The Specialist
ANSWERS TO TOUGH QUESTIONS ABOUT TAXES AND INVESTING

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Three Tax-Friendly Life Insurance Strategies

By Ed Slott, CPA

Higher taxes could follow in the wake of soaring government spending on pandemic relief measures — a likelihood that shines a new light on the tax advantages of life insurance. Permanent life insurance offers a tax-free death benefit, and a portion of each premium goes into a cash-value account that accumulates on a tax-deferred basis. The policy owner may also access the cash value, if needed, without triggering income taxes.

Assets in tax-deferred retirement accounts will eventually be taxed as ordinary income, whether distributions are taken by the current owner or a beneficiary who inherits the account. Thus, taxpayers with well-funded retirement accounts should bear in mind that today's historically low tax rates are scheduled to expire after 2025.

However, taking IRA distributions while taxes are low and shifting the money to life insurance could provide a hedge against future tax increases.

Here are three ways in which permanent life insurance can be used in retirement and estate strategies.

Taxpayers with well-funded retirement accounts should keep in mind that today's historically low tax rates are scheduled to expire at year-end 2025.

Supplement retirement income. The cash value is available for emergencies as well as for normal retirement expenses such as housing costs and health care. You can generally make tax-free withdrawals (up to the amount paid in premiums) or use loans to tap into the accumulated cash value. Although policy loans accrue interest, they are free of income tax (as long as they are repaid) and usually do not impose a set schedule for repayment.

Still, you should generally have a need for life insurance protection and evaluate a policy based on its merits as such. Loans from a life insurance policy will reduce the policy's cash value and death benefit, could increase the chance that the policy will lapse, and might result in a tax liability if the policy terminates before the death of the insured. Additional out-of-pocket payments may be needed if actual dividends or investment returns decrease, if you withdraw policy cash values, or if current charges increase.

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If you have any questions about the topics in this newsletter or about your financial future, call us. We are available to help.

Sequence Risk: Preparing to Retire in a Down Market

"You can't time the market" is an old maxim, but you also might say, "You can't always time retirement."

Market losses on the front end of retirement could have an outsized effect on the income you receive from your portfolio by reducing the assets available to pursue growth when the market recovers. The risk of experiencing poor investment performance at the wrong time is called *sequence risk* or *sequence-of-returns risk.*

Dividing Your Portfolio

One strategy that may help address sequence risk is to divide your retirement portfolio into three different "baskets" that could provide current income, regardless of market conditions, and growth potential to fund future income. Although this method differs from the well-known "4% rule," an annual income target around 4% of your original portfolio value might be a reasonable starting point, with adjustments based on changing needs, inflation, and market returns.

Basket #1: Short term (1 to 3 years of income). This basket holds stable liquid assets such as cash and cash alternatives that could provide income for one to three years. Having sufficient cash reserves might enable you to avoid selling growth-oriented investments during a down market.

Basket #2: Mid term (5 or more years of income). This basket — equivalent to five or more years of your needed income — holds mostly fixed-income securities such as intermediate- and longer-term bonds that have moderate growth potential with low or moderate volatility. It might also include some lower-risk, income-producing equities. The income from this basket can flow directly into Basket #1 to keep it replenished as the cash is used for living expenses. If necessary during a down market, some of the securities in this basket could be sold to replenish Basket #1.

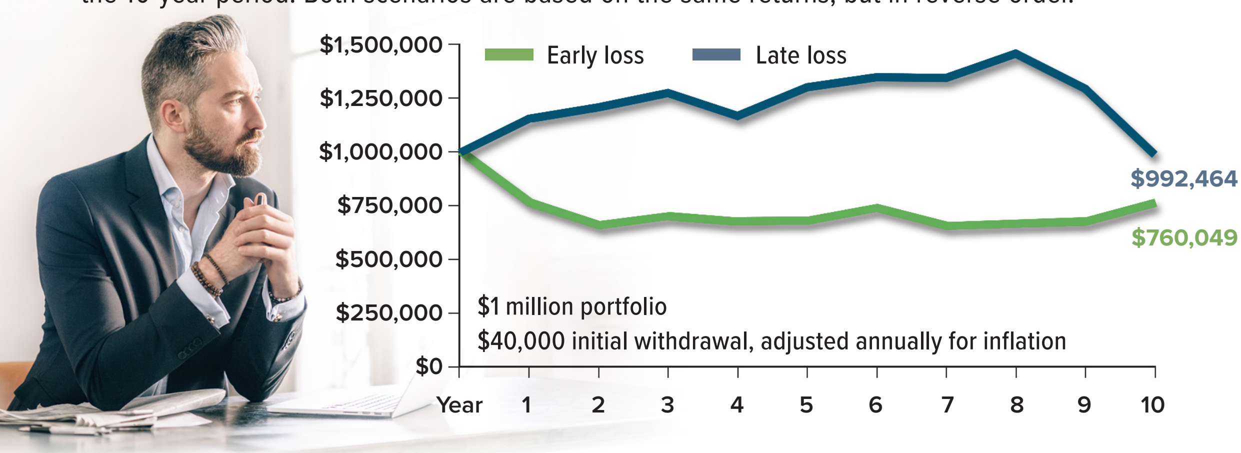
Basket #3: Long term (future income). This basket is the growth engine of the portfolio and holds stocks and other investments that are typically more volatile but have higher long-term growth potential. Investment gains from Basket #3 can replenish both of the other baskets. In a typical 60/40 asset allocation, you might put 60% of your portfolio in this basket and 40% spread between the other two baskets. Your actual percentages will depend on your risk tolerance, time frame, and personal situation.

With the basket strategy, it's important to start shifting assets before you retire, at least by establishing a cash cushion in Basket #1. There is no guarantee that putting your nest egg in three baskets will be more successful in the long term than other methods of drawing down your retirement savings. But it may help you better visualize your portfolio structure and feel more confident about your ability to fund retirement expenses during a volatile market.

All investments are subject to market fluctuation, risk, and loss of principal. Asset allocation does not guarantee a profit or protect against investment loss. The principal value of cash alternatives may be subject to market fluctuations, liquidity issues, and credit risk. Bonds redeemed prior to maturity may be worth more or less than their original cost. Investments seeking to achieve higher yields also involve higher risk.

Early Losses

A significant market downturn during the first two years of retirement could make a big difference in the size of a portfolio after 10 years, compared with having the same downturn at the end of the 10-year period. Both scenarios are based on the same returns, but in reverse order.



Sequence of returns

Year	Early loss	Late loss
1	–20%	20%
2	–8%	8%
3	12%	9%
4	3%	–5%
5	7%	15%
6	15%	7%
7	–5%	3%
8	9%	12%
9	8%	–8%
10	20%	–20%

Assumes a $40,000 withdrawal in Year 1, with subsequent annual withdrawals increased by an inflation factor of 2%. This hypothetical example of mathematical principles is used for illustrative purposes only and does not represent the performance of any specific investment. Fees, expenses, and taxes are not considered and would reduce the performance shown if they were included. Actual results will vary.

Your Estate: Have You Looked at These Legal Documents Lately?

If you haven't prepared certain estate documents, or the ones you have are out-of-date, your intentions could easily become a matter of dispute. The courts might have to make critical decisions regarding your medical care and finances or determine who will receive your assets when you die.

Having a thorough estate strategy in place might be the ultimate gift for your loved ones. Unfortunately, it's easy to procrastinate or simply forget to make the appropriate arrangements in writing as your family situation changes over time.

Financial Matters

A **will** details your wishes regarding who should inherit your property and who you want to act as guardian for your children (if any). This is a good place to start, but it may not go far enough. A will must go through probate, which can be an expensive and slow process. Plus, when a will is filed with the court, the details could become public.

A **trust** may offer more privacy and flexibility than a will, primarily because assets held in a trust avoid probate. You also may have more control over how and when trust assets are distributed after your death. For example, a trust might be used to provide for a dependent with special needs, preserve a family business, and/or make a substantial gift to your favorite charitable organization.

A **durable power of attorney for finances (DPOA)** authorizes someone else to act on your behalf, so he or she can do tasks such as pay everyday expenses, collect benefits, make investment decisions, and file taxes. A DPOA may become effective immediately (standby power) or could be triggered when you become physically or mentally incapacitated (springing power).

Medical Decisions

Advance medical directives state your preferences regarding medical treatment or designate someone to make medical decisions for you in the event you can't express your wishes. If you don't have an advance medical directive, health-care providers must prolong your life using artificial means, if necessary.

There are three kinds of advance medical directives, and their use differs by state. A **living will** outlines which medical procedures you would want (or not want) in the event of a debilitating illness. It is often used to authorize the removal of artificial life support in the event of a terminal illness.

Having a thorough estate strategy in place might be the ultimate gift for your loved ones.

A **durable power of attorney for health care** (known as a health-care proxy in some states) appoints a representative to make medical decisions for you. You decide how much power your representative will or won't have.

A **do-not-resuscitate order (DNR)** tells medical personnel not to perform CPR if your heart stops or you stop breathing.

Beneficiary Forms

A simple form filed with a financial institution or insurance company could turn out to be one of your most crucial estate documents. In fact, the assets in most bank and brokerage accounts, retirement plans, and insurance policies convey directly to the people named on the beneficiary forms — even if they are different from the people named in a will or a trust — and the money does not go through probate.

You should review and update all beneficiary forms and estate documents periodically, especially when there are changes in your life that could affect your decisions, such as marriage, divorce, the birth of a child, or the illness or death of a family member.

Because requirements can vary, you should consult with an attorney who is familiar with the laws of your state. Of course, there are costs associated with the creation of these legal instruments.

Full House: Adult Children Coming Home

Almost 3 million adults moved in with a parent or grandparent during the months of March, April, and May 2020.[1] Although COVID-19 created a unique situation, there was already a shift to living in the family home. In 2014, a third of young adults ages 18 to 34 were living with a parent, up from one out of five in 1960. And for the first time on record, dating back to 1880, the percentage of young adults living with a parent was higher than the percentage living with a spouse or partner in their own household.[2]

Having your adult child live with you can offer precious family time and new opportunities to get to know one another as you are today. But it can also be a challenge. Here are some ideas to help ensure a peaceful and productive living situation.

Treat your child like an adult. When an adult child returns to the family home, it's easy to fall into old patterns and old roles. Both generations need to work to avoid this, but you can take a big step by treating your child respectfully, as you would with any other adult in your home.

Have a plan and a purpose. Discuss the reasons for moving back home and the time your child expects to stay. Is it until public health conditions improve? Until he or she finds a job? While completing education? Open-ended? You both may have to be flexible, but it helps to have a road map.

Agree on ground rules. Develop a plan for sharing chores, making meals, and buying groceries. Discuss schedules for work, sleep, and other activities, and respect the need for privacy and quiet time. Look for solutions together rather than dictating hard-and-fast rules.

Require some cost sharing. If your son or daughter is working, consider charging a low level of rent (especially if you are still paying a mortgage) and/or a portion of other household expenses. On the other hand, if your child is out of a job, paying off student debt, or saving for a specific goal such as a security deposit on an apartment or a down payment on a house or car, you might pay all housing expenses for a period of time. A working young adult who is on your mobile phone plan or covered by your medical insurance should pay an appropriate share of the monthly phone charges and out-of-pocket medical expenses.

Establish whether monetary help is a gift or a loan. Allowing your adult child to live with you is one thing, but paying his or her personal expenses is a different level of support. Depending on your child's age and overall financial situation, you might make direct financial help a loan with a realistic repayment schedule.

1) *The Atlantic*, July 3, 2020
2) Pew Research Center, 2016 (most recent data available)

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Cover long-term care. Many retirees worry that their savings could be depleted later in life by the escalating cost of long-term care. A long-term care rider attached to a life insurance policy could help pay for these expenses if they are ever needed. Any payouts for covered expenses reduce (and are usually limited to) the death benefit, and they are typically much less generous than those of a traditional "use-it-or-lose-it" long-term care policy. Optional benefit riders are available for an additional cost and are subject to the contractual terms, conditions, and limitations outlined in the policy; they may not, however, benefit all individuals.

Leave a tax-free legacy. Most nonspouse beneficiaries who inherit IRAs must now empty the account within 10 years, and heirs who are forced to take distributions in their peak earning years could face large income tax bills. By contrast, the death benefit from a life insurance policy could provide a tax-free inheritance.

Before implementing a strategy involving life insurance, it would be prudent to make sure you are insurable. The cost and availability of life insurance depend on factors such as age, health, and the type and amount of insurance purchased. In addition to the life insurance premiums, other costs include mortality and expense charges. If a policy is surrendered prematurely, there may be surrender charges and income tax implications. Any guarantees are contingent on the financial strength and claims-paying ability of the issuing insurance company.

Ed Slott is a professional speaker and the creator of several public television specials, including "Retire Safe & Secure! with Ed Slott." He is the author of *The Retirement Savings Time Bomb...And How to Defuse It* and many other books about IRA planning.