CONSUMER RETIREMENT REPORT

compass
RETIREMENT ALLIES

It's Time to Get Serious About Tax Planning

Historical data coupled with proposed legislation are pointing towards tax increases. Learn what you can do to help reduce your future taxation and protect the longevity of your retirement income.

October 2021

This report is designed to provide general information on the subjects 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. The information within this presentation is not endorsed or approved by the Social Security Office or any other Government Agency.

As Americans, it is our duty to pay taxes. Taxes help afford much of what makes this country great. However, it is not our duty to overpay them, and for those entering and in retirement — when preserving and protecting every penny becomes a priority — this is especially important.

While we may not be able to predict the future, we can learn from our past and discover new opportunities for navigating the ever-evolving, complex, tax rules and regulations, so that we may extend our wealth's longevity and help provide income for what we *need* and *want* in retirement.

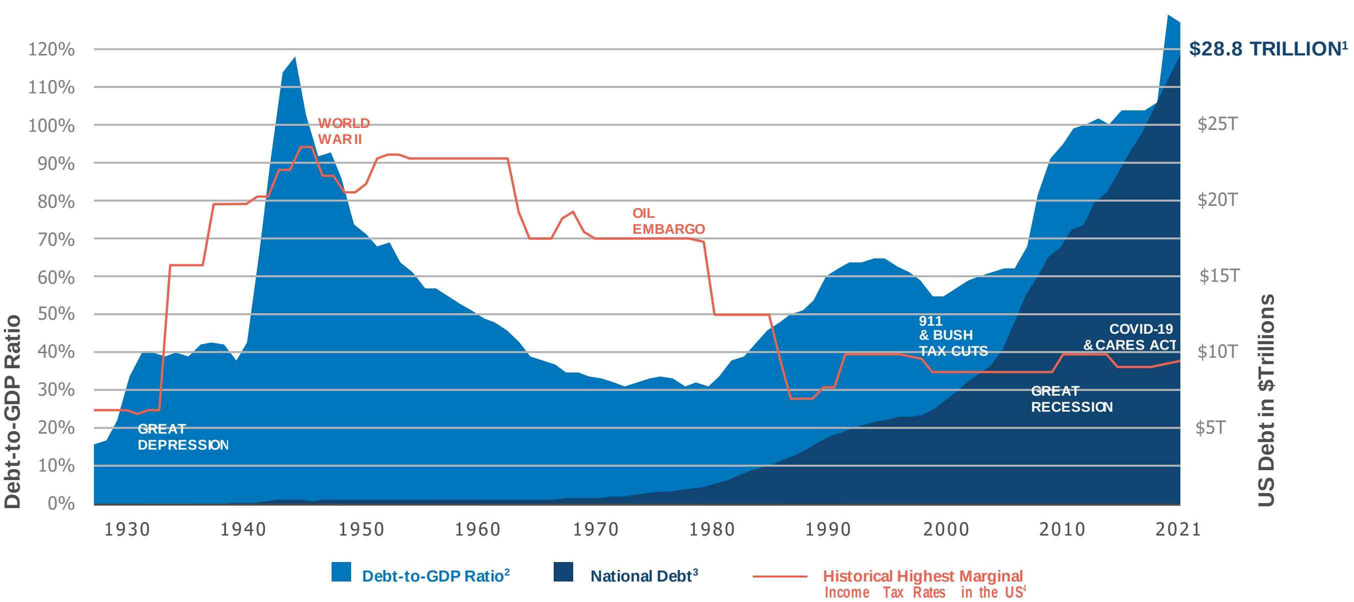
> *"In this world nothing can be certain, except death and taxes."*
>
> **— Benjamin Franklin**

History Shows Us That Taxes Will Most Likely Increase

In the U.S., we have observed a correlation between national public debt-to-Gross Domestic Product (GDP) as a leading indicator of tax increases. The reason for this correlation is that 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. Figure 1.1 illustrates the fluctuation of our debt-to-GDP from 1930 to 2021 and the correlating highest marginal tax rate.

FIGURE 1.1

Debt-to GDP as a Leading Indicator of Taxes



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Understanding the escalated pace at which our national debt has grown

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 $28 Trillion (and growing). 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.

The path of proposed tax legislation

To build upon the concern of future tax increases, it's important to examine pending legislation. President Biden and his administration recently proposed the following changes to tax rules and regulations that could potentially affect those in or approaching retirement in a significant way, especially if they are affluent:

- **Capital Gains Increases.** Individual filers earning $400,000, and married couples with $450,000 in income will experience a capital gains tax increase to 25%, a potentially 5-10% increase from 2021, depending on their 2021 income levels and filing status.[5]
- **Highest Marginal Tax Rate Increase.** The top individual tax rate will increase by 2.6 percentage points, making the new top individual income tax bracket 39.6%. Plus, a 3% surcharge will be imposed on individual income above $5 million.[6]
- **New Roth Conversion Limitations Based on Income Level.** Roth conversions in individual retirement accounts and 401(k)-type plans will be repealed for those earning more than $400,000 a year.[7]
- **Roth and Traditional IRA Contribution Limits Imposed.** Individuals will be prohibited from making more contributions to their Roth IRA or traditional IRA if the total value of their combined IRA and defined-contribution plans exceeds $10 million.[7]
- **Elimination of Backdoor Roth Strategy.** Individuals will no longer be able to convert a workplace plan such as a 401(k) to an IRA and then convert it to a Roth vehicle to bypass the Roth income limitations.[7]
- **Elimination of the Mega-Backdoor Roth Strategy.** Individuals, regardless of income level, will not be able to make after-tax contributions to their workplace plans.[7]
- **Required Minimum Distributions Mandated for 'Mega' IRAs.** Individuals whose combined IRAs and defined-contribution plans exceed $10 million at year's end, will have to withdraw at least 50% of the excess funds the following year. This applies to individuals with more than $400,000 of taxable income, $450,000 for married taxpayers, and $425,000 for heads of household.[7]
- **Capital Gains Taxation at Death or Gift.** Currently, when someone dies, heirs of any assets that appreciated in value will not pay capital gains tax on that unrealized appreciation. New tax proposals would like to make unrealized capital gains taxable at death or when the asset is transferred by gifting. This proposal also includes a $1 million tax exemption for unrealized appreciation for single persons ($2 million for a married couple – plus the $500,000 per couple capital gain exemption for a primary residence).[8]
- **Estate Tax Exemption Would Sunset in 2021 Instead of 2025.** Americans may also experience a reduction in the estate tax exemption this year, only allowing up to $5 million of an estate to be passed onto heirs, tax free, compared to the current $11.7 million allowance. For estates valuated above $5 million, there is potential for a 40% federal estate tax.[9]

Our debt and tax history, coupled with proposed legislation make tax risk a real concern for many Americans. However, with this obstacle comes opportunity to take a proactive approach today to reduce future tax liabilities of tomorrow.

Working to Reduce Future Tax Risk

Many Americans will owe some form of tax in retirement. Taxable income sources can include Social Security, pension, individual retirement accounts, and/or 401(k) income tax, 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 while you're no longer earning an income. This is tax risk.

Tax risk can work against you in retirement in three different ways:

Tax Increases
If taxes go up when you are in retirement, it is likely that your tax bill will increase too, meaning you could have less money for the things you need and want in retirement.

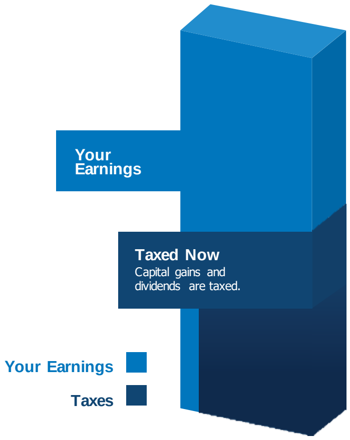
Reduced Tax Deductions
Traditionally, tax deductions are also reduced in retirement, meaning, there are fewer ways to minimize what taxes are owed. Common deductions that are lost in retirement, when you are no longer working, include those associated with 401(k) or traditional IRA contributions. Also, in most cases, retirees can no longer claim any dependents. Lastly, if your home is paid off, then there is loss of the mortgage interest deduction as well.

Higher Than Expected Tax Bracket
In retirement, many of us will spend time doing the things we love while maintaining or enhancing our existing lifestyle. This can mean spending more money. In this instance, there is a good chance that the income you will need to withdraw could keep you in the same or higher income tax bracket and therefore owe more taxes.[10]

How Tax Diversification Strategies Can Help Lower Tax Risk

Now that we have a better understanding of the probability of heightened tax risk from historical data and proposed legislation, let's seek to understand how we can potentially lower this risk through tax diversification strategies.

Tax diversification refers to the strategic allocation of assets among multiples investment accounts with varying taxation: tax-now, tax-later, and tax-free accounts. When reviewing these strategies, it's important to recognize to what degree tax risk could affect your future retirement income.



TAX-NOW STRATEGIES

Tax-now strategies include accounts where income is taxed on any earnings (capital gains and dividends) received each year in non-qualified accounts. 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 likeliness that so will your tax obligation.

TAX-LATER STRATEGIES

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. Tax-later account type examples 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 and wanting to offset their present tax obligations. However, if you are concerned about tax rate increases while in retirement, it may make sense to consider planning strategies that will allow you to transfer assets so that you may lock-in today's tax rates for some of your retirement income sources.

TAX-FREE STRATEGIES

Lastly, are the tax-free diversification strategies. These strategies can help the account owner to accumulate earnings tax-deferred, income-tax free, and penalty free. Tax-free account type examples 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 finding themselves in a higher tax bracket in retirement. Additionally, if you are already maximizing your traditional retirement savings vehicles, tax-free strategies can help you bolster your savings while reducing your tax risk on future retirement income.

The Tax-Free Strategy That Can Help Reduce Your Tax Risk

One tax-planning strategy that is growing in popularity is Index Universal Life Insurance (IUL), sometimes known as a 702(j) plan.[11] An IUL is a form of permanent 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 you 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. It is important to note that these withdrawals do not count towards your earnings threshold and therefore will not impact your Social Security benefit income amount.

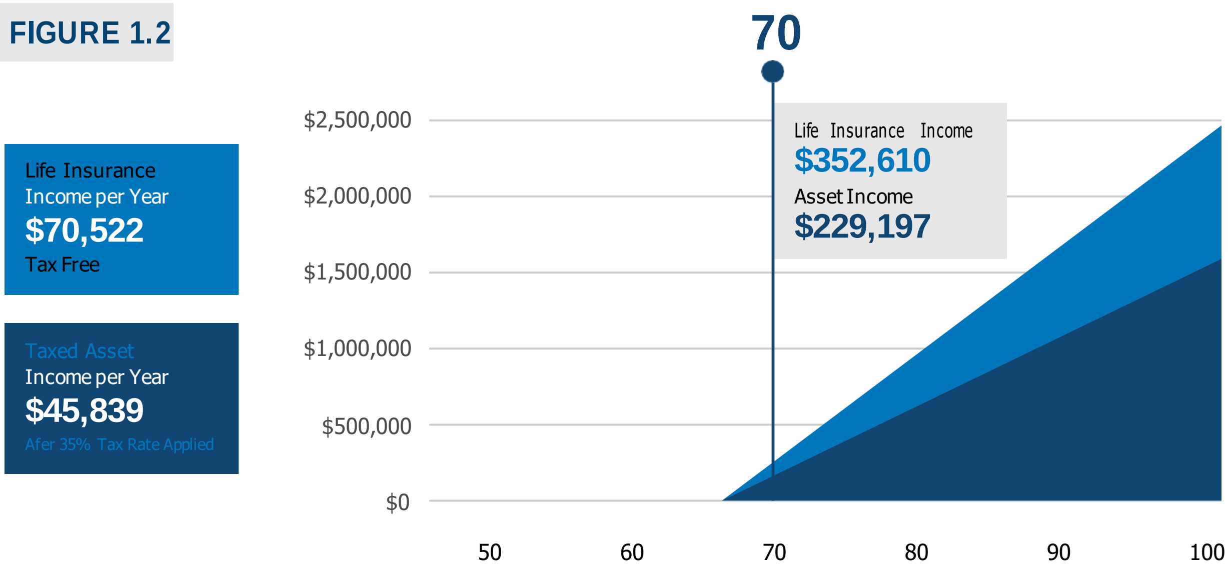
As for the death benefit, any remaining value left in the policy (once loans have been repaid) can be transferred to your beneficiary, income tax-free. It is important to note that for an IUL to help protect against tax risk, you must ensure that the policy is in good standing.

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.

Example: Tax-Free Income Versus Taxed Asset Income

IULs can provide you with the opportunity to receive more income compared to assets that are taxed. Figure 1.2 demonstrates a hypothetical situation, where the retiree receives $70,522 of income each year through an IUL, 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 tax-free advantages of Index Universal Life Insurance.

FIGURE 1.2



This is a hypothetical example 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.

Take the Time to Have the Tax Risk Conversation

In retirement, protecting the income that you *need* so that you can work to maximize the income for things that you *want* is often a priority. As we project tax risk to rise, there's no better time to meet with a qualified financial professional to see if tax-free diversification strategies, specifically that of Index Universal Life Insurance, could help you reduce this risk and possibly increase longevity of your assets in retirement.

To see if you could benefit from tax-free diversification strategies, please contact:

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Karla Leonard, Retirement Specialist | Insurance Professional IMI ASSET MGMT CO
7710 Limonite Ave, Ste E3, Jurupa Valley, CA 92509
E: kmld@imiassetmanagementco.com
P: 888-383-3068 D: 951-333-3068
www.imiassetmanagmentco.com CA LIC#0B42336

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