Planning Now For Tax-Advantaged High-Net-Worth Outcomes Later

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Today's Retirement Challenge

Retirees and their advisors know something about retirement that clients in their 40s and 50s may not: while spending patterns often change once full-time work ends, overall outgo usually declines very little, if at all.

On the income side, since relatively few Americans aside from government employees now have a defined benefit pension, most retirees will rely on income drawn from savings and investments[1] — largely in qualified plans including IRA accounts and workplace plans including 401(k)s and 457s, as well as non-qualified accounts — and Social Security benefits. For many new retirees, after years or decades of making contributions and seeing balances grow, the decumulation process can cause unease. Equally discomforting, perhaps, is discovering that tax bills may not be much different in retirement, especially when income is coming largely from tax-deferred sources. Worse, when the market slumps as it did in 2022, and any expected shrinkage in assets through distributions is made worse by sharp portfolio losses, discomfort can turn into fear and panic.

Meeting the future income needs of clients who are now in their prime working years while also being mindful of their likely tax obligations in retirement is a challenge for advisors. That challenge is threefold: Creating a portfolio and a holistic financial approach that both grows and helps protect wealth; encouraging long-term market participation in the face of volatility and downturns; and finding opportunities for tax-free retirement income to offset the probability of high tax bills in the future. Ironically, one of the most effective solutions to this complex challenge involves a product typically overlooked or ignored — whole life insurance.

Integrating whole life insurance into a financial strategy for high-earning younger investors can address challenges in accumulation, decumulation and protection in ways that advisors may have never fully considered.

Maximizing Retirement Outcomes: An Independent View

Advisors expect insurers to recommend whole life insurance. But what about a recommendation from an independent source? The respected international accounting and consulting firm of EY recently looked at how insurance in various forms could affect retirement outcomes for couples starting to invest at ages 25, 35 and 45. Using Monte Carlo analysis of 1,000 scenarios for strategies that consisted of investments only; term life insurance plus investments; whole life insurance where all premiums are paid by age 65, plus investments; adding a deferred income annuity (DIA) with increasing income protection (IIP) to investments; and a combination of investing, whole life and a DIA.

What EY found is that adding whole life insurance to a retirement strategy consistently delivered higher retirement income and a greater legacy than an investment-only portfolio. For example, for a couple age 25, EY found that a portfolio consisting of a 50/50 mix of a whole life policy with all premiums paid by age 65 plus investments produced 1% greater annual income in retirement and a 20.4% greater legacy than an investment-only portfolio. For the same couple, a 30/70 insurance/investment portfolio produced 2% greater annual income than an investment-only portfolio and created a 13.4% greater legacy than an investment-only portfolio.

EY tweaked the whole life/investments mix by adding an annuity and found that by doing so investors could dial up or dial down their preference for the likelihood of greater retirement income or a greater legacy. A 30/30/40 mix of whole life, an annuity and investments, for example, produced 5.4% higher annual retirement income than an investment-only portfolio and an 18.7% greater legacy.

Although the 10/90 mix of term/investment combination yielded a 0.2% greater legacy than an investment-only approach, all other term insurance/investment combinations EY examined — 10/90, 30/70 and 50/50 — produced lower income and legacy outcomes than whole life/investment combinations.

While the results of EY's research clearly favor a mix of investments and whole life insurance, the study does not address why or how such a mix is able to outperform an investment-only or an investment with term insurance approach. Those answers lie in the structure of whole life insurance, which provides unique advantages to investors in the accumulation as well as de-cumulation years — especially for higher-income investors in need of income protection and for whom taxes are persistently top of mind. Those advantages are difficult, if not impossible, to duplicate through other vehicles.

New Ways to Think About Whole Life

"Buy term and invest the rest." "Whole life is too expensive." "Whole life is a poor investment." These often-heard remarks reflect long-held beliefs and biases against using whole life insurance that often are based on perceptions of the product that do not fully reflect all its features. The perceptions also may reflect assumptions about retirement in the areas of taxes, market performance and healthcare that often go unexamined.

A deeper look at the features of whole life and the reality of retirement can illuminate the ways in which the product can deliver surprisingly positive outcomes. That being said, the decision to purchase life insurance should be based on long-term financial goals and the need for a death benefit.

Life insurance is not an appropriate vehicle for short-term savings or short-term investment strategies. While the policy allows for loans, you should know that there may be little to no cash value available for loans in the policy's early years.

Overcoming Retirement Tax Challenges and Qualified Plans' Restrictions

Many advised clients in their 40s and 50s, as well as younger clients known as HENRYs — the acronym for "high earners, not rich yet" — are diligent savers and investors, making maximum contributions to 401(k) plans at work as well as investing through a variety of traditional IRAs, if eligible. The challenge for high-income earners building wealth through these qualified accounts is threefold.

First, high-income earners often reach the limits of how much they can contribute to qualified plans and can benefit from other investments that are treated favorably from a tax perspective.

Second, if a younger investor before the age of 59-1/2 has an unexpected need for cash, such as in the case of an emergency home repair or a health or family issue, withdrawing money from a qualified account exposes the investor to costly penalties.

Finally, funds in qualified accounts that are decumulated throughout retirement are subject to taxation at ordinary income rates. Since most affluent retirees wish to maintain a lifestyle in retirement comparable to that enjoyed during their working years, those with a substantial portion of retirement income coming from qualified sources are likely to face high rates of taxation well into retirement.

In addition to providing permanent life insurance protection, whole life insurance accumulates guaranteed cash value that increases each year on a tax-deferred basis and never decreases in value due to market conditions. So it can be a reliable alternate source of funds during financial downturns. Whole life insurance also offers some attractive income-tax advantages that allow the policyowners to access the cash value on a tax-advantaged basis. Distributions under the policy (including cash dividends and partial/full surrenders) are not subject to taxation up to the amount paid into the policy (cost basis).[2] This flexibility can be particularly attractive for those who need a significant sum of money to meet an emergency expense, for example. For a retiree's advisor, it means that long-term portfolio holdings can remain intact, financial plans are not disrupted and withdrawals are not made at times that may be least favorable, such as during a market downturn.

What Tax Diversification Looks Like

The chart below is a simplistic illustration of how establishing different sources of income, based on how they are taxed, can help manage taxes during retirement. In the non-diversified scenario, the investor receives $97,500 in net income while in the diversified scenario, which incorporates whole life, the investor receives $121,500 in net income.

- In the Non-diversified scenario, $150,000 of income is taken from a 401(k) plan.
- In the Diversified scenario, $50,000 is taken from 3 diverse accounts, each taxed differently, as indicated, for a total of $150,000.

	NON-DIVERSIFIED WITHDRAWALS				DIVERSIFIED WITHDRAWALS			
	Taxable Non-Qualified Account	Tax Advantaged Account Whole Life	Tax Deferred Account (35.00%)		Taxable Non-Qualified Account (22.00%)	Tax Advantaged Account Whole Life	Tax Deferred Account (35.00%)	
Withdrawal	-	-	$150,000		$50,000	$50,000	$50,000	
Taxes	-	-	$52,500		$11,000		$17,500	
	-	-	$97,500		$39,000	$50,000	$32,500	
			Combined Net Income	**$97,500**			**Combined Net Income**	**$121,500**

Assumes that distributions from the tax-deferred account like a 401(k) are taxed at an effective ordinary income tax of 35%, while distributions from taxable accounts, such as mutual funds, are taxed at a blended rate of 22% to include capital gain and ordinary income. The actual tax paid will depend on tax law at time of retirement, as well as the cumulative distributions taken in each category of tax. Qualified plans also require a minimum distribution (RMD) from the plan beginning at age 73 whether or not income is needed. If the full RMD is not taken as required, the shortfall will be subject to an excise tax. The "Tax-Advantaged Account Whole Life" column refers to the policy cash values, which are not guaranteed. The returns and account values of each tax category do not reflect fees and charges associated with an actual investment.

A Way to Encourage Long-Term Investing and Mitigate Risk

In addition to providing income protection, the guaranteed growth of a whole life insurance policy - as well as any non-guaranteed dividends that can help build that cash value, in the case of a whole life policy from a mutually owned life insurance company - is not correlated to market performance. Integrating whole life into a financial and investment plan, principally by using it as a replacement for a portion of an investor's fixed-income allocation, can significantly improve overall client outcomes by mitigating sequence-of-return risk, encouraging long-term equity investing and reducing the need to draw down portfolios during periods of market declines.

Revisiting Health and Healthcare Cost Assumptions

Younger investors often make assumptions about their near-term and long-term health, as well as healthcare costs, that could be detrimental to their lifelong financial well-being. Near-term, many younger investors simply assume they will always be able to access lower-cost term insurance. As many find out, however, waiting to purchase life insurance until you are older or have an unexpected change in health can lead to much higher premiums and the risk that the coverage may not be available. If either of those events occur, families can be left without insurance to replace the insured's income in case of death. In contrast, once a whole life policy is purchased, it is permanent and cannot be cancelled (assuming premiums are paid) regardless of changes in health.

Overcoming Sequence-of-Return Risk

Most investors understand that the stock market has good years and bad years but tends to provide attractive returns over the long run. Many, however, do not understand the importance or risk of precisely when, over the long run, those bad years occur. To illustrate the potential consequences of sequence-of-return risk, consider what happens to a hypothetical $1 million investment from which annual withdrawals of $65,000 are made over 25 years. Also assume two different combinations of the same 25 annual hypothetical returns. The two different scenarios, of course, produce the same average annual return of 6.28% — but when the actual annual returns take place, it leads to widely different outcomes.

In scenario 1, the investor is left with $897,665 after withdrawing $65,000 a year for 25 years. In scenario 2, which uses the same hypothetical annual returns, but just reverses their order, the investor runs out of money in year 21.

Having a whole life insurance policy with substantial cash value can help mitigate sequence-of-return risk by offering the option of taking tax-preferred distributions from the policy instead of from an investment portfolio, giving the investment account sufficient time to recover. Accessing the cash value of a life insurance policy can be structured so that tax-advantaged distributions are taken, up to the cost basis in the policy, after which tax-advantaged loans are taken.[2]

DECUMULATION STAGE - INCOME TAKEN						
Scenario 1: Order 1				Scenario 2: Reverse of Order 1		
	Hypothetical Annual Return	Investment	Income		Hypothetical Annual Return	Investment
		$1,000,000				$1,000,000
1	10.0%	$1,028,500	$65,000	25	-7.0%	$869,550
2	9.0%	$1,050,215	$65,000	24	-12.0%	$708,004
3	-6.0%	$926,102	$65,000	23	5.0%	$675,154
4	12.0%	$964,434	$65,000	22	-2.0%	$597,951
5	25.0%	$1,124,293	$65,000	21	5.0%	$559,599
6	7.0%	$1,133,443	$65,000	20	12.0%	$553,951
7	-3.0%	$1,036,390	$65,000	19	9.0%	$532,956
8	9.0%	$1,058,815	$65,000	18	17.0%	$547,509
9	10.0%	$1,093,197	$65,000	17	12.0%	$540,410
10	-7.0%	$956,223	$65,000	16	9.0%	$518,196
11	6.0%	$944,696	$65,000	15	-5.0%	$430,537
12	23.0%	$1,082,027	$65,000	14	7.0%	$391,124
13	12.0%	$1,139,070	$65,000	13	12.0%	$365,259
14	7.0%	$1,149,255	$65,000	12	23.0%	$369,319
15	-5.0%	$1,030,042	$65,000	11	6.0%	$322,578
16	9.0%	$1,051,896	$65,000	10	-7.0%	$239,547
17	12.0%	$1,105,323	$65,000	9	10.0%	$192,002
18	17.0%	$1,217,178	$65,000	8	9.0%	$138,432
19	9.0%	$1,255,874	$65,000	7	-3.0%	$71,229
20	12.0%	$1,333,779	$65,000	6	7.0%	$6,665
21	5.0%	$1,332,218	$65,000	5	25.0%	$0
22	-2.0%	$1,241,874	$65,000	4	12.0%	$0
23	5.0%	$1,235,717	$65,000	3	-6.0%	$0
24	-12.0%	$1,030,231	$65,000	2	9.0%	$0
25	-7.0%	$897,665	$65,000	1	10.0%	$0

The returns and account values do not reflect fees and charges associated with an actual investment.

Similarly, younger investors tend to make overly optimistic assumptions about health care costs in retirement. While 2022 marked the first time in more than two decades that the increase in healthcare costs was lower than the general inflation rate, the historic cost differential is likely to resume.[3] In retirement, Medicare covers many healthcare costs, but it doesn't cover everything — which many people realize only when they retire. Medicare does not cover most continuing long-term care costs, for example, nor many of the routine out-of-pocket medical expenses that a recent report by RBC Wealth Management[4] estimated now total $11,400 a year for the average married couple. Even Medicare premiums themselves can be surprisingly expensive. The RBC report found that the monthly Medicare Part B premium for a married, high-income individual can reach $560.50, which represents a significant portion of even a large Social Security benefit.

Many advisors and higher-income individuals may not be aware that the cash value in a whole life insurance policy can be used to pay for unexpected, higher-than-anticipated medical and healthcare costs in retirement. If they are mindful of the potential tax consequences of cash-value distributions that exceed total premiums paid retirees with a whole life policy having significant cash value can enjoy greater flexibility in tapping tax-free cash when the need arises.

Key Takeaways

Creating a financial plan and investment program that incorporates a whole life insurance policy — especially one from a mutual insurer with a track record of paying dividends — can help an advisor improve client outcomes in three ways. An investments-plus-whole-life approach grows and protects wealth, encourages long-term market participation in the face of volatility and downturns, and provides opportunities for tax-free income to lower the tax bills retirees are likely to face in the future. What's more, it provides all those benefits while also protecting families with guaranteed coverage that can't be cancelled.

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1. Insured Retirement Institute (IRI), 2016
2. Distributions under the policy (including cash dividends and partial/full surrenders) are not subject to taxation up to the amount paid into the policy (cost basis). If the policy is a Modified Endowment Contract, policy loans and/or distributions are taxable to the extent of gain and are subject to a 10% tax penalty if the policyowner is under age 59½. Access to cash values through borrowing or partial surrenders will reduce the policy's cash value and death benefit, increase the chance the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured.
3. Kaiser Family Foundation(KFF), November 2022
4. RBC Wealth Insights, Taking Control of Healthcare in Retirement, March 2021

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