PETER L. McCARTHY

JD, MBA, CLU, ChFC, is a senior advanced marketing attorney for ING's national sales support team. He has over 20 years of experience in advanced marketing and has previously worked as advanced marketing counsel for Minnesota Life, Prudential Insurance Company, and American Express Financial Advisors.

McCarthy practiced law as an estate planning attorney with a large Minneapolis law firm. He earned his JD degree from the University of Miami (FL) School of Law and an MBA from Rollins College. A number of his articles on estate, business, and charitable planning concepts have been published in national financial journals and magazines, and he frequently speaks about estate and business planning concepts to industry groups and continuing education forums for the legal and accounting communities.

McCarthy can be reached at ING, 20 Washington Avenue South #5750, Minneapolis, MN 55401. Telephone: 866-464-7355. Email: ***peter.mccarthy@us.ing.com****.*

The Forgotten Part Of Retirement Planning: Income Tax Diversification

"Don't Put All Your Eggs In One Basket!" This is the classic investment advice that has been drilled into the minds of millions of people who are planning to retire during the next 15 years. Unfortunately, many may find themselves disappointed with their standard of living in retirement, even though they saved and carefully diversified their investments. When the time comes to convert their retirement investments into cash, they could be shocked to find they have substantially less spending money than they expected.

Their problem could be that they didn't understand there are two stages in retirement planning: the accumulation and the distribution stage. Many people focus all their energy on the accumulation stage and ignore the distribution stage. They diversify their investments but overlook the importance of diversifying the income taxes due on those investments. As a result, a greater percentage of their retirement nest egg can be lost to taxes.

People who are best prepared for retirement are those who consider both investment diversification and income tax diversification in their planning. Cash value life insurance can be useful in both accumulating and distributing retirement income.

Income Tax Diversification

With investment diversification (also known as asset allocation), we consciously purchase complementary investments to protect against risk of loss. But investment diversification protects us from market risk only. It doesn't protect us from loss in investment value due to taxes—tax risk. Taxes are an unavoidable part of investing. That's why income tax diversification is a critical part of retirement planning.

Income tax diversification is the selective ownership of investments to optimize spendable income when retirement investments are converted into cash. Many people make the mistake of saving too many of their retirement dollars in financial vehicles that have high income tax rates. The result is reduced spendable income.

For example, suppose Bob Smith is retired. His retirement savings are packed into a $500,000 IRA made up of a portfolio of impeccably diversified stocks. Bob has all his retirement eggs in one income tax bucket. Every dollar in IRA distributions will be taxed as ordinary income. The actual spendable value of his IRA will be reduced because every dollar is taxed when distributed.

Since all Bob's retirement savings are in his IRA, he has no flexibility in the taxation of his retirement income. He's stuck paying ordinary income taxes. In addition, Bob must start taking distributions annually after the year he reaches 70 1/2. And he can't take advantage of investment losses that take place within his IRA. Even if his IRA loses money, every dollar that comes out will be fully taxed.

Income tax flexibility can be very important to retirees when they need to convert their retirement savings into cash they can spend. Having retirement assets that are taxed in different ways can be beneficial in deciding the best time to sell, exchange, liquidate or annuitize assets to create

retirement income. There are four reasons why income tax diversification is important to retirees:

1. Retirement can last 20 to 40 years.
2. Retirees won't be able to earn much additional money, so it will be very difficult for them to make up for the part of their investments lost to taxes.
3. The value of each different investment will fluctuate annually.
4. Tax laws will change over time. One thing that seems inevitable in government is that taxes and tax rates will change. As governments need more or less revenue, new tax laws will be proposed and adopted. With each new change, there are winners and losers. Retirees who haven't diversified their investments among several financial vehicles won't have the flexibility to change the source of their retirement income to maximize what is left after taxes.

Income taxes impact every retirement investment. The key to retirement investing isn't how much the investment grows in value, but rather, it's how much of that growth remains after taxes. Income tax on a particular investment often depends on the financial vehicle in which the investment is located. In short, it's not only *what* investment is bought, it's *where* it was bought. For example, the same mutual fund could be purchased in any one of five different ways: (1) own it personally, (2) in an IRA, (3) in an investment subaccount inside a variable annuity, (4) in a Roth IRA, or (5) in a variable life insurance policy subaccount.

When the time comes to convert the mutual fund into retirement income, the income tax costs will be different depending on which of these five options was used. The mutual fund's gross value will be the same in each of these five approaches, but its net spendable value will vary depending on where it was owned. Thus, the spendable value of a retirement asset depends on its "location, location, location."

Income Tax Variables

Different financial vehicles have different income tax consequences. The net income from any of them depends on the availability of three tax benefits:

1. Tax deductible contributions.
2. Tax deferred asset growth.
3. Tax free distributions.

Unfortunately no financial vehicle can deliver all three of these tax benefits. Under our tax laws today, the most you can have is two of these three income tax benefits. The challenge is to choose consciously the financial "locations" for retirement investments so the income tax consequences are diversified. If retirement investments are in at least two locations, you will have much more flexibility to maximize after tax retirement income.

Chart 1

Buckets	Contributions	Growth	Distributions
1—Equities	After Tax	Tax Deferred	Growth Taxable
2—Taxable Income	After Tax	Taxable	Growth Taxable
3—Tax-Free Income	After Tax	Tax Deferred	Tax Free
4—Tax Qualified Plans	Pre-Tax	Tax Deferred	Fully Taxable

The Retirement Savings Bucket

Investments can be grouped together based on their ability to use these tax benefits. This is called their "tax profile." An effective way to visualize these groups is to think of them as "buckets." Most retirement investments fall into one of four buckets based on tax profile (see Chart 1).

1—Equities Bucket holds capital investments like stocks, real estate and deferred annuities. After tax dollars are used to purchase these assets. Growth in asset values is tax deferred. Income taxes on this growth are imposed when the asset is converted into cash. The income tax rate depends on the asset in the bucket. Most capital assets have their growth taxed at the current 15 percent capital gains rate. However, the growth in deferred annuities is taxed at ordinary income rates as it is distributed.

2—Taxable Income Bucket holds savings accounts, money market accounts, certificates of deposit (CDs), bonds that pay annual interest, and personally owned mutual funds. These assets are treated harshly under the income tax laws. First, they are purchased with after tax dollars. Second, the interest the asset earns from year to year is taxable as ordinary income. Third, capital gains distributions for mutual funds are taxed. Finally, growth in the asset's capital value is taxed when it is sold.

3—Tax-Free Distributions Bucket assets are purchased with after tax dollars. As the asset grows in value, its growth is tax deferred. Distributions from these assets are generally income tax free.

Financial vehicles that are most often in this bucket are municipal bonds, Roth IRAs and cash value life insurance policies. Unfortunately, only the interest paid on municipal bonds is income tax free. Any growth in the underlying value of the bonds is subject to capital gains tax when the bond is sold. Also, annual contributions to a Roth IRA are limited to $3,000 (a $500 catch-up contribution is possible for those over age 50). And life insurance is only available to those whose health is good enough to pass through the underwriting process.

4—Tax Qualified Accounts Bucket holds IRAs and other tax qualified plans people fund through their work. It is the only bucket in which contributions are pre-tax. Sometimes the employer will contribute extra dollars to the account by "matching" part of the employees' contributions. The tax-free contributions from both the employee and employer grow tax deferred.

Unfortunately, all distributions from the account are taxed as ordinary income. Interestingly, income taxes are assessed even though the account loses money. Every dollar in this bucket will be subject

to ordinary income taxes regardless of investment performance.

Most Retirement Assets Are In Tax Qualified Accounts

Knowledge is power in retirement planning. It is important to know which retirement bucket(s) we are using. Armed with that knowledge, we can analyze the income tax impact when we convert retirement assets into spendable cash. We can then determine if we are likely to have enough net retirement income. If the analysis indicates a shortfall, then it may make sense to rearrange retirement savings dollars into different buckets.

Most retirees have been taught to save for retirement in the tax qualified accounts of Bucket 4. Although there may be some miscellaneous assets in the other three buckets, the financial reality is that most of us concentrate the majority of our retirement investments in tax qualified accounts.

In addition to having heavily taxed distributions, the tax qualified accounts of Bucket 4 have some other limitations. These accounts are heavily regulated. Many complex rules govern the administration of these accounts. These rules include:

- Limitations on the amount that can be contributed annually.
- Vesting rules for the account balance.
- Tax penalties can be triggered if funds are withdrawn prior to age 59 1/2.
- Tax penalties can be triggered by not taking large enough withdrawals after age 70 1/2.
- Investment options are limited to those allowed by the plan.
- Limitations on beneficiary selection.
- Borrowing against the account balance is limited.
- Balance at death may be subject to estate taxes because the account is part of the taxable estate.
- Distributions to beneficiaries after death are also taxed as ordinary income.

Opportunities in Bucket 3

Of the three buckets that are built with after-tax contributions, Bucket 3 is potentially the most valuable, because it offers both tax deferred growth and tax free distributions. Consequently, we should consider locating a substantial portion of our other retirement investments in Roth IRAs, municipal bonds or cash value life insurance. Roth IRAs are very attractive. Unfortunately, the maximum annual contribution to a Roth IRA is quite small: $3,000 per year for most people and an additional $500 catch-up amount for anyone over 50. With contribution limits this small, it may be difficult to build up a meaningful Roth IRA balance before retiring. With municipal bonds, only the interest is income tax free. If the bond is sold or redeemed, any growth in its capital value will be subject to capital gains taxes. So municipal bond interest is in Bucket 3, but its capital value is really in Bucket 1.

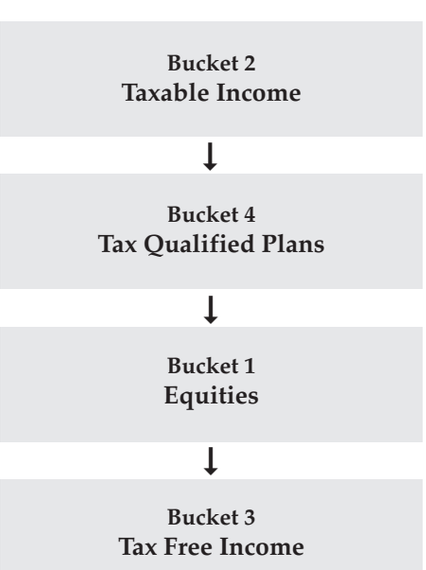
What about cash value life insurance as an option in Bucket 3? Many people don't initially consider life insurance as a retirement savings tool because they aren't familiar with its features or flexibility. Many cash value life insurance policies on the market today are surprisingly versatile financial tools. Here are some common features in today's retirement-friendly cash value life insurance policies:

- No limit on contributions (however, the policy should not become a MEC).
- Contributions vary from year to year and may even be skipped in some years.
- Cash values grow income tax deferred.
- Distributions of cash values are not required.
- Cash values that are distributed can be income tax free through a combination of withdrawals and loans.
- Distributions do not trigger any income taxes on Social Security benefits.
- Death benefits can be paid out before death under certain conditions.
- Death benefits paid out to beneficiaries are also income tax free.

Which Buckets Should Be Emptied First?

Before we retire, we need to have a game plan for converting our retirement assets into spendable income. We should have retirement assets in at least two buckets so we have an element of income tax diversification. Our objectives should be (1) to continue tax-free growth for as long as possible and (2) to convert the investments subject to the highest income tax rates to cash first. That will leave the lower taxed investments to continue to grow tax deferred. With this in mind, accessing retirement income buckets should be carried out in this sequence:

1. The Taxable Income Bucket (2) does not allow for tax deferred growth; therefore, it should be liquidated first. It may also be appropriated to those assets in Bucket 3 to take advantage of tax deferred growth and tax free distributions.
2. Distributions from the Tax Qualified Account Bucket (4) are taxed at the highest tax rate of all distributions; therefore, they should be the next assets liquidated to create spendable income.
3. The Equities Bucket (1) generally has the next highest tax rate; after Bucket 4 is empty, convert assets in this bucket to cash, as needed, for spendable income.
4. The Tax Free Income Bucket (3) should be the last bucket remaining. Its ability to deliver both tax-deferred growth and tax free distributions makes it the most valuable of the buckets. After Bucket 1 is empty, begin converting this bucket into spendable income.



What about the Funds That Are Left Over?

Our biggest concern in retirement planning is running out of money while we're still alive. If we do a good job of investing and distributing, that won't happen. Most of us will plan conservatively. We would rather die with money left over than be broke before we die. If we are smart, we will build a "cushion" into our plan to minimize the chance that we will outlive our assets. Since it is quite possible that we won't use up all our retirement assets, we should also consider what assets are the best ones to pass along to our spouse, children or grandchildren.

Which retirement assets would make the most sense for them to inherit? Financially, it probably makes the most sense for them to inherit the death benefits from a life insurance policy. This is true for four reasons: (1) there are no income taxes on life insurance death benefits; (2) these death benefits have additional investment growth built into them (the death benefits will always exceed the policy premiums); (3) there are no transaction costs or fees that will reduce the size of the death benefits (no broker's fees or institution costs); and (4) in many states life insurance death benefits are protected against claims from a beneficiary's creditors.

Conclusion

Most of us are focusing too much attention on the accumulation stage of retirement and forgetting about the distribution stage. It's important to save and invest so we can accumulate a reasonable retirement nest egg, but it's also important to diversify our investments to minimize taxes and maximize net spendable retirement income. Taxes on our retirement investments are inevitable. Through income tax diversification we can minimize these taxes and maximize what we will have to live on. Consciously positioning our retirement investments with an eye on how they will be taxed when they are converted into spendable income is critical in retirement planning.

Blindly accumulating retirement assets in the tax-qualified accounts of Bucket 4 can be a costly mistake. Those who want to have the most income flexibility in retirement will diversify by positioning some of their investment assets in the Tax Free Income Bucket 3. Life insurance and Roth IRAs are the best assets in Bucket 3 for maximizing spendable income. When retirement is likely to last 20 to 30 years, income tax diversification is an important strategy for improving long term financial security. ❑

Reprinted from BROKER WORLD May 2004
Used with permission from Insurance Publications

www.brokerworldmag.com
Subscriptions $6/yr. 1-800-762-3387