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counting on change Financial Planning for the Next Ten Years

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Financial Planners are not in the business of predicting the future. They practice in a world of uncertainty, often avoiding the word *guarantee*. The fact is in the financial planning world the only guarantee seems to be change. That is, markets ebb and flow, interest rates vacillate. The term “New Economy” is used every decade or so only to be followed by growth, contraction, recession and explosive recovery. Economic change is a constant force. Being able to plan on and react nimbly to continuous change are characteristics that separate successful financial advisors from those who are phenomenal.
FIRST OF A SERIES

This series will review the current state of federal income taxation, interest rates and macroeconomic market cycles and provide best practice strategies to help clients succeed in an environment of change. Preparing for the following five elements of change can help prepare financial advisors for the future:

1. Marginal Federal Income Tax Rates Will Increase for Affluent Americans
2. Domestic Stock Markets Will Recover
3. The Case for Universal Life Insurance in Uncertain Times
4. The Regulatory Landscape Will Shift
5. Social Security Will Be Modified or Reformed

This article is not intended to predict when the above events will take place, rather, it provides techniques that can be implemented today to help both financial professionals and clients achieve success.

MARGINAL FEDERAL INCOME TAX RATES WILL INCREASE FOR AFFLUENT AMERICANS

In 2008, if a client had an adjusted gross income of $500,001, the last dollar earned was subject to a 35% federal income tax and a 1.45% for Medicare. Assuming the Social Security wage base had been met earlier in the year, a client would receive about 63 cents for every dollar s/he earned. This tax rate has remained consistent since 2003 as established by the EGTRRA 2001 tax law. Painting a historical picture: the highest marginal tax rate on $500,001 has varied since the federal income tax was established permanently by the sixteenth amendment in 1913. Even within the last 30 years, the tax rate for those earning $500,001 (in 2009 dollars) has been as high as 68 percent. Looking at the chart in Figure 1, today's highest marginal tax rate is lower than the historical mean of 44 percent.

In 2009, America is involved in two international military operations (Iraq and Afghanistan). Our economy has generated billions of dollars of new debt through TARP arrangements and direct corporate bailouts. A proposed national health care plan that will require government funding is waiting in the wings. The Medicare and Social Security deficits will need to be addressed, as will the funding of Medicaid. While the middle class may not realize any tax increases, more affluent Americans will almost certainly see federal income taxes rise to pay for past, current and future federal revenue needs. The following are some suggested steps planners may use to protect higher income clients.

• Take advantage of Roth conversions in 2010.
  Through 2009, the ability to convert traditional IRA dollars to Roth IRAs was limited by an income threshold. Beginning in 2010, this threshold will be removed and any tax payer can transfer monies in a traditional IRA to a Roth IRA. Maximize a client’s access and use

FIGURE 1
Federal Income Tax Rates on $500,001 (2009 dollars) since 1980

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>80.0%</td>
</tr>
<tr>
<td>1985</td>
<td>70.0%</td>
</tr>
<tr>
<td>1990</td>
<td>60.0%</td>
</tr>
<tr>
<td>1995</td>
<td>50.0%</td>
</tr>
<tr>
<td>2000</td>
<td>40.0%</td>
</tr>
<tr>
<td>2005</td>
<td>30.0%</td>
</tr>
<tr>
<td>2010</td>
<td>20.0%</td>
</tr>
</tbody>
</table>

of lower tax brackets every year. In 2008, federal income tax brackets for a married couple were:

<table>
<thead>
<tr>
<th>Marginal Tax Rate</th>
<th>Tax Brackets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Over But Not Over</td>
</tr>
<tr>
<td>10.0%</td>
<td>$0 $16,700</td>
</tr>
<tr>
<td>15.0%</td>
<td>$16,700 $67,900</td>
</tr>
<tr>
<td>25.0%</td>
<td>$67,900 $137,050</td>
</tr>
<tr>
<td>28.0%</td>
<td>$137,050 $208,850</td>
</tr>
<tr>
<td>33.0%</td>
<td>$208,850 $372,950</td>
</tr>
<tr>
<td>35.0%</td>
<td>$372,950 -</td>
</tr>
</tbody>
</table>

Convert traditional IRA to Roth accounts with the intent of filling lower marginal tax brackets. This technique will lower overall taxes paid and Roth assets do not require minimum distributions.

- **Consider municipal bond positions.** Municipal bond funds have rebounded quite nicely in 2009, up 9.82 percent in September (based on the S & P National Municipal Bond Index). Annual yields remain low for this asset class, but fundamental after-tax yield pricing dictates that as income tax rates increase, the after-tax yield of these bonds increases as well. For example, a 10-year municipal bond earning 3 percent has a nominal equivalent rate of return of 5 percent, assuming a 40 percent tax bracket (35 percent federal and 5 percent state). Furthermore, a rise in tax rates increases the equivalent rate of return.

- **Accelerate distributions from tax deferred accounts today.** If a client needs cash flow today and is over 59 and a half, consider taking distributions from qualified assets. S/he may realize a greater net dollar benefit than if forced to take distributions in a higher income tax environment.

- **Evaluate Defined-Benefit Plans for small business owners.** Defined Benefit plans require a reliable revenue stream and may not be appropriate for all clients. However, clients with a constant revenue stream (doctors, lawyers, accountants, financial professionals) can realize tax savings far above administrative costs.

Assume an affluent client in the highest marginal tax bracket is making $150,000 of DB plan contributions in 2008. The client is deferring money into a DB plan which otherwise would have cost the client $52,500 in federal income taxes. If tax rates increase to 40%, then the client would save $60,000 in federal income taxes by utilizing a DB plan.

Position the additional $7,500 as savings that can be used to pay pension attorney, tax reporting and third party actuary (TPA) costs. Defined contribution plans will see similar increased tax advantages if tax rates rise, but DC plans are more restrictive on total contributions for older business owners than their defined benefit counterparts. Speak with a tax professional or pension attorney before recommending DB plans to clients.

- **Purchase deferred annuity contracts today that allow future premium funding.** Deferred fixed and variable annuity contracts allow tax-deferred growth, and annuity contract pricing is subject to the laws of supply and demand. Tax reform could also include changes to qualified dividends, capital gains tax rates and the definition of long-term and short-term gains.

Purchasing deferred contracts today with guaranteed expenses (Administrative and Mortality Charges) today provides a tangible hedge against future expense charges. If the affluent investor’s tax environment in non-qualified investments becomes arduous, more non-qualified money will flow into annuity products, increasing the demand for deferred products. An increased demand coupled with investor concerns about insurer stability will increase underlying product costs.

I can make a firm pledge, under my plan, no family making less than $250,000 a year will see any form of tax increase. Not your income tax, not your payroll tax, not your capital gains taxes, not any of your taxes.

– President Barack Obama
• Tax deferred products provide attractive alternatives to non-qualified brokerage accounts. Tax deferral allows the client to select when to pay taxes on gains, where traditional mutual fund and stock investing relegates income decisions to board directors and fund managers. Tax deferral potentially increases growth rates, especially in times of increasing marginal tax rates.

Assume an affluent client invests $1,000,000 in a variable annuity and $1,000,000 in a portfolio of equity and bond mutual funds this year. The annuity has annual expenses of 2.30% and mutual funds average 1.00%.

The client earns 9.0% annually beginning this year (At the time this article was written, the S&P 500 was up 12.5% for 2009). 5% of the return came from long term capital gains, 2% from short term gains and the remaining 2% from dividends and interest payments.

The annuity is illustrated to grow to around $2,040,000 in ten years, including contract costs. Assuming today’s highest marginal income rate (35%), long term capital gains rate (15%) and short term capital gains rate (35%), the brokerage account is estimated to grow to around $1,870,000. If marginal and short term gain tax rates revert to their highest mean (44%) and long term tax rates to 20%, the brokerage account is estimated to grow to $1,753,000. (See Figure 2)

The client will eventually pay income tax on annuity assets; but, if the client chooses to annuitize this account in the future, distributions will contain a return of basis lowering the client’s taxes due.

• Collaborate with an insurance-friendly Certified Public Accountant who prepares personal income tax returns. Ask colleagues with whom they work, and find a CPA who can help move clients through today’s challenges. Consult with the accountant on an hourly basis to ensure compliance with any new rules and how to present reliable estimates.

Our nation is experiencing a period of change, and this change will be felt with marginal income taxes for the affluent. Financial service professionals are in a position to help their clients effectively and efficiently prepare for income tax challenges. Stick to the fundamentals – utilize educational resources and re-tool. Change may not create new economies, but it does require planners to become intimately familiar with new rules and laws as they occur. The planners who learn the rules first will have a definite advantage over those who wait.


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