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Asset location

A new lever in strategic retirement saving to reduce taxable income.

Executive summary

Today more than ever, Americans of every age and income need insights and guidance on a retirement savings strategy and maximizing retirement income. In addition to current economic concerns:

- Many pre-retirees overestimate the power of Social Security or a pension to replace or supplement their retirement income, and
- Popular wisdom that healthcare costs will be the biggest concern in retirement may divert focus from a more impactful out-of-pocket expense: taxes. Many pre-retirees believe taxes in retirement are beyond their control when, in fact, actions can be taken at every life stage to reduce taxes in retirement.
- Ninety percent of retirement savings nationwide are accumulating without consumers understanding the impact that taxability — or asset location — of their savings will have on their spending power and lifestyle in retirement.

Insight into the power of asset location is a crucial value-add to any prudent retirement financial plan.

Retirement today

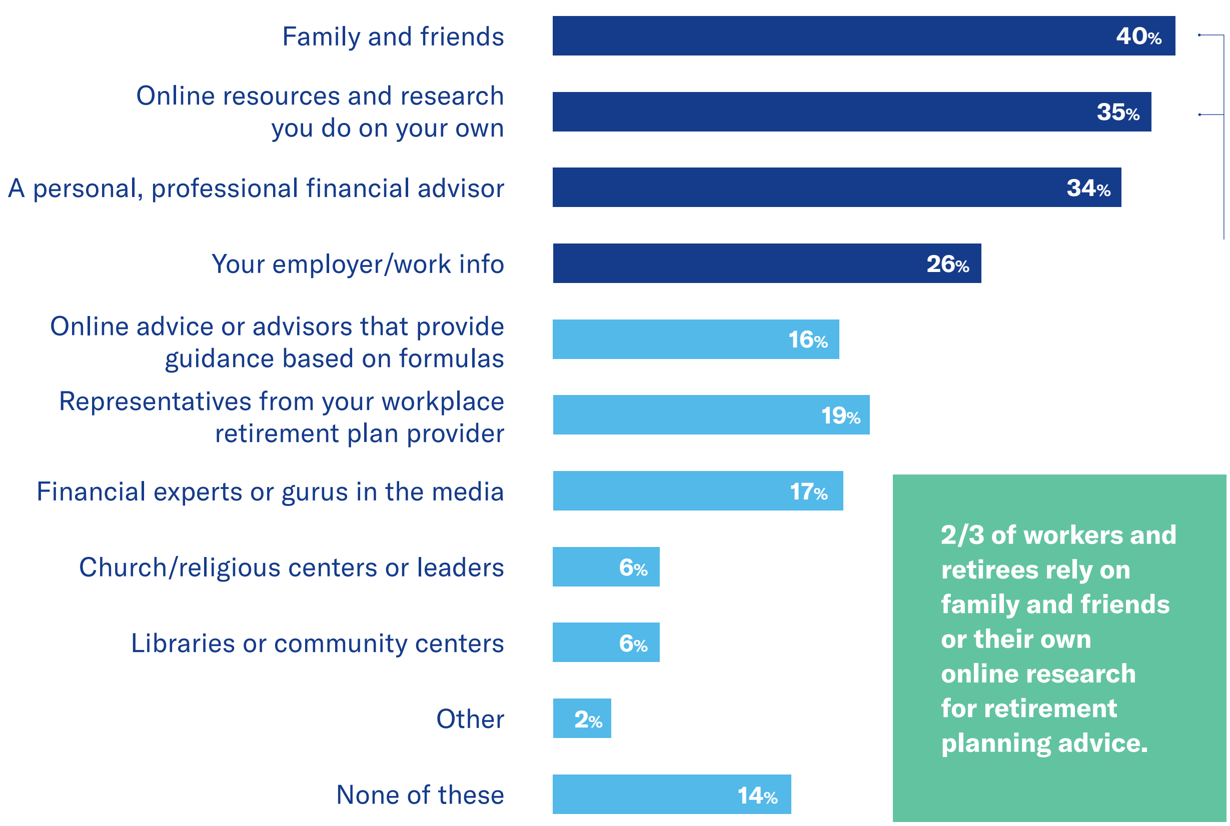
Attitudes and outcomes

Many American retirement savers have been unsettled by recent events and accompanying financial challenges. In a 2023 Retirement Confidence Survey, 29% of workers and 42% of retirees say the events of the last two years have made them somewhat or significantly less confident they will have enough to live comfortably throughout retirement. Four in 10 workers say these events have negatively affected their ability to save for retirement and one-half report that debt has negatively impacted their ability to save for retirement.[1]

Simultaneously, both workers and retirees exhibit confusion about sources of retirement income. Two thirds rely on family/friends or their own online research vs. financial professionals for retirement planning advice, with only 34% citing a professional financial advisor as a source.[1] These trends increase the likelihood that savers' decisions may be made based on dated information and that fresh insights and practices, like asset location, will have low awareness.

Retirement planning advice

Which of the following people or groups do you use as a source of information for retirement planning?[1]



1 EBRI and Greenwald 2023.

2 EBRI and Greenwald 2023.

3 EBRI and Greenwald 2023, 2023 Workers n=1,507.

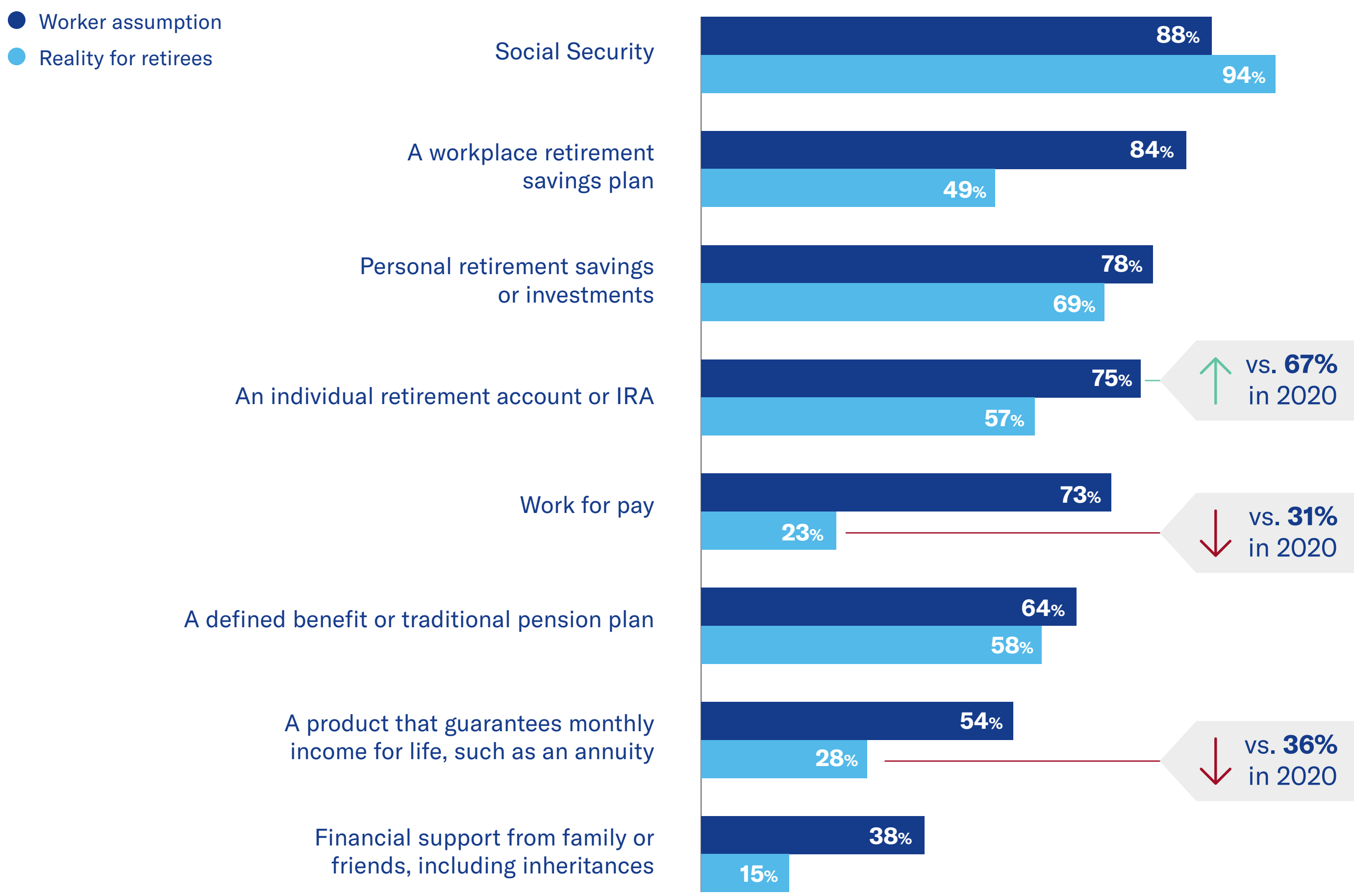
Sourcing retirement income

Assumption vs. reality

By 2030, the entire Baby Boom generation and one-fifth of the U.S. population will have reached the traditional retirement age of 65. **When the last of the Boomers entered the workplace around 1980, 60% of private sector employers offered a pension plan with protected lifetime income. In 2020, that number was just 4%.** As of 2021, six in 10 retirees rely on traditional pension plans as part of their retirement income. With that attrition, pension plans will be an income source for very few private sector workers in the future, and the need for clarity around workplace retirement savings plans and Social Security becomes increasingly important. Yet expectations voiced by workers and retirees about their sources and quantity of retirement income vs. their actual outcomes show dissonance and confusion.

One specific example, and opportunity for financial planners: **The share of surveyed retirees who say they receive income from a product that guarantees monthly income for life, such as an annuity, decreased from 36% in 2020 to 28% in 2023**. Yet half of workers state an expectation that this type of product will be a source of income in retirement.[4]

Net: Major/minor source of income in 2023



4 EBRI and Greenwald.

Likewise, there is a disconnect in pre-retirees' understanding of how retirement will occur, with many anticipating a gradual transition at age 65 in which work for pay will play a significant part. Reality: Median retirement age is 62 and only 19% of employees experience a gradual transition, with 73% reporting that retirement was a full-time stop. Sixty-eight percent expected work for pay to be at least a minor source of retirement income, but just 23% report that it is.

Top 5 sources of retirement income[5]

	Assumption	Reality
1	Social Security	Social Security
2	Workplace-defined contribution plan	Personal savings
3	Personal savings	Defined benefit pension
4	IRA	IRA
5	Work for pay	Workplace-defined contribution plan

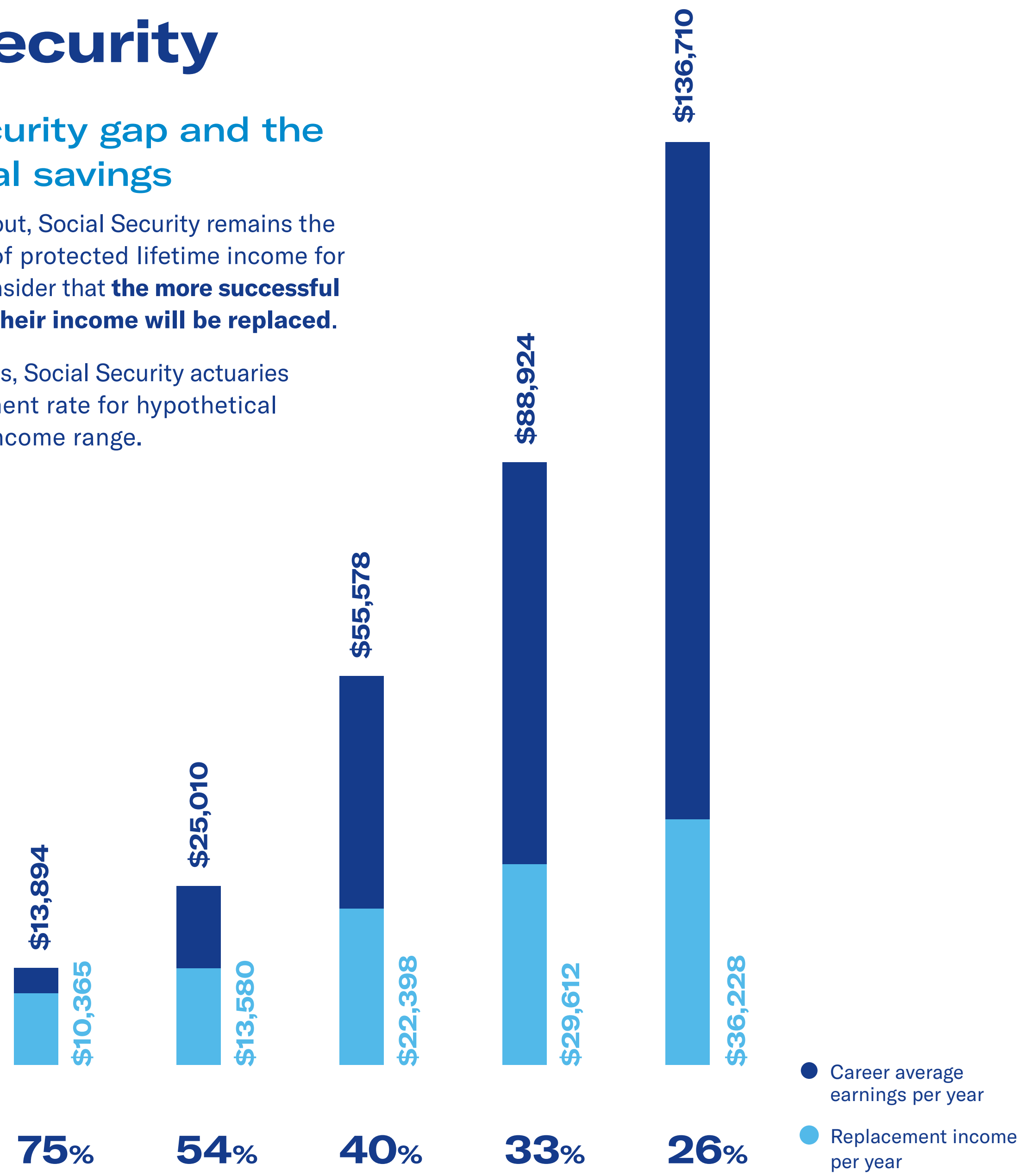
5 EBRI and Greenwald 2023.

Social Security

The Social Security gap and the role of personal savings

With the pension phase out, Social Security remains the #1 and the only source of protected lifetime income for many Americans. Yet, consider that **the more successful the earner, the less of their income will be replaced.**

In an August 2021 analysis, Social Security actuaries calculated the replacement rate for hypothetical retirees across a wide income range.



For workers who claim benefits in 2022 at the age of 66 and 4 months — the full retirement age for people born in 1956 — they found that the replacement rate would be:

Today's medium to high earner faces a reality in which Social Security will replace less of their earnings, and for whom taxes on personal savings will be a larger consideration, indicating a need for customized asset location solutions.

Three noble (un)certainties

In the post-pension era, workers have been guided by common wisdom we call the three noble (un)certainties of retirement income planning:

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1 "Max out tax-deferred savings"

Focus on and maximize **tax-deferred savings** through your employer (401(k), 403(b), or 457). If you have the means to save more and are within contribution limits, consider self-funded IRA accounts.

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2 "Healthcare costs will be the biggest expense in retirement"

Healthcare costs will be your biggest and most uncertain expense in retirement.

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3 "Tax brackets will drop in retirement"

Your tax bracket will be lower when it comes time to pay tax on 401(k), 403(b), or 457 and IRA savings in retirement.

We believe these (un)certainties deserve a fresh look...

1

(Un)certainty #1

Should I put all my retirement savings in tax-deferred investments?

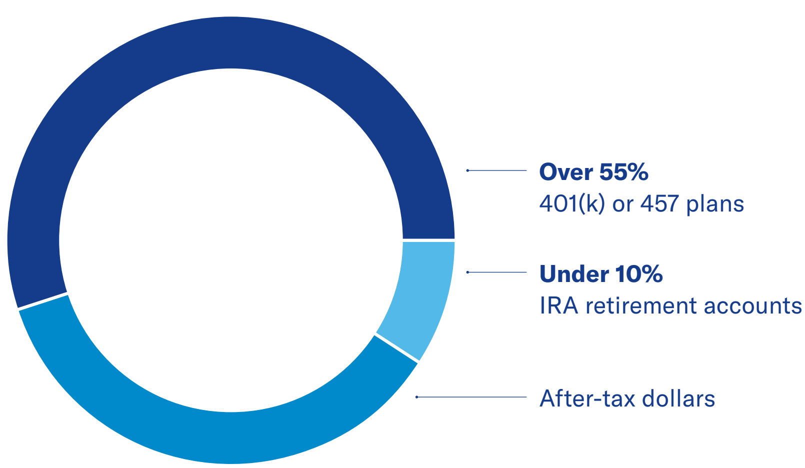
Many workers have dutifully embraced the advice to focus on tax-deferred retirement saving. More than half (55%) of non-retiree savings are held in tax-deferred 401(k), 403(b), or 457 retirement savings plans. An additional 36% are held in IRA retirement accounts which are also tax-deferred. Less than 10% of personal retirement savings are held in after-tax dollars.

Consumers are buoyed by the growth of their tax-deferred savings over time. However, in addition to the limitations on the eligibility and dollar contributions to these plans, these savers may find their real retirement income less than hoped, based on the reality of paying tax on virtually all the income they receive in retirement.

While tax-deferred investments are a key component of retirement savings, they alone may not provide the kind of income retirees need, especially when it becomes 100% taxable upon retirement.

For those who have the financial means after maxing out pre-tax contributions, additional taxable (or even tax-free) investments should be considered.

Workers have dutifully embraced the advice to focus on tax-deferred retirement saving.



2

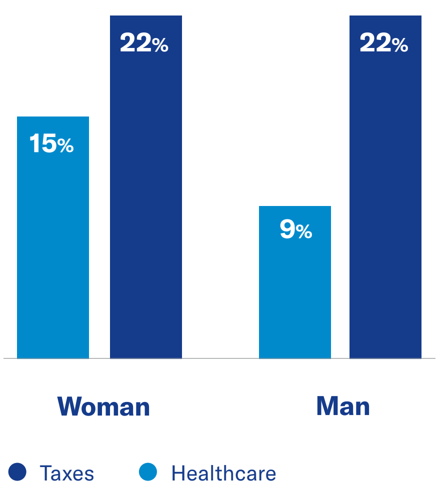
(Un)certainty #2

Will healthcare really be my biggest expense in retirement?

A 2017 study reported that the percentage of retirement income spent on healthcare **for men was 9%** and **for women was 15%** (difference based on disparity in Social Security income). These figures included both premium and out-of-pocket medical costs.[6]

Assuming this still holds true, **it may be taxes — and not healthcare —** that will likely be your highest expense in retirement.

Percentage of household income spent on taxes vs. healthcare



For example:

- A man earning $75,000 may pay $16,500 in taxes and $6,750 in healthcare costs.
- Likewise, a woman earning $50,000 will pay $11,000 in taxes, but $7,500 in healthcare costs.

The amount paid in taxes may be more than the average amount paid toward healthcare costs.

There is a potential solution, however:

Put asset location strategies in place now to create tax-deferred and tax-free retirement income sources later.

It will likely be taxes and not healthcare that will be your highest expense in retirement unless asset location strategies are proactively put in place to create tax-deferred and tax-free retirement income sources.

6 Forbes 2018.

3 (Un)certainty #1

Will my taxes really be lower when I retire?

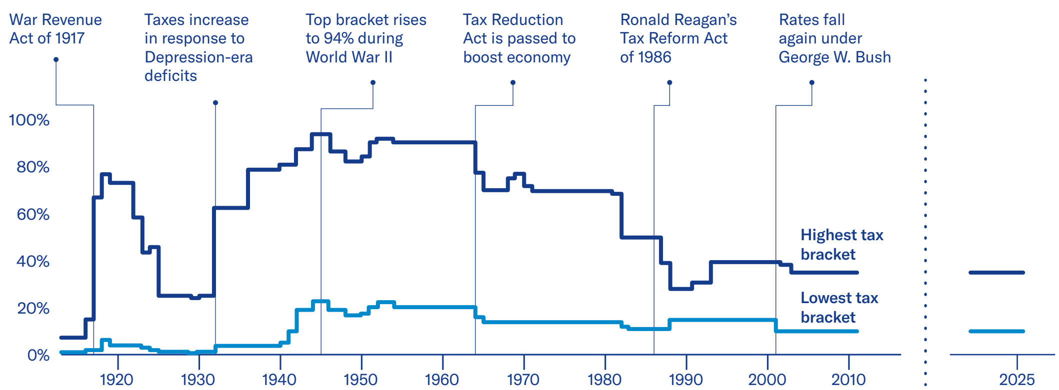
With over 90% of Americans' retirement savings held in pre-tax accounts, and the potential impact of taxes on retirement income, questioning the assumption that taxes will be lower in retirement becomes crucial to insightful planning. Based on demographics, recent economic events in the United States associated with the pandemic, and thought and policy leadership on many fronts, it appears unlikely.

Tax rates may change for everyone

The retirement of the Baby Boomers is a seismic demographic event which will require the federal government to fund Social Security, Medicare, and Medicaid at unprecedented levels. Bridging the gap between that outlay and current funding will require policy and budget changes, the most expeditious of which would be to increase taxes. Despite most consumers' impressions that tax rates are high today, they are at historical lows.

In addition to the impact of federally funded programs illustrated below, legislative events also suggest increased taxes are on the horizon. President Biden has proposed tax increases to fund infrastructure, but some of those hikes are poised to happen in any event. This is due to the way lawmakers structured the 2017 Tax Cuts and Jobs Act, which calls for the top marginal tax rate to increase to 39.6% from the current 37% in 2026.

Tax rates over the past century



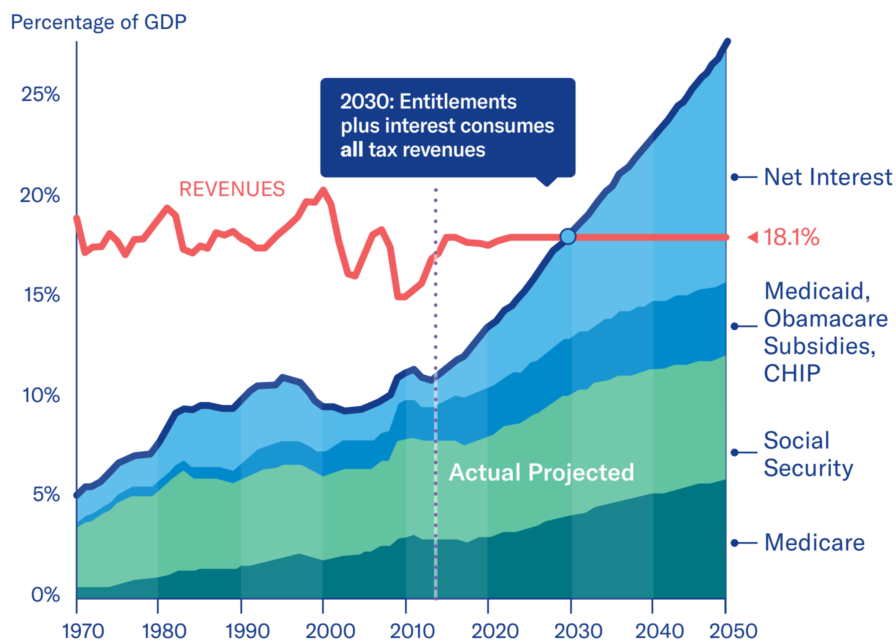
Source: Internal Revenue Service

We are already at a very low tax rate compared to taxes throughout history.

Recent tax rates represent a continuation of this trend with the lowest tax bracket at 10% and the highest at 37%.

Government entitlement program payouts will shortly exceed revenue from taxes — increasing the possibility that taxes, including taxes on retiree income, will increase in the future.

Entitlements on track to soon exceed tax revenues



Sources: Congressional Budget Office and Office of Management and Budget

Tax rates may change based on individual circumstances

In addition, many savers do not consider life changes that may affect tax rates in retirement. Losing a spouse could result in paying higher taxes as a single vs. married taxpayer. In addition, paying off a mortgage or not having dependent children may also increase your effective tax rate. A young working family with children will more often have a lower effective tax rate than a retired individual or couple.

The rising cost of Medicare, Social Security, Medicaid, the Affordable Care Act, and interest all drive up the U.S. GDP. Revenues are not rising at an equal rate, but they could with an increase in taxes.

Asset location

Tax-smart retirement saving

We all acknowledge the power of asset allocation, of diversifying investments across a variety of asset classes to manage market volatility and protect against risk.

Yet even with the most vigilant allocation and rebalancing of portfolios, whether it be 80/20, 60/40, or 50/50 stocks/bonds, investors may still fall short of generating the income needed in retirement. Often overlooked are smart tax strategies that can help reduce the potential shortfall.

Asset location. The taxable status of the assets that generate income in retirement is equally important. If, like the average American, 90% of retirement assets are held in tax-deferred 401(k) 403(b), or 457 and IRA accounts, a retiree's income will be 100% taxable — possibly at a higher tax rate than a pre-retiree saver would pay today.

Here are a few more general examples to show how asset location can make a significant difference in what you get to keep:

A retiree with $1.5 million in retirement assets at age 65, growing at a 5% return, can expect a difference of more than $30,000 in annual income in retirement, depending on the tax position of their savings.

While the best retirement plans informed by asset location hold a mix of all three categories, needs will vary by individual.

Tax-deferred

100% in 401(k), 403(b), or 457 and IRA funds at 65, lasting 25 years:

$71,000/yr.
after tax

Taxable

100% in brokerage account at 50% basis, lasting 25 years:

$90,000/yr.
after tax

Tax-free

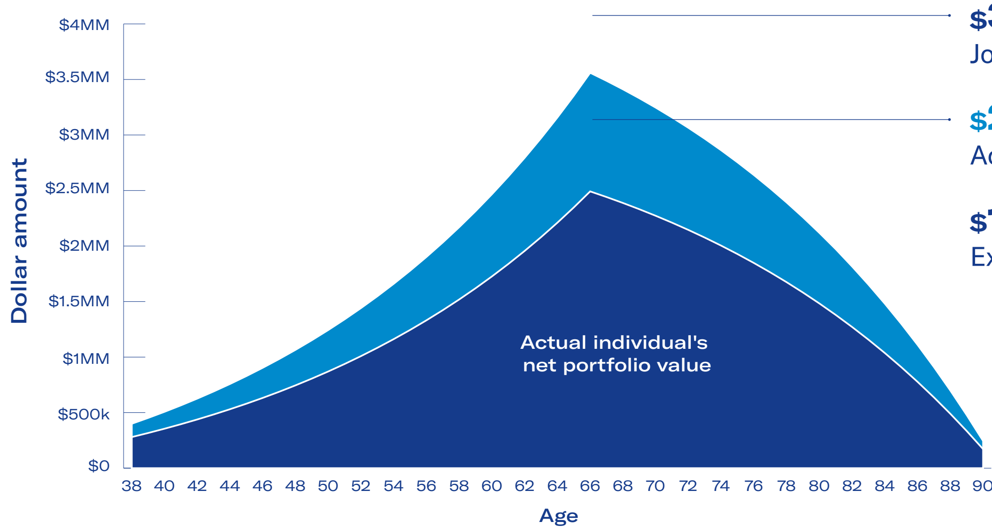
100% in tax-free Roth, lasting 25 years:

$101,000/yr.
after tax

How much difference can asset location make?

To illustrate the very real impact of asset location on what retirees get to keep and spend of their retirement savings, consider this example of how the tax position of the savings sources being tapped for retirement income can vary retirement income and lifestyle:

What you earn isn't always what you keep



At retirement age 65:

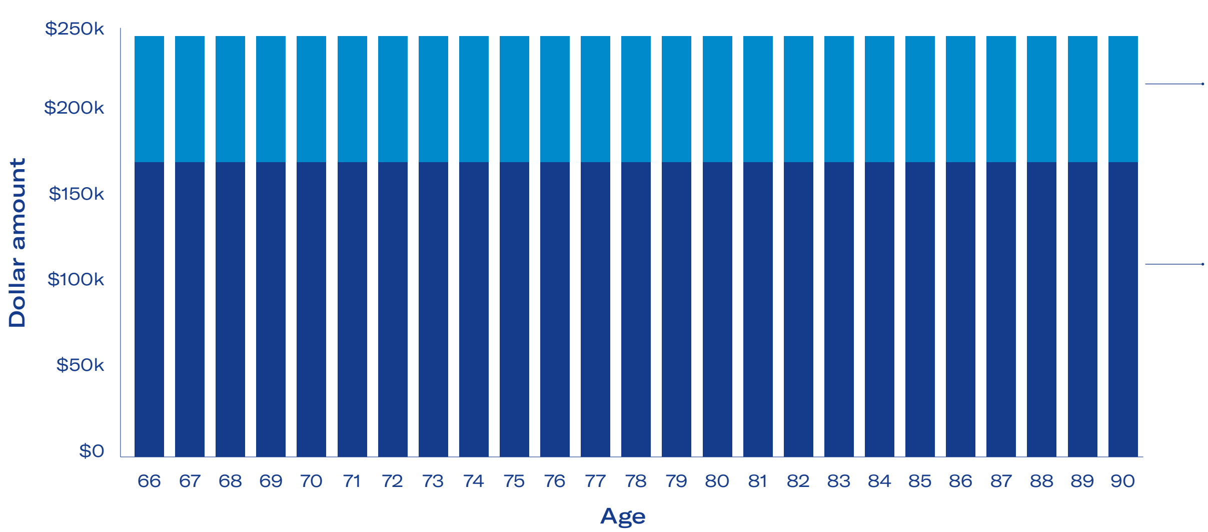
$3,560,174
Joe's total portfolio value

$2,492,121
Actual net portfolio value

$1,068,052
Expected tax liability on portfolio

Joe, a 37-year-old engineer, contributes $22,500 per year pre-tax to his 401(k) and gets a $7,500 company match each year until he retires at age 65. Both pre- and post-retirement, his portfolio grows at 6%.

If we assume Joe's tax liability at any point in time is 30% (both on portfolio value and distributions), his gross annual income will be $245,063 until his 401(k) is depleted at age 90. However, after taxes, **Joe will only get to keep $171,544 of that in his pocket, and $73,519 will go to taxes**.



Ages 66-90:

$73,519
Estimated annual tax liability

$171,544
Net annual distribution

Asset location solutions

Building an asset location strategy that safeguards retirement portfolios against tax exposure requires an understanding of the account types within which to accumulate savings, and their tax treatment upon distribution.

Tax-deferred income

401(k)s, 403(b)s, 457s, and other qualified plans; traditional IRAs; Social Security; annuities

Pre-tax dollars — fully taxable as ordinary income at distribution

Taxable income

Brokerage accounts, savings, money market, all 1099 income

Savings are taxed as they are accumulated in after-tax dollars

Tax-free distributions

Roth IRAs and Roth 401(k)s, municipal bonds, cash value life insurance, variable universal life

Distributions are tax-free in retirement

Taxable vs. tax-deferred calculator

For more specific insight into the tax status of savings and investments, Equitable has provided a calculator handy for illustrating impacts:

equitable.com/tax-strategies/tax-calculators/compare-taxable

Tax considerations and asset location solutions by life stage

Taxes are an important part of our financial planning at every life stage. As investors progress through their financial life stages, knowing which tax strategies are available based on age, income, and expectations is important. Here are some options to consider.

Profiles

Starting out
Age <35

Work-life balancers
Age 35-52

Pre-retirees
Age 53-64

Early and mature retirees
Age 65-80+

Tax and asset considerations by life stage

Starting out
Age <35

Profiles

- **A mix of Gen Z and Millennials,** just starting out on their own
- Use employer-sponsored retirement plans
- Balancing financial obligations and debt with saving for the long term

Considerations

- Balancing savings with current financial concerns around debt and establishing households
- Half homeowners, half with children
- Open to risk but need advice

Work-life balancers
Age 35-52

Profiles

- **A mix of Millennials and Gen X,** beginning to accumulate wealth
- Most feel financially secure and optimistic and are starting to think long term
- Concerned with building retirement savings

Considerations

- Strategies will differ based on savings focus and investible assets
- Some will focus on paying down debt; some will be able to increase retirement savings and explore additional options

Pre-retirees
Age 53-64

Profiles

- **A mix of Gen X and Boomers** who have reached a point in their lives in which they feel they have achieved many of their life and financial goals
- Actively planning for retirement
- Concerned with a continuous, sufficient income stream in retirement

Considerations

- Less than 50% have a formal retirement financial plan
- Helping to plan retirement income will show areas for improvement

Early & mature retirees
Age 65-80+

Profiles

- **Early-stage retirees** have reached retirement age, are enjoying life, or have delved into a second career
- Concerned with income and safe-guarding savings for wealth transfer
- **Mature retirees** have been retired for several years and may be planning for long-term care and managing end-of-life decisions

Considerations

- May need to reevaluate their retirement income needs
- Concerned with wealth transfer and leaving a legacy of wealth for family

Conversation Starters	Possible Solutions
• **Do you have the means to fully fund your workplace retirement plan?** • **Are you contributing the allowed maximum?** • **Do you have extra "discretionary" income to save for retirement?**	• To balance tax implications later in life, consider investing in a workplace plan to the level that fully takes advantage of the company match *(if available)* and the maximum annual contribution. • If you can afford to save more and have an emergency fund (generally, 6 months of living expenses), consider funding a Roth IRA with after-tax dollars to get tax-free income in retirement.
• **Do you have the means to fully fund your workplace retirement plan?** • **Do you have extra "discretionary" income to save for retirement?** • **What financial protections have you incorporated into your plan?**	• Once workplace accounts are funded to the maximum contribution, use any additional savings to fund new Roth IRAs and convert existing IRAs to Roths. • Ensure Work-Life Balancers aren't overfunding their "emergency fund" savings in taxable accounts (i.e., > 6 months living expenses). • Consider reinvesting any excess savings in tax-free investment vehicles. • If you've reached the max you can invest in accounts with contribution limits, consider allocating additional after-tax dollars to fund annuity solutions that guarantee for lifetime income. • And, if life insurance is needed, consider variable universal life (VUL)[7] as future tax-free income, and wealth transfer.
• **Do you know what your retirement income needs are?** • **Do you know the sources of your retirement income and how they will be taxed?** • **What strategies have been incorporated in your plan to maximize income?** • **Are you prepared for a long-term care (LTC) event?**	• Illustrate the impact of tax on retirement savings and the possibility of a higher tax bracket in retirement. • Convert tax-deferred savings to a tax-free Roth or 72(t). • If working a "second stage" job, use portion of wages to fund new Roth. • After age 59½, withdraw only up to standard deduction. • Discuss the benefits of annuities. • Consider LTC needs to be met by VUL with an LTC rider.
• **Are you paying too much in taxes on your retirement income?** • **How will you handle your required minimum distributions (RMDs)?** • **Do you want to leave an inheritance to your family?** • **How would you pay for a long-term care event?**	• Evaluate potential to shift assets to more tax-advantaged income solutions. • Discuss opportunities to shift RMDs to other investments that limit future tax liabilities. • Consider LTC needs to be met by VUL with an LTC rider. • Discuss tax-advantaged ways to transfer wealth through gifting, trusts, Roth conversion, and life insurance products.[7] • Long term care services riders are generally available for an additional charge and do have restrictions and limitations. You may qualify for the life insurance but not the rider.

7 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. There is investment risk, including the possible loss of principal invested.

Conclusion and recommendations

The choices we make about asset location — the taxable status of the assets that generate income in retirement — are as important as the decisions we routinely make today around asset allocation. We've identified several disconnects related to income and taxes that challenge the outdated noble (un)certainties of retirement planning logic:

- What we assume will fund retirement income is not what actually does. In reality, personal savings plays a bigger role than workplace plans and IRAs. This is an opportunity to revisit the taxability of the entire portfolio — ideally before retirement begins — and reposition assets for reduced taxation.

- Healthcare costs are well highlighted in retirement planning literature; however, in reality, the average amount spent annually on healthcare is less than what the average retiree spends in taxes. Putting these insights into perspective is important, and another opportunity to evaluate asset location strategies.

- Tax brackets are near the lowest we've seen in nearly a century. If they go up — due to economic changes in entitlement funding or an individual's personal situation — it could mean traditional tax-deferred savings options alone will be less effective. Balancing income distribution to also include tax-free sources, like Roth IRA/401(k) or income from variable universal life policies, could make a significant difference to the income a retiree gets to keep in their pocket.

Illustrating the difference asset location can make to a pre-retiree's income and lifestyle in retirement is an important responsibility. By addressing and minimizing the impact of taxes, we can have a positive influence and provide a lasting benefit resulting from advance planning.

To learn more, or if you have questions, visit equitable.com/tax-smart.

Sources:

2021 Retirement Confidence Survey.
Employee Benefits Research Institute — Washington, D.C.
Greenwald Research — Washington, D.C.
AARP, June 3, 2020, Forbes 2018.
Tax charts from Internal Revenue Service and Congressional Budget Office and Office of Management and Budget.

This brochure is not a complete description of all the material provisions of a variable universal life insurance policy. **Variable universal life insurance is sold by prospectus only that contains more complete information on investment objectives, Fees, charges and expenses. You should read the prospectus and consider the information carefully before purchasing a policy or sending money. Contact a financial professional for a copy of the current prospectus.**

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