Advanced Markets

The case for tax diversification in retirement planning

Don't put all your tax eggs in one basket

It's a reality that taxes exist… even in retirement. Does your current retirement plan consider future tax exposure? Many retirees are often shocked by the toll that taxes can take on their investment portfolios when it comes time to access the money for retirement. If you are concerned about your potential tax exposure in retirement, the good news is there are planning decisions that can be made today that can help alleviate your tax exposure in the future.

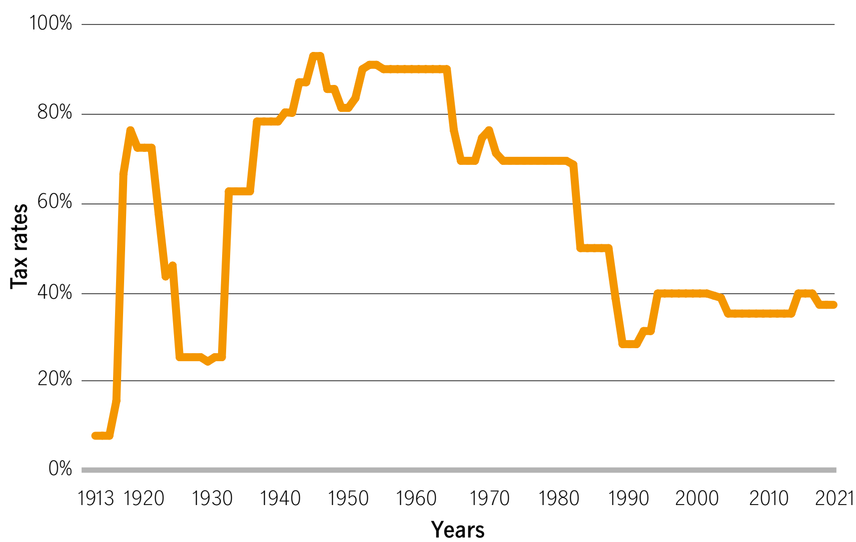
Why consider diversification for tax purposes:

- Taxes and tax rates change
- Tax-deferred growth is a good thing
- Taxes impact growth, distributions, benefits, and more

Will taxes be higher or lower during retirement?

The answer is unknown, but the expectation should be that taxes should change not only at the beginning of retirement, but also might change during the retirement years. Below is a chart with the historical income tax rates.

Highest marginal tax rate 1913-2021



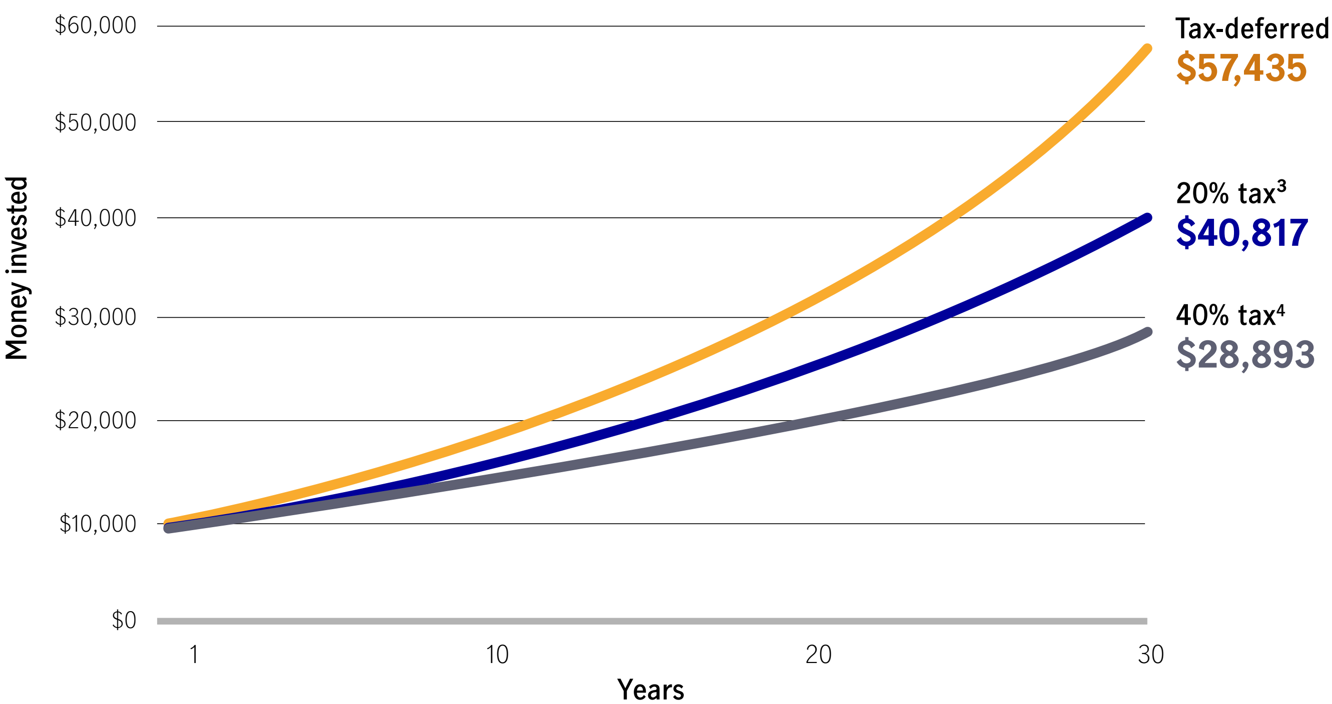
Source: Tax rates shown are from the Tax Foundation. www.taxfoundation.org

Tax deferred growth is a good thing

No matter your age, income or financial goals, taxes can take a bite out of your long-term savings. That's why it makes sense to make the most of as many opportunities as you can to set aside money in tax-deferred accounts. Tax benefits and compound growth make small regular contributions grow into more than you might think. Over long periods of time, tax deferral makes a difference in the amount of money you have in an account.

To understand the basics, let's look at a simple example. The chart below shows a hypothetical $10,000 investment,[1] returning a steady 6% in three tax situations: tax-deferred,[2] a 20% rate and a 40% rate. As you can see, the tax-deferred account grows faster than the accounts that pay taxes each year.

$10,000 invested at 6%



Source: http://www.jhinvestments.com/Article.aspx?ArticleID=%7BEAD829D7-2052-4B0A-8B1E-6B21E5DCF3DA%7D

1. This example is hypothetical and does not represent any particular investment.
2. Taxes would be due upon withdrawal for the tax deferred investment.
3. Assuming 15% Federal and 5% state tax rates.
4. Assuming 35% Federal and 5% state tax rates.

Taxes impact growth, distributions, benefits, and more

Will you have less to invest due to taxes? Let's consider the taxes that may have the biggest impact on your financial planning — now and in the future:

		2021 tax rate
Top federal tax rates	Individuals with income over $523,600 ($628,300 for married filing jointly)	**37%** (ordinary and earned income)
	Individuals with income over $445,850 ($501,600 for married filing jointly)	**20%** (long-term capital gains & qualified dividends)
Top state tax rates	Depending on the state you live in or own/hold property, you may have additional income and capital gains tax liability	**Depends on the state**
Medicare payroll tax	This tax is an additional tax imposed on wage and self-employment income for individuals earning more than $200,000 ($250,000 for married filing jointly)	**0.9%**
Net investment income tax	This tax is imposed on the lesser of an individual's net investment income or modified adjusted gross income (MAGI) exceeding $200,000 ($250,000 for married filing jointly)	**3.8%**

Qualified plan limitations

For many individuals, a primary way to save for retirement is through the use of pre-tax deductions via qualified plans (401(k)s, IRAs, etc.). Unfortunately, limitations on contributions to qualified plans and income restrictions may prevent high income earners from doing substantial planning in 2021 qualified plans and/or Roth IRAs:

		2021
Qualified plan contribution limits[5]	Maximum elective deferral to retirement plans (e.g., 401(k), 403(b), 457(b))	$19,500[6]
	Maximum IRA contribution limit	$6,000[7]
Qualified plan income limitations for contributions	Maximum compensation limit for employer matching contributions	$290,000
	Roth IRA phase out (married filing jointly)	$198,000-$208,000
	Roth IRA phase out (single, head of household, married filing separately)	$125,000-$140,000

Additional tax considerations in retirement

Retirement does not necessarily mean that you will be in a lower tax bracket. During retirement your income might even affect your Social Security Benefits and Medicare Premiums:

Social Security	Up to 85% of social security benefits are subject to income taxes if your income exceeds certain thresholds
Medicare premiums	The standard monthly Medicare Part B premium in 2021 is $148.50, but could be up to $504.90 depending on your income

Investment options

Pre-Tax	Taxable	Tax Advantaged
What are they? These are your traditional 401(k)s, profit-sharing plans, IRAs and other qualified plans. **How are they funded?** They are funded using pre-tax dollars. **How is the growth taxed?** These accounts grow tax deferred. **What about distributions?** Distributions are taxed as ordinary income. Distributions prior to 59½ result in a 10% penalty and Required Minimum Distributions (RMD) have to be made starting at 72.	**What are they?** These are your mutual funds, stocks, bonds, real estate, and other investments. **How are they funded?** They are funded with money that has already been taxed (a.k.a. after-tax money) **How is the growth taxed?** Dividends and capital gains can be assessed depending on the type of investment. **What about distributions?** Capital gains may also be assessed on the growth during distributions.	**What are they?** These are municipal bonds, Roth IRAs, and Cash Value Life Insurance. **How are they funded?** They are funded with after-tax money. **How is the growth taxed?** They grow tax deferred. **What about distributions?** Distributions are generally tax free, but Roth IRA accounts distributions have to be made after 59½, otherwise there is a 10% penalty.
Benefits		
Pre-tax contributions, and potential for employer contribution match.	There are no contribution limits, and accounts are liquid and accessible (i.e. no penalty if accessed prior to 59½).	Accounts grow tax deferred and are generally distributed income tax free.
Considerations		
Limited access to accounts without penalty, and distributions are taxable.	Investments may be subject to ongoing taxation, which will affect overall growth.	Income limits may prevent you from contributing directly to a Roth IRA. A 10% penalty also applies when funds are withdrawn from a Roth prior to age 59½.
Pre-tax contributions	**After-tax contributions**	**After-tax contributions**
Pre-Tax Contributions 401(k) IRA	**Taxable** Mutual Funds Stocks Annuities Real Estate	**Tax Advantaged** Muni Bonds Roth IRA Life Insurance
Withdrawals may be subject to 100% income tax	Withdrawals may be subject to capital gains, and even ordinary income tax	Withdrawals can be accessed income tax-free

Why tax diversification is important

Deciding where to invest today may affect retirement savings as it pertains to taxes. Diversifying the income tax treatment of investments can reduce income taxes in retirement.

Let's take a look at a $120k withdrawal

Non-diversified withdrawals

Let's assume Mary and John Smith withdrew $120,000 from their 401(k); they would be left with $78,000 (assuming a 35% tax rate).

100% ordinary income tax

401(k) plan	Mutual fund	JH Life policy	
$120,000 withdrawal	**$0 withdrawal**	**$0 withdrawal**	**$78,000 potential net income**

Diversified withdrawals

Instead, if they took $40,000 from each of the three alternatives – $40,000 from their 401(k), $40,000 from a mutual fund, and $40,000 from a John Hancock permanent life insurance policy – they could potentially receive net income of $100,000 (assuming a 35% income tax bracket and 15% in capital gains taxes).

100% ordinary income tax	**Capital gain tax**	**Tax-free**	
401(k) plan	Mutual fund	JH Life policy	
$40,000 withdrawal	**$40,000 withdrawal**	**$40,000 withdrawal**	
$26,000 +	$34,000 +	$40,000 =	**$100,000 potential net income**

Look at the taxable difference.

Advantages of diversifying with cash value life insurance

Regardless of when you decide to retire, a John Hancock cash value life insurance policy added to your retirement portfolio can help protect your savings and provides the following tax advantages:

- **Retirement income from policy withdrawals and loans**, which do not affect your:
  - Income tax bracket
  - Medicare premiums
  - Capital gains
  - AGI or MAGI
  - Social Security
- **Income tax-free death benefit for your beneficiaries**
- **Tax-deferred growth**
- **No retirement contribution limits**
- **Potential to access** cash prior to age 59 1/2

What life insurance could do for you in retirement

Pre-tax & taxable accounts	Versus	Permanent life insurance
Distributions from pre-tax investments taxed as ordinary income and subject to 10% penalty	Before age 59½	**Income-tax free distributions** without any penalties and tax-free growth of cash value
	59 1/2	
Distributions from pre-tax and taxable investments are subject to income tax and increase MAGI	After age 59½	**Income-tax free distributions** that do not increase MAGI
	65	
Distributions from pre-tax, taxable and tax-exempt investments may cause you to pay more in Medicare premiums, which are affected by increases in your MAGI	At age 65	**Distributions not considered as part of MAGI,** thus having no effect on Medicare premium costs
	72	
Starting after age 72*, **you are required to take distributions ("RMDs") from your pre-tax investments**	At age 72	**You are never required to take any distributions from your policy;** access to cash value is completely in your control

*The SECURE act changed the RMD from age 70 1/2 to 72 and applies to participants turning 70 1/2 after 12/31/19.

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5. These are only a subset of qualified plan limitations.
6. An additional $6,500 catch-up is available for those ages 50+.
7. An additional $1,000 catch-up is available for those ages 50+.

Life Insurance can offer tax free distributions as long as the policy is structure properly. Modified endowment contracts (MEC), lapsing or surrendering a contract may cause income taxation. Roth IRAs can offer tax free distributions, but if money is accessed prior to 59½, the distributions may be subject to income tax and 10% penalty. There are also income limitations on Roth Contributions. Pretax accounts, generally include 401(k)s and IRAs. Withdrawals prior to age 59½ may result in a 10% penalty and taxes.

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Loans and withdrawals will reduce the death benefit and the cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Withdrawals in excess of the cost basis (premiums paid) will be subject to tax and certain withdrawals within the first 15 years may be subject to recapture tax. Additionally, policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59 1/2. Withdrawals are available after the first policy year.

Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are few exceptions such as when a life insurance policy has been transferred for valuable consideration.

Insurance products are issued by: John Hancock Life Insurance Company (U.S.A.), Boston, MA 02210 (not licensed in New York) and John Hancock Life Insurance Company of New York, Valhalla, NY 10595.

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