and is not guaranteed.*

IMPLEMENTING TAX ALLOCATION

Today, many taxpayers do not have the foundation in place to utilize a tax allocation approach to retirement. As a result, steps will need to be taken to begin diversifying retirement income sources. This will require a close working relationship with a client's qualified tax professional.

Roth conversions, taking taxable distributions from traditional IRAs to fund a cash value life insurance policy, leveraging non-qualified annuities, or looking for ways to leverage vehicles that receive capital gain treatment, are just a few steps to consider. However, each step may result in taxable events. Careful attention should be given to ensure that clients do not experience tax-bracket creep or lose other tax benefits. Also, be aware that Medicare premiums are based in part on a client's modified adjusted gross income. In essence, higher income will result in higher Medicare premiums.

Nonetheless, a tax allocation strategy will provide many clients with the flexibility to pivot should taxes increase or their tax filing status change. By taking steps today, before changes take place, your clients may be better positioned for the future.

(1) https://www.usdebtclock.org/
(2) https://www.cbo.gov/publication/57170
(3) See note 2
(4) See note 2
(5) Tax Policy Center - Urban Institute & Brookings Institution: Statistics - Historical Highest Marginal Income Tax Rates 1913 to 2022, February 2022
(6) https://www.pewresearch.org/fact-tank/2020/09/25/few-in-u-s-owned-stocks-outside-of-401ks-in-2019-fewer-said-market-had-a-big-impact-on-their-view-of-economy/
(7) https://www.ici.org/system/files/2021-09/21_rpt_recsurveyq2.pdf
(8) https://www.ici.org/system/files/2022-01/per28-01.pdf
(9) https://www.insuranceandestates.com/life-insurance-statistics/

Life insurance 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 an unrecovered cost basis will be subject to ordinary income tax. Tax laws are subject to change. Clients should consult their tax professional.

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