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Embracing distribution planning with a tax-free strategy

Thought leadership paper

By David McKnight

Why Equitable commissioned this report on variable universal life (VUL) insurance

These days, Americans are worried about rising taxes and the effect that might have on their future. They need help figuring out ways to minimize taxes in retirement, so they can secure their financial well-being, pursue life's possibilities and prepare for life's uncertainties.

At Equitable, we believe in helping our clients face the future with courage, strength and wisdom. To do this, we strive to provide educational opportunities and explore different perspectives by engaging with experts within our industry and beyond. This report was written by David McKnight, a thought leader on financial and tax planning for financial professionals, and our clients. We hope you find it helpful and informative.

David McKnight graduated from Brigham Young University with Honors in 1997. He has been featured in *Forbes, USA Today, The New York Times,* Fox Business, Bloomberg Radio, MarketWatch, CBS Radio, CNBC, Yahoo Finance, Nasdaq.com, *Reuters, Investor's Business Daily, Kiplinger's* and numerous other national publications. David was a focus speaker at the worldwide annual meeting of MDRT in 2013 and 2021 and is a multiple Top of the Table qualifier. He is a renowned author of the bestselling book *The Power of Zero*. His follow-up book, *Tax-Free Income for Life,* launched in November 2020.

Abstract: Rising national debt driven by unfunded obligations for Social Security and Medicare, and more recently COVID-19, are forcing Americans to reevaluate the types of accounts within which to save for retirement. With all signs pointing toward higher income tax rates in the next 10 years, pre-retirees are shifting their focus away from traditional tax-deferred approaches like 401(k)s and IRAs, and toward tax-free alternatives like Roth IRAs and Roth 401(k)s.[1] And while these traditional alternatives can be an important part of a balanced tax-free strategy, they do have limitations, particularly for high-earning Americans. Increasingly, these high earners are incorporating a new strategy into their stable of tax-free alternatives: variable universal life (VUL). Not only does VUL allow for substantial tax-deferred accumulation, its death benefit feature provides protection against premature death. This paper will show how the VUL can be a dynamic facet of a balanced approach to mitigating tax rate risk in retirement.

1 washingtonpost.com/business/personal-finance/millennials-are-racking-up-retirement-savings-in-roth-iras/2020/02/14/7f6de960-4eac-11ea-9b5c-eac5b16dafaa_story.html

The prospect of rising tax rates

The comptroller general of the United States, David M. Walker, wrote a widely read op-ed in 2009 in which he grimly predicted that the United States would have to double its tax rates, or risk going broke as a nation.[2] Due to a demographic glitch known as the Baby Boom, the United States would soon need huge infusions of cash to pay for promised entitlement programs, such as Social Security, Medicare and Medicaid. Over the next 12 years, however, the federal government did not increase tax rates — they simply borrowed money. As a result, our nation's debt-to-GDP ratio has soared to levels unseen since World War II.[3]

Dialogue on how to bridge our country's fiscal gap has continued to be a subject of debate. Consider the study done by the Committee for a Responsible Federal Budget. They concluded that if every American paid an effective 40% tax rate on all income earned above $50,000, the growth of our national debt would stabilize at $1 trillion per year.[4] The study's conclusions were clear: to solve our country's fiscal problems, the federal government may soon have to raise taxes on virtually all American taxpayers.

Saving for retirement in the face of higher taxes

The threat of higher taxes is particularly relevant to Americans who are evaluating the types of accounts within which to save money for retirement. Currently, 94% of all retirement balances in America are situated in tax-deferred vehicles such as 401(k)s and IRAs.[5] Absent proactive planning, the vast majority of Americans could be forced to pay tax on their retirement assets at a time when tax rates are likely to be higher, dramatically reducing their net after-tax spendable income. Building a strategy that safeguards against higher taxes requires an understanding of the basic types of accounts within which to accumulate savings as well as their tax treatment upon distribution. The process of strategically allocating dollars within these accounts in order to maximize after-tax distributions at retirement is known as distribution planning.

2 edition.cnn.com/2009/POLITICS/04/15/walker.tax.debt/
3 visualcapitalist.com/timeline-150-years-of-u-s-national-debt/?fbclid=IwAR3gA6jC7NJkI2QZT8kDUSTIkrd8szjNOkF2OI8DqOGV6X0OaP-R6_eUurg
4 crfb.org/blogs/can-we-fix-debt-solely-taxing-top-1-percent
5 ici.org/system/files/attachments/pdf/2022_factbook.pdf

The three investment buckets

At the heart of distribution planning is a basic understanding of the three types of accounts within which money can be saved: taxable, tax-deferred and tax-free. For the purposes of this paper, I will refer to these accounts as buckets of money. What follows is an analysis of each bucket along with ideal funding levels in a rising tax rate environment.

1 The taxable buckets

Within the taxable bucket, the IRS requires you to pay taxes on the growth of your investments each and every year. These are the least efficient of all investments from a tax perspective but tend to be very liquid and should be used primarily for emergency funds and short-term savings goals (down payment for home, wedding expenses, etc.). Common examples include savings accounts, money markets, CDs and bonds.

Ideal balance: In its function as an emergency fund, it should hold no more than 6 months' worth of basic living expenses in addition to what might be required to meet short-term savings goals.

2 The tax-deferred bucket

Tax-deferred investments are the retirement accounts with which many Americans may be most familiar. You make tax-deductible contributions at the outset and pay taxes at ordinary income rates on all distributions. These accounts make sense if you plan on being in a lower tax bracket in retirement. Common examples of tax-deferred investments include 401(k)s, IRAs, 403(b)s, etc.

Ideal balance: It is important to have some money in tax-deferred investments because when you retire, you'll be able to take distributions up to your standard deduction ($27,700 in 2023) without paying any tax at all. Ideally, you may want your tax-deferred balances to be low enough that they produce required minimum distributions (RMD) at age 72 that are equal to or less than your standard deduction at the time. You may also want your balance to be low enough that it doesn't cause Social Security taxation (more on that in the next section). If you don't have any other sources of income in retirement (pension, rental income, etc.), the ideal balance in this bucket for a married couple filing jointly is around $350,000. This would create an RMD small enough that it would be fully offset by the standard deduction while keeping provisional income low enough that Social Security would be free from taxation. The ideal balance for single filers is half that amount.

3 Tax-free bucket

With tax-free investments, you contribute after-tax dollars and take tax-free distributions. True tax-free investments fit the following criteria:

- You don't pay state tax, federal tax or capital gains tax upon distribution.
- Distributions don't count as provisional income and therefore don't count against the thresholds that cause Social Security taxation. Provisional income thresholds are as follows:

Joint provisional income for married couples

Provisional income	Percent of Social Security subject to tax
Under $32,000	0%
$32,000 to $44,000	Up to 50%
Over $44,000	Up to 85%

Provisional income for single or head of household

Provisional income	Percent of Social Security subject to tax
Under $25,000	0%
$25,000 to $34,000	Up to 50%
Over $34,000	Up to 85%

Ideal balance: Anything above and beyond the ideal balances in your taxable and tax-deferred buckets should be considered for systematic repositioning to your tax-free bucket.

Tax-free retirement alternatives

In a period of high tax rates, the lion's share of your retirement savings should be positioned in tax-free instruments. By evaluating the pros and cons of each of the available tax-free alternatives, you can craft a flexible retirement strategy that maximizes their benefits while minimizing their drawbacks. What follows is a discussion of the tax-free alternatives that should be considered as you build out your tax-free distribution plan.

Roth IRA

Roth IRAs are attractive tax-free alternatives because they give you full liquidity on all contributions from day one.[6] That means the Roth IRA can also double as an emergency fund. Note that any distributions taken above and beyond your principal prior to owner age 59½ are subject to taxes and a 10% IRS penalty.

While Roth IRAs do grant you a measure of liquidity, contributions are restricted to $6,500 per person for those under age 50 and $7,500 per person for those 50 and above. Furthermore, contribution limits are gradually phased out as your income reaches certain thresholds. Single filers get phased out between $138,000 and $153,000 of modified adjusted gross income (MAGI) while those married filing jointly are phased out between $218,000 and $228,000 of MAGI. So, for notwithstanding the Roth IRA's tax-free benefits, certain high-earners may not qualify.

Roth 401(k)

The Roth 401(k) has the same liquidity features as the Roth IRA, only with greater contribution limits. Those under 50 can contribute $22,500 per year while those 50 and above can contribute an additional $7,500. As with the Roth IRA, contributions can be distributed tax- and penalty-free at any time.

Similar to the Roth IRA, any distributions taken above and beyond your principal prior to age 59½ are subject to taxes and a 10% penalty. Furthermore, unlike the Roth IRA, you will be required to take RMDs at age 72.

6 investopedia.com/articles/personal-finance/040714/how-use-your-roth-ira-emergency-fund.asp

Roth conversions

Roth conversions can be powerful tax-free retirement tools because they permit you to transfer unlimited dollars from either your IRA or 401(k) to a Roth IRA or Roth 401(k). And, unlike the Roth IRA, there are no income limits on Roth conversions. The only requirement is that you be willing to pay the taxes in the year in which you make the conversion.

The process of paying taxes on a Roth conversion, however, can be tricky, particularly if you're younger than 59½. If you undertake a Roth conversion prior to 59½, you must have enough money in your liquid taxable investments with which to pay the tax. If you attempt to pay the tax out of the conversion itself, you'll be hit with a 10% penalty. If you don't have the liquid taxable savings necessary to pay the taxes on a Roth conversion, you'll have to hold off until 59½. And, by postponing this tax payment decision, you expose yourself to the risk of higher taxes.

Cash value life insurance

A cash value life insurance policy provides potentially tax-free cash value accumulation while still providing an income tax-free death benefit to the insured's beneficiary. Unlike a Roth IRA, a life insurance policy has no contribution limits or income limitations. Keep in mind that, while contributions apply to a Roth IRA, contributions to a life insurance policy are called premiums. Furthermore, there are no taxes or penalties on distributions made prior to age 59½ so long as those distributions are made by way of a tax-free loan.[7] Lastly, when key features of these policies were changed by the federal government in 1982, 1984 and 1988, policies already inforce were grandfathered under the old rules.

The government grants you all of these benefits with a proviso: you must have a need for life insurance and a willingness to pay for the associated mortality costs as well as other expenses. Here's the good news: if you have a spouse or children, you may have already budgeted for the cost of term life insurance. In that case, it could make sense to recapture those term insurance premiums, redirect them to your cash value life insurance policy, then take advantage of potentially tax-free cash value accumulation that wasn't previously available to you.

7 Under current federal tax rules, you may generally take federal income tax-free withdrawals up to your basis (total premiums paid) in the policy or loans from a life insurance policy that is not a Modified Endowment Contract (MEC). A MEC is a life insurance policy in which cumulative premium payments exceed IRS guidelines resulting in adverse tax consequences to the owner of the policy. Certain exceptions may apply for partial withdrawals during the policy's first 15 years. If the policy is a MEC, all distributions (withdrawals or loans) are taxed as ordinary income to the extent of gain in the policy, and may also be subject to an additional 10% premature distribution penalty prior to age 59½, unless certain exceptions are applicable. Loans and partial withdrawals will decrease the death benefit and cash value of your life insurance policy, and may be subject to policy limitations and income tax. In addition, loans and partial withdrawals may cause certain policy benefits or riders to become unavailable, and may increase the chance your policy may lapse. If the policy lapses, is surrendered or becomes a MEC, the loan balance at such time would generally be viewed as distributed and taxable under the general rules for distribution of policy cash values.

Variable universal life

Once you've determined that cash value life insurance can play a role in your tax-free retirement plan, you must then elect a strategy to grow your cash value. This can generally be done in one of two ways. The first is to offload the risk to an insurance company who invests it in its general portfolio. This approach can produce modest but more predictable returns and is primarily suited to investors age 55 and over.

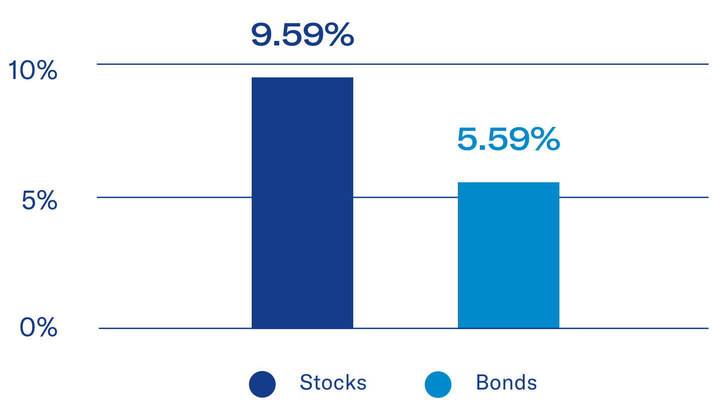
The second way of growing cash values is to assume the investment risk yourself, just like you might in your 401(k) or IRA. This is done by passing premiums through the insurance company into investment portfolios called subaccounts. This type of insurance policy is known as VUL. This approach may be suited to high income earners between ages 30 and 55 with a higher risk tolerance. Keep in mind that with this alternative, there must be a primary need for life insurance coverage.

Please remember, there is investment risk with VUL, including the possible loss of principal invested. Additionally, there are fees and charges associated with variable life insurance contracts, including mortality and risk charges, administrative fees, investment management fees, premium charges, front-end load, surrender charges and charges for optional riders.

Risk tolerance

Many investors between the ages of 30 and 55 who have a need for life insurance coverage tend to gravitate toward the VUL because of their higher risk tolerances and longer investment horizons. As the chart below demonstrates, stock portfolios have proven far more productive since The Great Depression than an equivalent investment in bonds.[8] Of course, past performance is not indicative of future results.

Stock and bond performance since the Great Depression[9]



8 mindfullyinvesting.com/articles/6-what-to-invest-in/6-1-historical-returns-and-risks/
9 forbes.com/advisor/investing/stock-and-bond-returns/

Investors with mid- to long-term investment horizons may prefer the VUL approach. To understand why, consider the following example:

A 35-year-old investor wants to contribute $6,500 to a Roth IRA but has been phased out due to income limitations. She's confident that a stock-heavy mutual fund allocation within that Roth IRA would have averaged 8% per year. By directing that $6,500 to a VUL policy instead, she can invest in the investment portfolios of the variable life insurance where she can allocate her premiums to subaccounts that have a similar risk profile.

If she instead contributes that $6,500 to a life policy that invests her money in an insurance company's general portfolio, her potentially lower rate of return could be much closer to the after-tax rate of return of a tax-deferred account growing at 8%. As a result, she has potentially counteracted the tax benefits that justified her purchase of the policy to begin with.

Case study

To better understand how a VUL might fit into a balanced tax-free retirement strategy, consider the following case study involving Jack and Greta Smith.

Their financial profile is as follows:

Meet Jack and Greta

Early 40s with three children
Retirement age of 65

Jack is 45 with an income of $350,000 and Greta is 43 with an income of $80,000. They have three children ages 12, 9 and 6, and are concerned about the future of tax rates.

Taxable bucket	Tax-deferred bucket	Tax-free bucket
Mutual funds: $200,000 (Contributing $60,000/yr)	Jack's SEP IRA: $800,000 (Contributing $35,000/yr)	Greta's Roth 401(k): $80,000 (Contributing $4,000/yr)

Recommendation

Jack is self-employed and does not have access to a Roth 401(k) and the Smiths' modified adjusted gross income far exceeds Roth IRA income limits. The VUL's $1 million death benefit will help protect Jack's family against the risk of his premature death. He may therefore consider a VUL with a death benefit of $1 million (we assume this is the minimum death benefit required by the IRS in order to contribute $35,000 per year for 20 years).[10]

Should there be a rising tax rate environment, Jack already has a balance in his SEP plan that exceeds the ideal balance for a tax-deferred investment. Remember, we want the balance in their tax-deferred bucket to be low enough that RMDs are equal to or less than their standard deduction, but also low enough that it doesn't cause Social Security taxation. As mentioned previously, that balance is around $350,000 for a married couple. Once Jack retires, he should consider rolling his SEP into an IRA. He could then convert his IRA to the point where his remaining balance produces an RMD at age 72 that is offset by his standard deduction, while keeping his provisional income levels low enough that he avoids Social Security taxation.

Greta currently contributes $4,000 per year to her Roth 401(k), far below the annual maximum of $22,500. She should consider recapturing an additional $18,500 from their $60,000 annual contributions to their taxable mutual funds and directing it to her Roth 401(k).

If Jack and Greta follow this course, they will receive the following streams of tax-free income in retirement:

Jack's VUL	Potentially **tax-free**
Greta's Roth 401(k)	**tax-free**
Jack's IRA (distributions up to standard deductions in retirement)	**tax-free**
Jack's Roth IRA	**tax-free**
Social Security (assuming provisional income levels are low enough)	**tax-free**

These five streams of tax-free income put the Smiths in the 0% tax bracket, effectively shielding them from the threat of higher taxes. Why? Because if tax rates double, as David Walker predicts, two times zero is still zero.

10 At a 0% rate and guaranteed charges, the policy would lapse at Jack's age 80.

A balanced and flexible approach to tax-free retirement

Given the possibility of higher tax rates, it's worth considering tax-free alternatives in addition to tax-deferred investments like 401(k)s or IRAs. In a rising tax rate environment, we must approach retirement planning with an eye toward maximizing tax-free income. This is accomplished through a strategy known as distribution planning, which involves accumulating the mathematically ideal amount of money in each of your three investment buckets. As a reminder, your taxable bucket should have 6 months' worth of basic living expenses in addition to what may be required to meet any short-term savings goals. Your tax-deferred bucket should have a balance that produces an RMD equal to or less than your standard deduction while also remaining low enough that it doesn't cause Social Security taxation. If you have satisfied the ideal balances in these buckets, any additional retirement savings should be directed to your tax-free bucket. Roth IRAs and Roth 401(k)s are important sources of tax-free income, however they have limits, including income limitations, contribution limits, taxes and penalties prior to age 59½, and forced RMDs at 72.

A VUL insurance policy may help plug significant gaps in your tax-free accumulation strategy because of your ability to access a portion of your cash value through loans and withdrawals and lack of income or contribution limits. Furthermore, the VUL provides an income tax-free death benefit feature that affords your loved ones crucial protection against the risk of your premature death.

Under current federal tax rules, you may generally take federal income tax-free withdrawals up to your basis (total premiums paid) in the policy or loans from a life insurance policy that is not a Modified Endowment Contract (MEC). A MEC is a life insurance policy in which cumulative premium payments exceed IRS guidelines resulting in adverse tax consequences to the owner of the policy. Certain exceptions may apply for partial withdrawals during the policy's first 15 years. If the policy is a MEC, all distributions (withdrawals or loans) are taxed as ordinary income to the extent of gain in the policy, and may also be subject to an additional 10% premature distribution penalty prior to age 59½, unless certain exceptions are applicable. Loans and partial withdrawals will decrease the death benefit and cash value of your life insurance policy, and may be subject to policy limitations and income tax. In addition, loans and partial withdrawals may cause certain policy benefits or riders to become unavailable, and may increase the chance your policy may lapse. If the policy lapses, is surrendered or becomes a MEC, the loan balance at such time would generally be viewed as distributed and taxable under the general rules for distribution of policy cash values.

Things to think about before moving ahead:

While there are similarities between a Roth IRA and cash value life insurance, there are also differences. A Roth IRA is an IRS plan designed to facilitate retirement savings. Cash value life insurance is a contract that builds value and provides a death benefit backed by the claims-paying abilities of the issuing life insurance company. Carefully review all the features, benefits and costs of a cash value life insurance policy with your financial professional before making a purchase.

- **If your life insurance policy lapses, you will lose the death benefit and may lose substantial money in the early years.**
- **To be effective, you need to hold the policy until death. A life insurance policy generally takes years to build up a substantial cash value.**
- **Tax-free distributions will reduce the cash value and face amount of the policy. You may need to pay higher premiums in the later years to keep the policy from lapsing.**
- **You must qualify medically and financially for life insurance, unlike a Roth IRA.**

A variable universal life insurance policy is sold by prospectus only which contains complete information on investment objectives, fees charges and expenses. Please read the prospectus carefully and contact your financial professional for a copy of the current prospectus.

David McKnight is neither an employee nor affiliated with Equitable. Equitable commissioned and provided remuneration for this white paper. The opinions expressed are solely his own and do not necessarily reflect those of Equitable.

Generally, there are additional charges associated with a variable life insurance policy, including, but not limited to, a front-end load, administrative fees, mortality and expense risk charges, investment management fees, cost of insurance charges, premium charges, charges for optional benefits selected and potential surrender charges.

A life insurance policy is backed solely by the claims-paying ability of the issuing life insurance company. It is not backed by the broker/dealer or insurance agency through which the life insurance policy is purchased or by any affiliates of those entities, and none makes any representations or guarantees regarding the claims-paying ability of the issuing life insurance company.

A variable universal life insurance contract is a contract with the primary purpose of providing a death benefit. It is also a long-term financial investment that can also allow potential accumulation of assets through customized, professionally managed investment portfolios. These portfolios are closely managed in order to satisfy stated investment objectives. There are fees and charges associated with variable life insurance contracts, including mortality and risk charges, administrative fees, investment management fees, front-end load, surrender charges and charges for optional riders.

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