Financial Security Insights

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Unique Tax Mitigation Strategies for High Net Worth Individuals and Business Owners

STUERMANN CONSULTING

Overview

In 2021, the U.S. federal government collected $4.05 trillion in revenue and spent $6.82 trillion dollars, pushing the federal debt to $28.43 trillion.[1] As of December 2021, Congress had approved $4.5 trillion in COVID-19 relief spending and more could be coming.[2] News continues to come out about the Biden administration's tax proposals, and we are still waiting for additional drafting of proposed legislation. Regardless of any specific proposals and based solely upon our country's spending trajectory, higher taxes seem inescapable. Families and businesses can take steps today to mitigate expected tax increases and protect their legacies.

Personal Tax Strategies

Longevity planning is key to ensuring there is sufficient retirement income and that incidents of disability or long-term care do not eat away at assets. In 2021, Dr. Joseph F. Coughlin, founder and director of the MIT AgeLab, released some eye-opening data:[3]

- Americans have 20 healthy years of life after age 60, on average.
- The fastest-growing population segment is the 85-plus age group.
- Half of the babies born in wealthy nations today will live to age 100 if current life expectancy trends hold.
- Some research suggests that 142 years will be the "new normal" life expectancy in the future.
- One-person households are the fastest growing—with 43% of women over 65 today living solo.
- Nearly one-third of couples over 65 now live without their children nearby.

In meeting retirement income needs, tax-efficiency is equally critical. After maximizing contributions to qualified retirement plans, consider other tax-advantaged sources of retirement income such as cash value life insurance and annuities. Recent legislation and new product designs have made these options more flexible and customer friendly.

Cash Value Life Insurance

By maximum funding a cash value life insurance policy, a policyholder purchases as little death benefit as permitted by law in order to keep the cost of insurance low and to maximize the income tax-free inside build-up (growth) of the policy's cash value. At some point in the future, the policy's cash value can be accessed by the policyholder to take capital gains and income tax-free withdrawals and loans.

Federal legislation passed in 2020 permits a policyholder to significantly increase funding for most cash value life insurance policies. Even with this advantage, it is recommended policyholders commit to holding their policies for at least 15 years before accessing it for distributions.

Annuities

Similarly, an annuity is a long-term investment that is issued by an insurance company and designed to help protect the owner from the risk of outliving their income. The ability to grow contributions made to an annuity tax-free and then generate tax-advantaged lifetime income are attractive and compelling features.

Through annuitization, all purchase payments contributed, and any resulting growth, are converted into periodic payments that can last for life. While most clients will invest a lump sum or invest over a period of time and receive distributions in the future, there are annuities which allow the owner to start receiving payments immediately.

Cash value life insurance and annuity policyholders can choose from variable, fixed and indexed rates of return as well as performance and principal protection guarantees.

Irrevocable Life Insurance Trusts

As important as creating tax-efficient sources of future income is taking steps to prevent the erosion of assets from one generation to the next. The highest federal estate tax rate is 40% and many states pile on with their own transfer tax. For instance, New York's estate tax tops out at 16%. While the 2022 lifetime federal gift estate tax exemption is just over $12 million per person, this sum will fall to nearly $5 million per person at the end of 2025. Congress could reduce or eliminate this exemption at any time.

By gifting assets to an irrevocable trust, clients can leverage their existing gift and estate tax exemption to move the value of these assets outside of their estate. In addition, transferred assets will receive a step-up in basis at the death of the donor, eliminating capital gains taxes for heirs. Once a client's exemption is exhausted, techniques such as private split dollar can 'freeze' the value of assets loaned to a trust where the assets can appreciate estate tax-free outside of the estate.

Funds gifted or loaned to an irrevocable life insurance trust can be used to purchase a trust-owned life insurance policy. The income and estate tax-free policy proceeds will be exempt from the client's estate and can replace any wealth lost from taxation to heirs.

Business Tax Strategies

Most business owners rely upon their companies as the source of both current and future income. Rising corporate tax rates, reductions in deductions and retirement plan limitations and restrictions are all barriers to saving for the future. Mitigating these obstacles has become a priority for many business owners who are turning to several tax-efficient strategies.

Loan Regime Split Dollar

When a company's corporate tax rate is lower than that of an owner's or an executive's personal rate, it may make sense to take advantage of this arbitrage via split dollar plans. In a split dollar arrangement, a company loans premiums to an owner or executive to maximum fund a cash value life insurance policy. The policy is then pledged as collateral for the loan.

The business owner or executive are able to receive money from the company without having to pay income tax on anything other than the minimal loan interest required by these arrangements. The business owner or executive can access cash value in the form of capital gains and income tax-free policy withdrawals and loans down the road.

Cash Balance Plan

Cash balance plan is a type of defined benefit retirement plan which has higher benefit and contribution limits compared to 401(k) and Profit-Sharing Plans and permits the company to take an immediate income tax deduction for all contributions. Benefits are guaranteed, provided annual funding is made.

Each year, eligible participants receive their benefit in the form of a pay credit and an interest credit that is added to their hypothetical account. However, the plan is still funded like a traditional defined benefit plan with funds going into a pooled account.

The cash balance defined benefit plan formula considers salary only. As a result, it can be designed to equalize the contribution for owners or highly compensated employees with the same compensation, but different ages. Cash balance plans may be funded with investments, life insurance and annuity contracts. If life insurance is used, with proper planning, cash values can be accessed income and capital gains tax-free to supplement retirement income.

Employee Stock Ownership Plan (ESOP)

Technically, an ESOP is a tax qualified defined contribution plan that permits the sale of a company to employees, often without incurring income and/or capital gains taxes. Functionally, ESOPs are a flexible financial and equity incentive instrument that uses corporate tax-deductible or tax-free dollars to achieve a variety of individual and corporate objectives, including shareholder liquidity, succession planning, raising working capital, and charitable giving.

An ESOP is unlike any other employee benefit plan in that the ESOP Trust is designed to hold primarily stock of the sponsoring employer. In its simplest form, a company establishes a trust to which the company contributes stock or cash to purchase stock. The stock is then allocated out to employees' individual accounts within the trust. When cash is contributed, it is used to purchase stock from shareholders and then allocated out to individual employee accounts.

Life insurance is often considered as a funding vehicle for ESOP repurchase obligations. The decision as to which entity is to own the insurance, as well as how the insurance proceeds are to be used, must be carefully made. Corporate Owned Life Insurance (COLI) is often the preferred choice due to its evergreen financing attributes.

Do The Math

When working with sophisticated clients and their advisors, it is paramount to analyze the pros and cons of all available planning strategies to make informed decisions.

Our proprietary analytical tools can compare, contrast and stress test them under various assumptions. In most circumstances, insurance costs are considerably lower than tax costs and management fees over time.

Act Now

While it is uncertain what tax policy, if any, will advance in 2022, recent federal spending suggests that tax rates are headed upward sooner than later.

At Stuermann Consulting, Inc we know how to help high net worth individual and business owners select and implement the right tax mitigation strategy to preserve their wealth.

As independent financial security professionals, we access the entire product universe to ensure that clients implement strategies that match their long-term planning objectives and risk profiles.

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[1] Data Lab. (2022). *America's finance guide: U.S. Treasury Data Lab*. America's Finance Guide | U.S. Treasury Data Lab. Retrieved February 6, 2022, from https://datalab.usaspending.gov/americas-finance-guide/

[2] Rattner, N., & Pramuk, J. (2021, December 9). *The U.S. has spent most of its Covid relief funding, but there are still billions left to Dole OutNate*. CNBC. Retrieved February 6, 2022, from https://www.cnbc.com/2021/12/09/covid-relief-bills-us-has-spent-most-of-coronavirus-aid-money.html

[3] Schwab.com. (2021). *Longevity planning: Help clients envision new retirement realities*. Schwab Brokerage. Retrieved February 6, 2022, from https://advisorservices.schwab.com/insights-hub/perspectives/longevity-planning-new-retirement-realities

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