Tax Efficient Investing in a Rising Tax Environment

Our previous two FAQs focused on current planning opportunities created by the interest rate and market environment and the importance of having your insurance portfolio reviewed.

In this piece, we turn our attention to concerns that future income and estate taxes will increase and how clients can invest in a more tax efficient manner in this environment.

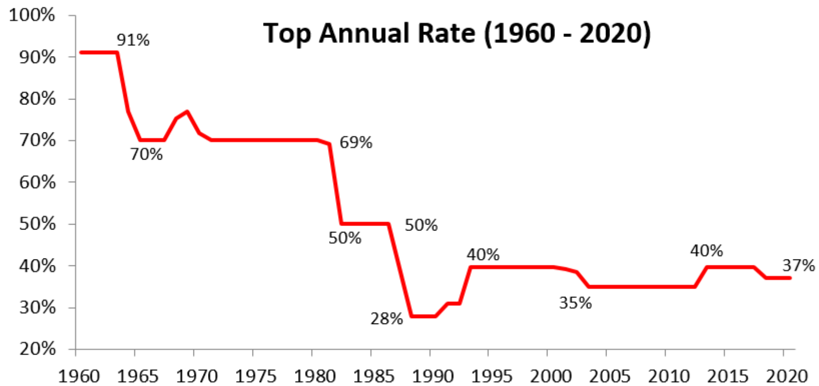
Historical Tax Rates

Where are current income taxes relative to historic rates?

The graph to the right tracks the highest marginal federal income tax rates from 1960—2020.

Although the individual income tax is progressive—meaning that effective tax rates tend to go up with income---the effective tax rates for those in the highest bracket have dropped substantially over time.

In fact, while it may feel like today's tax burden is quite onerous, the reality is that current federal income tax rates are actually historically low.



Source: IRS Statistics of Income, Table 23

Current Fiscal Implications for Taxes

What is the conventional wisdom regarding the future tax environment?

No one can predict the future with any certainty, but JR KATZ is actively discussing with our clients how to hedge their planning objectives against a higher income tax and estate tax environment.

Projections from the "Committee for a Responsible Federal Budget," an independent bipartisan policy organization, demonstrate that:

- The budget deficit will total $3.7 trillion (17.9 percent of GDP) in 2020
- As a share of the economy, debt will grow from 79 percent of GDP before the crisis to 101 percent by the end of 2020
- All major trust funds will exhaust their reserves in just over a decade: The Highway Trust Fund in 2021, the Medicare Hospital Insurance trust fund in 2023, and the theoretically combined Social Security trust funds by 2031.
- Under a scenario in which various expiring provisions are continued and more economic relief is enacted, deficits would average $2 trillion per year (7.8 percent of GDP) between 2021 and 2030 and debt would grow to 131 percent of GDP by 2030.

The Political Response

What has been the political response to the expanding debt and deficit (other than contributing to it)?

Both parties seem relatively aligned in the belief that additional short-term spending will be needed to get us through this pandemic. Beyond that, Republicans have said little other than rumblings about making the 2017 Tax Act permanent. Not surprisingly, Biden, the presumptive democratic nominee (as of August 2020), has put forth an aggressive plan to raise taxes for certain income brackets. 93% of the tax increases come from the top quintile of households.

Biden's proposals include*:

- Repealing major provisions of the 2017 Tax Act for those making more than $400k per year
- Eliminating dividend and long-term capital gains preference for those making more than $1M per year
- Eliminating social security tax cap (currently set at $137,700) for those making more than $400k per year
- Eliminating the step-up in basis at death
- Contemplating reducing estate tax exclusions and raising the estate tax rate
- Capping the value of itemized deductions at 28%
- Phasing out the Section 199A qualified business deduction for those making more than $400k per year.
- Raising the corporate tax rate from 21% to 28%

Source: www.TaxFoundation.org

Non-Taxable Life Insurance Vehicle for Retirement

I max out my 401K contributions and my income level is too high to contribute to a Roth IRA. Is there another non-taxable bucket to which I can contribute?

The most powerful force in tax planning is tax-free compounding. A properly structured life insurance policy has four distinct tax advantages:

- Funds within the policy accumulate without a taxable event
- Non-taxable disbursements can be made during the life of the insured
- All gains are converted into an income tax-free death benefit
- If owned by an irrevocable trust, it will be the sole trust asset that will receive a step-up in basis at the grantor/insured's death

The underlying structure of this income mitigation strategy is a Variable Universal Life contract (VUL). Within a VUL, the policy owner may invest in a variety of funds thereby creating a bespoke allocation model.

If a Private Placement VUL is used, the policy owner may establish a separately managed account overseen by the client's investment advisor.

The Potential Benefits of a Tax-Free Structure

I am 45. If I used this strategy, how can I calculate the value of insurance tax wrapper?

- 45 year old male
- 6.5% net of return
- 20% effective tax rate
- Funding of $100k per annum for 7 years

Hypothetical example for illustrative purposes. Actual results may vary.

Given these assumptions, at age 95, the value of the life insurance is more than $5M greater than the taxable account. This equates to a 66% absolute differential. The greater the return assumption and/or the greater the tax liability, the more effective the insurance chassis becomes as a tax-advantaged vehicle.

One Northbrook Place | 5 Revere Drive, Suite 550 | Northbrook, IL 60062 | www.jrkatz.com | 847-564-8430

Appendix / Disclosures

Assuming withdrawals to basis and then switch to non-taxable loans. Withdrawals in excess of basis are taxed as gain. Interest does accrue on policy loans, and borrowing will reduce any death benefits paid out unless the loan is paid back to the policy.

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS
The case study does not reflect actual clients. Any reference to securities is based upon historical data that is public sourced. No statement made herein is to suggest stock market performance or future performance, and no case study is used to imply future performance. The case study is intended to illustrate services available through the adviser. They do not necessarily represent the experience of any clients.

Variable universal life insurance is permanent life insurance that offers protection and an opportunity to build cash values. You will incur mortality and expense fees and subaccount expenses, and you may also incur optional rider expenses, surrender charges, and policy charges.

Please consider the investment objectives, risks, charges, expenses, and your need for death-benefit coverage carefully before investing. The prospectus, which contains this and other information about the variable life policy and the underlying investment options, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

The investment return and principal value of the variable life policy are not guaranteed. Variable life sub-accounts fluctuate with changes in market conditions. The principal may be worth more or less than the original amount invested when the policy is surrendered.

Accessing 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. Surrender charges may apply to the policy and 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 or exchanged with an outstanding loan. Taxable income could exceed the amount of proceeds available. Surrenders are generally taxable to the extent they exceed the remaining investment 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 be a 10% federal income tax penalty for distributions of earnings prior to age 59-1/2.

It is possible that coverage will terminate when either no premiums are paid following the initial premium, or subsequent premiums are insufficient to continue coverage.
The investment return and principal value of the variable life policy are not guaranteed. Variable life sub-accounts fluctuate with changes in market conditions. The principal may be worth more or less than the original amount invested when the policy is surrendered. Any guarantees offered are backed by the financial strength of the insurance company.

A fund underlying your policy in which a subaccount invests may have a name, portfolio manager, objectives, strategies and characteristics that are the same or substantially similar to those of a publicly traded retail mutual fund. Despite these similarities, an underlying fund is not the same as any publicly traded retail mutual fund. Each underlying fund will have its own unique portfolio holdings, fees, operating expenses and operating results. The results of each underlying fund may differ significantly from any publicly traded retail mutual fund.

Variable policy issuance is contingent upon financial insurability and subject to the carrier's underwriting process. The assessed life insurance risk class are a factor in determining the policy premiums.

Variable Universal Life requires medical underwriting in order to be issued. Medical underwriting is the process of evaluating an application for health insurance coverage by examining the applicant's medical history. The price of coverage is determined by the risk factors of the applicant. Depending on the insurance company's policies and on federal and state regulations, medical underwriting for high-risk candidates may lead to exclusion of coverage for certain conditions, denial of coverage altogether, or coverage offered only at a very high price. Medical underwriting also is practiced in determining individual rates for life insurance and disability insurance policies.

Private Placement Life Insurance policies are exempt funds and as such are not registered under the securities laws. They are not subject to the same regulatory requirements as registered funds. Among other activities, exempt funds may engage in potentially riskier investment practices, charge higher fees, and impose liquidity restrictions on policyowners' assets.

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