

# THE WINER WEALTH ADVISOR

*Information to Help You Build and Preserve Wealth*

**COMMENTARY: APRIL 2011**



## WAYS TO TAX DIVERSIFY YOUR RETIREMENT SAVINGS

When you think about diversification, you probably focus on your mix of asset classes (i.e. stocks, bonds cash, real estate, etc.) and securities. But what you may be overlooking is the role **taxes** play in your diversification picture. And it's a pretty big one!

Tax diversification means investing for greater tax efficiency. By investing strategically in accounts with different tax treatments (i.e. tax-free, tax-deductible/tax-deferred and taxable), you can minimize your tax obligations, keep more of your hard-earned money and build greater multi-generational wealth.

Investing with an eye on taxes is especially important today, considering the uncertainties we face regarding future tax rates. This article will show you ways to effectively incorporate tax diversification into your retirement and estate planning.

### **Pay the piper now, enjoy tax-free income later**

Imagine: After years of working to save and invest, you finally have the opportunity to enjoy your money or put it to good use, and perhaps not even have to pay taxes on the income! Those could all be your options if you effectively utilize investments that allow you to take tax-free income, including:

- Roth individual retirement accounts (IRAs)
- Roth 401(k)s
- Roth 403(b)s
- Municipal bonds (in most cases)
- Cash-value life insurance

### **The Roth IRA opportunity**

If you're among those eligible to invest in Roth IRA accounts, here's how they work: You make contributions with after-tax dollars and the Roth IRA account can grow free from current taxation. And, in time, you can withdraw your money tax-free, as long as you meet certain conditions.

If you expect to be in a higher income tax bracket in retirement, investing in a Roth account may be a smart strategy. You won't get a tax break today, but you'll be able to withdraw money tax-free later on — when you may be in a higher tax bracket.

Roth IRAs also offer flexibility for legacy planning purposes. Unlike traditional IRAs and all other qualified plans, including Roth 401(k) and Roth 403(b) plans, Roth IRAs have no lifetime required minimum distributions (RMDs). That means you won't have to start withdrawing money when you reach age 70½. Instead, you can keep your money in the account for as long as you want. This feature opens up some powerful legacy planning opportunities. For example: Through a Roth IRA, you can transfer assets to your heirs income tax-free. Then, beginning in the year following your death, your non-spouse beneficiaries must take at least an annual RMD from the inherited Roth IRA based on their own life expectancy. The money that remains in the Roth IRA will continue to grow tax-free.

Here's another benefit to the Roth IRA; As long as you have earned income, you can contribute to the Roth as long as you like — even after you've turned age 70½. This is not an option with traditional IRAs.

As I alluded to earlier, there are restrictions on who can invest in a Roth IRA. If your modified adjusted gross income (MAGI) is \$122,000 or more (single filers), or \$179,000 or more (joint filers), you can't contribute to a Roth IRA. You also can't contribute to a Roth IRA if you are married filing separately, lived with your spouse at any time during the year and had MAGI of \$10,000 or more.

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There are no income restrictions on contributing to a Roth 401(k) or a Roth 403(b), but your employer must offer the plan. If your plan allows, you may be able to rollover your vested elective deferrals in your 401(k) or 403(b) plan into a designated Roth account within the same plan.

### **The Roth IRA conversion is now available to everyone**

As of 2010, everyone can *convert* to a Roth IRA, regardless of income or tax-filing status. Prior to 2010, anyone with a MAGI greater than \$100,000 and married people filing separately were not allowed to convert.

With a Roth IRA conversion, you can take a different retirement account, such as a traditional IRA, and convert it to a Roth IRA. You will generally need to pay income tax on the pretax amount you convert. Once the tax is paid, your future distributions are tax-free, provided you meet certain requirements.

A Roth IRA conversion isn't appropriate for everyone, but our firm can help you determine whether or not this opportunity makes sense for you.

### **Municipal bonds: Tax-free income isn't limited to retirement accounts**

Municipal bonds and municipal bond funds also offer a way to earn federally tax-free income. Similar to Treasury, corporate and other "traditional" bonds, municipal bonds and municipal bond funds make regular income distributions. But unlike the traditional options, income from tax-free municipal bonds is free from federal, and in some cases state, income tax. Also, interest on certain private activity bonds may be subject to alternative minimum tax (AMT). While interest from a municipal bond is usually tax free, it is important to note that if a sale of a municipal bond results in a capital gain, capital gains taxes will apply. This is different from a Roth IRA, which exempts all types of income from tax as long as certain conditions are met.

The higher your income-tax bracket, the more attractive tax-free municipal bonds may be for the income-oriented portion of your investment portfolio. But in certain situations, other alternatives may be a better fit. Also, note that some newer municipal bonds are designed to produce taxable interest, so be sure to understand how a particular bond works prior to investing.

Financial problems in many state and local governments and the likelihood of rising interest rates are causing us concerns about municipal

bonds. We are encouraging our clients to avoid overweighting municipal bonds in their portfolios and to diversify among other tax-favored investment vehicles including...

### **Cash-value life insurance**

As you look at your retirement strategy, whether or not you have a life insurance need, using cash-value life insurance can help you balance your financial plan. It is one of relatively few retirement savings vehicles that can provide you with a potential source of tax-free supplemental retirement income. If structured properly, a cash-value life insurance policy allows you the flexibility to take money as needed through withdrawals and loans, making access to accumulated cash value income tax-free. Keep in mind, however, that loans and withdrawals may permanently reduce the policy's cash values and death benefit. In addition, with life insurance that's properly acquired, the death benefit passes directly to your heirs income tax-free, avoiding the potentially costly and time-consuming delays associated with probate. With proper planning some or all of the value of your life insurance policy can be excluded from your estate for estate tax purposes.

In addition to providing tax-free income, cash-value life insurance can also be an excellent retirement and wealth accumulation vehicle, with alternatives for both conservative and growth-oriented investors. Conservative investors generally prefer whole life insurance which builds cash value through the distribution of dividends at a guaranteed minimum rate and has limited growth potential. Investors seeking greater growth and higher rates of return generally prefer variable universal life (VUL) insurance which combines all of the features of cash-value life insurance with a wide selection of mutual funds (professionally managed portfolios of stocks, bonds, futures and commodities). With VUL, your growth potential can be unlimited and tax-free!

Because VUL provides many of the same benefits as a Roth IRA, it is a great investment alternative for high income or high net-worth individuals who do not qualify to contribute to a Roth IRA. And unlike the Roth, there is no limitation on contributions to a VUL policy. For that and many other reasons, we believe that VUL is ideally suited for the tax-free component of most investment portfolios, especially for high net-worth investors. However, proper risk-management of the investments is critical and professional management is recommended.

We can help you determine which investments and strategies would be most appropriate and effective for your tax diversification needs and objectives.

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### How to leverage tax-deductible and tax-deferred options to lift today's tax burden

Stashing your money in tax-deductible and tax-deferred accounts can potentially provide two huge advantages:

1. It can reduce your taxable income and, therefore, how much you have to pay to the government; and
2. It can help accelerate the growth of your investment because of the compounding potential on the untaxed accumulating balance.

### Tax-deductible and tax-deferred opportunities include:

- Traditional 401(k)s
- Traditional IRAs
- Pension plans

### Tax-deferred opportunities include:

- Annuities
- Cash-value life insurance policies

### Traditional IRAs, 401(k)s and pension plans

In most cases, these options allow you to contribute pretax dollars and grow your balance tax-deferred until you start tapping your account. Depending on your income level and participation in an employer-sponsored retirement plan, your contribution to a traditional IRA may not be tax-deductible. Pension plans are funded by your employer, so your employer receives the deduction for the contribution, but the contributions grow tax-deferred.

Withdrawals taken prior to reaching age 59½ may result in a 10% IRS early withdrawal penalty. Special rules apply for distributions from qualified plans to persons separating from service after reaching age 55. Once you withdraw your money, it generally will be taxed as ordinary income. The exception: Any after-taxed contributions made to a traditional IRA or 401(k) will not be taxed again, although the account's earnings will be.

Tax-deductible and tax-deferred accounts help you avoid taxes now. If you expect your tax bracket in retirement to be lower than it is today, you'll likely benefit from tax-deductible and tax-deferred accounts because they make it possible for you to cut your taxes during your higher-income years. But there are many variables to consider. For example, your income in retirement may be higher than you anticipate tax rates may change or you may inherit money or life insurance proceeds. This is why it can be helpful to spread your money across various types of tax-advantaged accounts.

### Annuities

The nice thing about annuities is they can provide growth and a guaranteed source of income. Fixed annuities provide guaranteed or indexed rates of interest while variable annuities offer unlimited growth potential in exchange for your investment being subject to market risk. While annuities held outside of a qualified retirement plan are not tax-deductible, they are tax-deferred; so their earnings can accumulate and compound untouched by federal, state or local income taxes until you begin making withdrawals, which is usually after retirement. Even though IRAs and other retirement plans are already tax-deferred, it may make sense to hold annuities in these plans based on features like death-benefit guarantees, annual step-ups and guaranteed lifetime income benefits. Those benefits and guarantees can be especially important to conservative investors who, without the combination of growth potential and guarantees annuities provide, would likely park their retirement savings in safe, low-yielding investments, put themselves in danger of underperforming inflation and risk outliving their retirement savings. Annuities that are not in IRAs also offer flexible withdrawal options and are not subject to RMD rules during life.

**Disclosures:** Annuities are long-term investment vehicles designed to help you through each stage of retirement — from accumulating your nest egg, to providing income in retirement, to leaving any remaining wealth to your heirs.

Annuity guarantees are based on the continued claims-paying ability of the issuing company and do not apply to the performance of variable annuity subaccounts, which will vary with market conditions. In return for the benefits they provide, annuities carry a mortality and expense fee and subaccount management fees. Other fees may include optional rider fees, surrender charges and an annual contract charge.

Withdrawals that do not qualify for a waiver may be subject to a withdrawal charge. Withdrawals are subject to income taxes and withdrawals before age 59-1/2 may incur an IRS 10% early withdrawal penalty.

### Cash-value life insurance revisited

As mentioned previously, a cash-value life insurance policy can potentially offer investment growth, a tax-free source of income in retirement and tax benefits while you save. With a cash-value life insurance policy, your earnings grow tax-deferred and without contribution limits based on your income. This can help you potentially build cash value more quickly. Even if you don't need the insurance protection, a cash-value life insurance policy can be a good investment choice — especially if you don't qualify for other tax-advantaged savings options like a Roth IRA or company retirement plan.

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Using cash-value life insurance as a retirement, tax-saving and wealth-transfer vehicle is extremely complex, as there are a lot of moving parts and variables to consider. But it can also be extremely beneficial, especially for high net-worth individuals and families. When properly incorporated into your retirement and estate plans, the innovative and effective use of cash-value life insurance could potentially save you a fortune in taxes during and after your life and create millions of dollars in tax-free multigenerational wealth.

### Remember Uncle Sam: Taxable accounts play an important role, too

Compared with the tax savings offered by tax-deductible, tax-deferred and tax-free accounts, taxable accounts may not seem attractive. Nevertheless, taxable accounts can be a key part of a well-rounded mix, typically providing more flexibility in terms of the liquidity they offer to cover daily and short-term future expenses.

A few of the most frequently held investments in the taxable realm include:

- Checking and savings accounts
- Mutual funds
- Stocks and bonds
- Bank CDs

Let's say you're facing a large one-time expense, such as a vacation, a child's wedding or a major home repair. Instead of tapping your tax-deferred accounts, which could subject you to a large tax bill and potential tax penalties, you can use the money in your taxable accounts to cover the expense. Then your tax-deferred accounts can continue to grow undisturbed.

### Diversify for long-term tax efficiency

Taxes could be one of your largest annual expenses in retirement. But by diversifying into multiple tax vehicles during your working years, you can promote greater tax efficiency in your later years. You'll maintain more control over how and when you are taxed while taking full advantage of market conditions, innovative investment vehicles and strategies and current tax legislation.

Clearly, tax diversification should be a key component of your financial foundation. But you will quickly find that it's a complex, dynamic and challenging undertaking. By strategically considering tax-free, tax-deductible/tax-deferred and taxable accounts, you'll have the flexibility to choose the most appropriate solution to address your individual needs and objectives.

If you would like help developing and implementing an effective tax-diversification strategy and coordinating it with your investment, insurance, tax, retirement and estate planning, please call us at (818) 673-1695. We would be happy to help you.

**Disclosures:** Accessing life insurance policy cash value through loans and surrenders may cause a permanent reduction of policy cash values and death benefit and negate any guarantees against lapse. The amount that can be borrowed or surrendered will be affected by the surrender charges applicable to the policy. Loans may be subject to interest charges. Although loans are generally not taxable, there may be tax consequences if the policy lapses or is surrendered with a loan (even as part of a 1035 exchange). It is possible that the amount of taxable income generated at the lapse or surrender of a policy with a loan may exceed the actual amount of cash received. Surrenders are generally taxable to the extent they exceed basis in the policy. If the policy is a modified endowment contract (MEC), pre-death distributions, including loans from the policy, are taxed on an income-first basis, and there may also be a 10% federal income tax penalty for taxable distributions prior to age 59½.

Before you purchase, be sure to ask your financial advisor about the life insurance policy's features, benefits, risks and fees, and whether the life insurance is appropriate for you, based upon your financial situation and objectives.

## PLEASE DON'T KEEP US A SECRET!

If you know someone who could benefit from a sound tax diversification strategy, please feel free to send them this newsletter.

Please also feel free to pass our name along to anyone you believe could benefit from our wealth management and financial planning services and expertise. Your referrals are how we grow our business and they are always greatly appreciated!

For more information on Winer Wealth Management, Inc., please visit our website at [www.winerwealth.com](http://www.winerwealth.com).

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