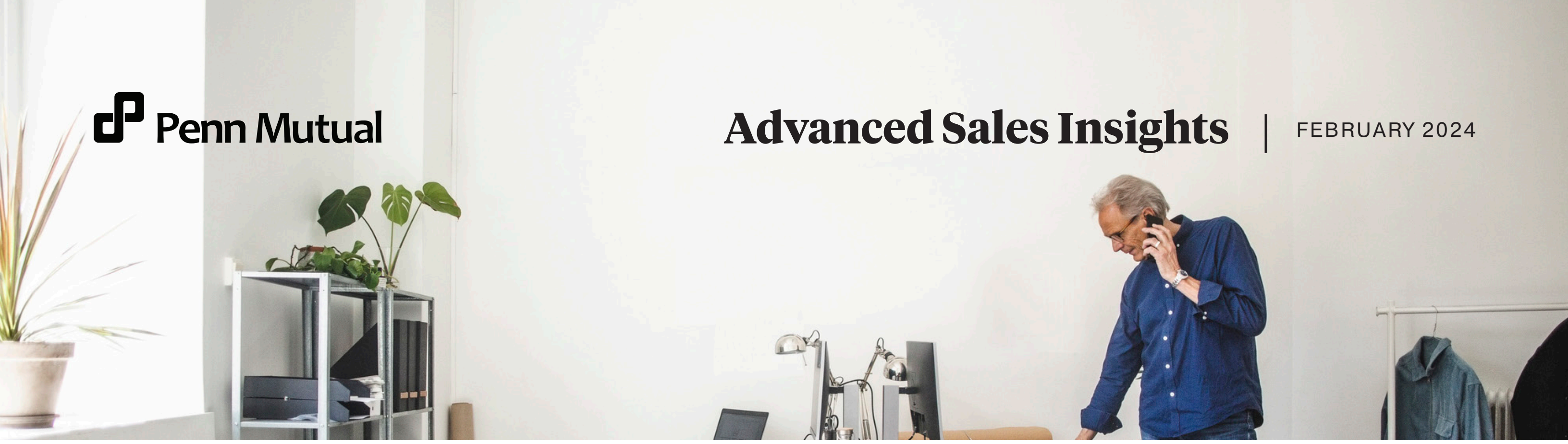

What's Tax-Rate Risk?

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HOW LIFE INSURANCE CAN REDUCE THE OVERLOOKED RISK ASSOCIATED WITH RETIREMENT PLANNING

A few years back, I was enjoying a fantastic lunch with an advisor and close friend in a now defunct Austin BBQ joint. Side note: with respect to Memphis, St Louis, the Carolinas and every other place that has wonderful BBQ, my favorite BBQ is found in Central Texas. We were talking about his clients and the type of planning he does for them. His firm had traditionally worked with a lot of high-net-worth families but he was in the process of diversifying his firm to work with a broader audience due to changes associated within the wealth transfer market. A new focus area for him was in retirement planning for local executives and he was having a lot of success acquiring new clients. His pitch generally involved qualified plans such as 401(k) or SEP Individual Retirement Accounts (IRAs) combined with other traditional assets to round out their retirement income portfolio. He talked about how his firm reduced investment, market and other risks associated with retirement planning by how they structured their client's portfolios. After listening to him for a while, I asked one simple question, what are you doing to reduce your client's tax-rate risk? His response – "What's tax-rate risk?"

Tax-rate risk is actually a pretty simple concept when you come to think of it. It's the risk that tax rates will be higher than you anticipated when you retire. Many people don't consider this when they are doing their retirement planning. Let me use a very simplified example to help illustrate why considering tax-rate risk is so important. Let's say a retiree spent their entire career saving for retirement using only their employer's qualified plan. They saved quite the nest egg and anticipate taking $300,000 per year out of the qualified plan to support themselves. The numbers look very different depending on the tax rate at the time of distribution:

25% TAX RATE	35% TAX RATE
DISTRIBUTION - $300,000	DISTRIBUTION - $300,000
TAXES - $75,000	TAXES - $105,000
SPENDABLE INCOME - $225,000	SPENDABLE INCOME - $195,000

Please note that I fully realize that this is an oversimplification – it is by necessity. I am a lawyer, I do words not numbers.

So in our simple example, our retiree lost almost $2,500 a month in spendable income just because of a change to the tax rate. While tax rates are important every tax year, when you are talking about retirement planning, the most important tax rate is the one that is in place when you retire. Take my personal situation. I am 50 years-old. If all goes according to plan, I will likely work another 17 to 20 years all the while maximizing my contributions within my qualified plan options. How much spendable income I have in retirement from qualified plans will be derived by a combination of: my level of contribution, the investment return within the plan and the tax rate when I retire and start taking distributions. I have no idea what the federal income tax rates will be in 2 years much less in 17 to 20 years. So, if my only retirement asset is my qualified plans (and any social security that I receive –a topic for a different day), I am taking tax-rate risk in my retirement planning.

Am I saying that people shouldn't use qualified plans to save for retirement? Absolutely not. Qualified plans are and should be the backbone of retirement planning for many Americans. Do I think that tax-rate risk can be completely eliminated? Again, absolutely not. However, tax-rate risk can be mitigated in a couple of different ways. One way, and for many people the simplest way, is to take advantage of ROTH contributions. Many qualified plans provide a ROTH option where you are taxed now on the contribution but you can take the money out during retirement, tax-free. For that, you are actually taking inverse tax-rate risk in that your contributions could be taxed at a higher rate than your distributions would be, but at least you have reduced the surprise associated with tax-rate risk. Another way is to do Roth conversions with existing IRAs, if possible, to reduce the surprise element associated with the distributions.

That said, I work for a life insurance company and so you know there is a life insurance component coming. Life insurance can be part of the mitigation of tax-rate risk. We know that distributions from cash value life insurance policies (e.g whole life, indexed universal life, variable universal life, etc.) via loans and withdrawals are tax-free as long as the policy is funded and maintained properly. It doesn't matter if tax rates in retirement are 25%, 35%, or, 45%, the tax rate associated with the policy distributions are going to be 0%. To reiterate, I am not saying that people should ditch their qualified plans and dump all of their retirement savings into life insurance. What I am saying is that a well-rounded retirement income portfolio, in many cases, will involve cash value life insurance. This will not only provide death benefit protection during the accumulation years and beyond, but help reduce tax-rate risk. The key to using life insurance as part of a retirement income portfolio is to start planning well before retirement. A cash value life insurance policy, if funded properly, can usually start providing supplemental retirement income after about 10 years knowing that the longer you let the cash value build, the better.

Let's get back to our simplified example to help illustrate how adding life insurance to the retirement income mix can help reduce tax-rate risk. Instead of taking a distribution of $300,000 from a qualified plan, what if the retiree took $200,000 from a qualified plan and $100,000 from a life insurance policy.

25% Tax Rate	Qualified Plan Distribution $200,000	Taxes $50,000	Life Insurance Distribution $100,000	Spendable Income $250,000
35% Tax Rate	Qualified Plan Distribution $200,000	Taxes $70,000	Life Insurance Distribution $100,000	Spendable Income $230,000

A discerning eye will notice that by adding life insurance to the mix not only was the tax-rate risk substantially curtailed, but the total spendable income went up in both scenarios since the life insurance distributions were taxed at a 0% rate.

So the next time you have a chance to talk to your clients about retirement planning, be sure to bring up tax-rate risk and how to plan for it. If you find yourself grappling with complex cases or seeking a deeper understanding of how these factors may impact your clients, don't hesitate to reach out to our Advanced Sales Team. Our dedicated experts are well-versed in the nuances of tax planning and can provide personalized insights tailored to your clients' unique situation.

Connect with us via email at advancedsales@pennmutual.com
or give us a call at 800-818-8184, option 8.

For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2)(i.e. the transfer-for-value rule); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

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