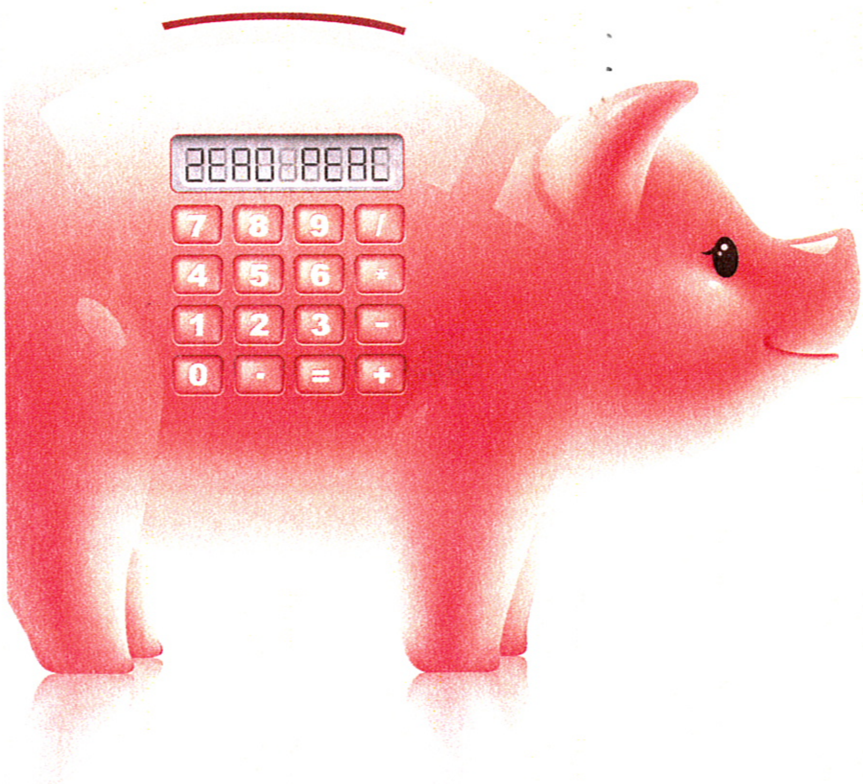
The Virtues of the 0% Tax Bracket

By carefully situating assets during accumulation, you can help clients be well-positioned to fend off a predicted rise in tax rates and reach the coveted 0% tax bracket during distribution. *By David McKnight*



On January 1, 2008, the first of 78 million baby boomers began the march out of the work force and onto the rolls of our nation's entitlement programs.[1] As of today, the government can pay for these entitlement benefits thanks, in large part, to the payroll taxes of baby boomers who have yet to retire. By 2017, however, payroll taxes won't be enough to cover the bill. The government will have to make up that revenue from other areas. Where? All indications point towards higher income taxes. In fact, the Congressional Budget Office projects that if "Social Security, Medicare and Medicaid go unchanged, the rate for the lowest tax bracket would increase from 10% to 25%; the tax rate on incomes in the current 25% bracket would have to be increased to 63%; and the tax rate of the highest bracket would have to be raised from 35% to 88%."[2]

This impending tsunami of government spending raises a very important question for our clients who are seeking to maximize spendable cash flow in retirement: How do they position their assets so as to protect themselves from rising taxes? The answer can be found by exploring the virtues of the 0% tax bracket.

To appreciate the benefits of the 0% tax bracket, we begin by defining the three basic types of investment buckets: taxable, tax-deferred, and tax-free.

The Taxable Bucket: This consists of investments such as money markets, CDs, stocks, bonds and mutual funds. Generally speaking, investors pay taxes on these investments every year as the investment grows. If that's the case then, why have them? They're important because they're the most liquid of all investments and make for great emergency funds. Financial experts generally agree that we should have roughly six months worth of income in these accounts as a buffer against life's unexpected emergencies. Having too little means we can be forced to withdraw money from inherently illiquid investments, incurring unwanted taxes or penalties. Having too much, on the other hand, means we are disproportionately affected by the rise of tax rates over time. From a tax efficiency perspective, therefore, balances in this bucket should be just the right amount. Any surplus accumulation should be systematically shifted into the tax-free bucket.

The Tax-Deferred Bucket: Because the tax-deferred bucket is taxed at ordinary income rates upon distribution, it is the bucket most impacted by the rise of tax rates over time. Exploring the most common tax-deferred vehicles gives us insight into how clients should situate their assets in order to hedge against higher taxes.

IRA: If our clients' goal is to be in a 0% tax bracket in retirement, allowing the IRA to grow in an unbridled way can largely frustrate those efforts. Here's why: A married couple retiring today, absent any other tax deductions, would have a standard deduction plus personal exemptions that would total $18,700.[3] They could therefore withdraw up to $18,700 from their IRA without incurring taxes, provided they are over 59½. Additionally, the IRS indexes standard deductions and personal exemptions for inflation. Therefore, a 55-year-old who is planning on retiring 15 years from now can anticipate, given a 3% inflation factor, deductions closer to $29,000 at retirement. In order to take tax-free distributions, this 55-year-old would want the balance of his IRA at retirement to be small enough that Required Minimum Distributions at age 70½ could be offset by this $29,000 deduction. If a client calculates that growing his existing IRA at a reasonable rate between now and retirement will create Required Minimum Distributions that are higher than the inflation-adjusted standard deduction and personal exemptions, then he should contemplate shifting dollars out of his IRA into the tax-free bucket during the accumulation phase. Will he pay taxes? Yes, but he'll likely do so at historically low tax rates and at a time when he may have more deductions to help offset those taxes.

401(k): Because many of our clients receive matches from their employers, it's easy for them to reflexively allocate all of their retirement dollars to this account. By growing this account through excessive contributions, clients compound the same tax problems experienced with the IRA. It may be better, therefore, to contribute up to the employer match, but not above and beyond. The downside is they will lose tax deductions while working. Nevertheless, we have to remind our clients that the true purpose of a retirement account is not to receive tax deductions. Rather, it's to maximize cash flow in retirement, when they can least afford to pay taxes.

The Tax-Free Bucket: To understand the virtues of the tax-free bucket, we must begin by defining what constitutes a tax-free investment. To be truly tax-free, there are two qualifications: First, it must actually be tax free. That means free from federal, state and capital gains taxes. Second, distributions from this bucket should not count against the Social Security tax threshold of which I previously spoke. As a caveat, municipal bonds, widely renowned as tax-free investments, fail on both counts. What does that leave?

Roth IRA: As long as it doesn't fall victim to Congressional legislation in the coming years, the Roth IRA will continue to be a formidable tax-free alternative:

- Contributions up to basis can be withdrawn pre-59½ tax free with no penalty
- Growth on contributions can be withdrawn tax free after 59½
- Distributions do not cause Social Security to be taxed
- There are no Required Minimum Distributions at 70½
- Clients can contribute $5,000 per year, or $6,000 per year beyond age 50

Cash Value Life Insurance: Clients who have a life insurance need may avail themselves of an additional tax-free alternative: Cash Value Life Insurance.[4] The qualities of this tax-free accumulation tool make it surprisingly flexible:

- Death benefit passes to heirs tax free.
- Dollars can be distributed pre-59½ with no penalty.
- There are no required minimum distributions at 70½.
- Contributions grow tax-deferred.
- Distributions can be tax free and cost free through a combination of withdrawals to basis and 0% loans on growth.
- There are no contribution limits.
- There are no income limitations.
- Distributions do not cause Social Security to be taxed.
- It may enjoy protection from future changes to tax law — when tax laws have changed in the past, existing contracts have been grandfathered.

Long-Term Care Insurance: Many companies these days also specify that, in the event a client can't perform two of six Activities of Daily Living, they will pay the death benefit during the insured's life to cover the cost of long-term care. This is an appealing alternative for those who don't like the traditional long-term care policies that have a "use it or lose it" premium payment approach. The idea of paying long-term care premiums for 20 years and then dying peacefully in one's sleep can be a source of heartburn for many clients. Instead of sending long-term care premiums off to an insurance company and risk never receiving a benefit, clients may choose to divert these dollars to

By The Numbers

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Source: Congressional Budget Office, "Long Term Economic Effects of Some Alternative Budget Policies," May 19, 2008 their Cash Value Life Insurance. In the event they die without needing long-term care, those dollars can be passed on to beneficiaries in the form of a tax-free death benefit.

In Summary: The first two buckets should be contributed to during working years only in carefully prescribed ways. The taxable bucket should house the emergency fund, but limited to about six months of income. Clients should contribute to the tax-deferred bucket, but only to the extent that projected distributions at retirement can be offset by future standard deductions and personal exemptions. The tax-free bucket then becomes the repository for all dollars not earmarked for the first two buckets. By so situating assets during the accumulation phase, clients can be well-positioned to be at the 0% tax bracket in retirement. Such a distribution strategy in retirement might include the following four sources of tax-free income:

Roth IRA: *Tax-Free*

Cash Value Life Insurance: *Tax-Free* (withdrawals up to basis and 0% loans thereafter)

Traditional IRA: *Tax-Free* (so long as distributions remain below the standard deduction and personal exemptions in any given year)

Social Security: *Tax-Free* (Distributions from the Roth IRA, Cash Value Life Insurance, and the Traditional IRA [at the above-mentioned levels] do not affect the income threshold where Social Security becomes taxable)

By taking distributions from these four pools of money, our clients remain in the 0% tax bracket. This is important because starting in 2011, the next best tax bracket is 15%. Throw in another 6% on average for State tax, and our clients face a minimum income tax rate of 21%. Moreover, if the Congressional Budget Office's predictions are accurate, then that best case scenario of 21% could easily become 42% or higher.

"A successful accumulation strategy will enable your clients to draw tax-free streams of income from the Roth IRA, Cash Value Life Insurance, the traditional IRA (up to the standard deduction and personal exemptions), and Social Security. So doing will put them in the 0% tax bracket."

In Conclusion: When investing with an eye towards eliminating taxes in retirement, proactive, calculated contributions to the three types of investment accounts are crucial. A successful accumulation strategy will enable your clients to draw tax-free streams of income from the Roth IRA, Cash Value Life Insurance, the traditional IRA (up to the standard deduction and personal exemptions), and Social Security. So doing will put them in the 0% tax bracket, giving them peace of mind and protection, even in the face of dramatically higher taxes.

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Footnotes:

1. http://www.socialsecurity.gov/pressoffice/pr/babyboomerfiles-pr.htm
2. Congressional Budget Office, "Long Term Economic Effects of Some Alternative Budget Policies," May 19, 2008, 8-9, http://www.cbo.gov/ftpdocs/92xx/doc9216/05-19-LongtermBudget_Letter-to-Ryan.pdf
3. http://www.irs.gov/pub/irs-drop/rp-09-50.pdf.
4. Throughout this article, cash value life insurance is referred to as a "tax-free" financial vehicle, based on the following tax attributes: income tax-free death benefit, tax-deferred accumulation of policy values, and tax-free access to basis. Policy loans in excess of basis are income tax-free so long as the policy remains in force. This assumes the policy is not a modified endowment contract. Loans taken directly from the policy will reduce the death benefit.