Tax-Efficient Investments and Family Protection Go Hand-in-Hand

All of us have similar basic financial goals–to accumulate as much wealth as possible to maintain or improve on our lifestyle, enjoy slowing down or retirement, and to support family members in their endeavors. Another important life goal that complements those goals is to protect each family member from the curveballs that life can sometimes throw at us, particularly at unexpected times. To achieve these goals, we work hard, budget our cash flow, save what we can, invest our savings and purchase several types of insurance.

How we each fulfill these goals may differ in some respects but, unfortunately, federal, state and local governments all have adverse influences on those goals. This includes taxes on our savings and investments. As Benjamin Franklin, in 1789, was attributed to saying: "Nothing is certain except death and taxes."[1] Judge Learned Hand noted in this now famous and oft-cited quote, however: "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[2]

As a result, there are certain universal strategies that we should all employ to accumulate wealth, reduce income taxes and protect our families from catastrophic life events. Here are a few that your Security Mutual life insurance advisor can help you with:

Cash Value Life Insurance

Permanent life insurance, also known as cash value life insurance, provides two important benefits when premiums are paid. The first is the protection component through an income tax-free death benefit that helps to financially protect the beneficiaries of the policy, typically family members, from the untimely passing of a loved one. With certain riders attached to the policy, a portion of the death benefit can also be accessed by the policy owner during the insured's lifetime, on a tax-free basis in the event of terminal or chronic illness.

The second component of a permanent life insurance policy is the tax-favored savings and investment element from the accumulation of cash values. Depending upon the type of policy, cash values can grow on a guaranteed basis or on a non-guaranteed basis subject to interest rates, investment performance, and the company's dividend payments, if any. Regardless of the type of permanent policy, however, cash values grow income tax-deferred. In addition, cash values can be accessed through tax-free policy loans* for any purpose.

*Loans are tax-free unless the policy is surrendered or lapses, which makes the outstanding indebtedness taxable to the extent of any investment gain in the policy.

Annuities

Annuities are investment products offered by life insurance companies. There are several different types of annuities. In general, they fundamentally work the same way. In return for a lump sum or continuing series of premiums, the life insurance company will guarantee a stream of income for a set number of years or for your lifetime, depending upon product features you choose. Having a guaranteed lifetime income beyond Social Security is becoming increasingly important, because Social Security benefits are generally insufficient to maintain the desired lifestyle especially as people continue to live longer.

Immediate annuities will generally start distributing income periodically, most commonly monthly, within the first year of purchasing the annuity. Deferred annuities accumulate funds and will continue to be invested and potentially grow in value. Income distribution will start based upon the contract features and the choices made by the annuity owner. Deferred annuities usually permit the policyowner to make withdrawals prior to starting the periodic income distribution. Withdrawals may be subject to penalties and income taxes.

Annuities also enjoy some unique tax features, including tax-deferral on the undistributed growth. When the annuity matures and the income distribution begins the income tax burden is spread over a period of time rather than in a single sum.

As you can see, life annuities provide protection in the form of an income stream during retirement that you cannot outlive. Annuities also offer income tax-favored investment savings.

IRAs and 401(k) Plans

Traditional IRAs allow you to make contributions, often on a tax-deductible basis depending upon certain income limits and other qualifications, to save for retirement and provide financial security in your later years. The contributions are typically invested in mutual funds, stocks and bonds, annuities, and bank certificates of deposit. Growth of these accounts, however, is tax-deferred but distributions are taxable.

Like a Traditional IRA, a Roth IRA also helps to provide financial security for your future. It allows you to make contributions on an after-tax basis but growth and distributions from the Roth IRA are tax-free provided that certain requirements are met.

A 401(k) Plan is an employer-sponsored retirement plan that allows employees to defer some of their income for the future. These salary deferrals are typically made on a pre-tax basis, helping to lower current taxable income and potentially keeping you in a lower tax bracket. Some plans may even offer employer matching and/or profit sharing contributions. Meanwhile, account balances grow tax-deferred in various investment vehicles such as mutual funds, individual stocks, bonds and other securities.

Some 401(k) plans also allow for after-tax salary deferrals into a Roth-type plan. In addition, 401(k) plans may also allow for additional after-tax contributions above typical salary deferral limits. Another feature of many 401(k) plans is that they allow for the purchase of life insurance inside of the plan. This helps to provide additional family protection through the death benefit from the insurance. Increasingly, 401(k) plans also are offering annuities as investment choices because of the possibility of guaranteed lifetime income that annuities can provide to protect the participant from outliving their money.

Ultimately, IRAs and 401(k) plans help to provide for future financial security while offering tax-favored investment features and, in some cases, tax-free distributions. They may also allow for a reduction in current taxable income to manage income tax exposure. These are excellent investment vehicles that provide tax-efficiency and help to protect the participant and their families.

Health Savings Accounts (“HSAs”)

HSAs are available to employees that have high deductible health insurance plans. HSAs are essentially savings accounts that help the employee to cover medical expenses that may fall within the deductible or out-of-pocket expense limits. As such, they help participants to protect themselves and their family members from the high costs of healthcare related services.

What's unique about an HSA, however, is that it offers several tax benefits.

1. If you're contributing to an employer-provided HSA, the contributions are generally made pre-tax. That helps you to manage your income tax exposure at the end of the year by reducing your taxable income or keeping you in a lower tax bracket. If you are contributing into an HSA that you established, your contributions may be deducted on your income tax return.
2. The money in the HSA may be invested, typically in interest-bearing accounts, mutual funds or stocks and bonds. The income and growth generated by those investments are tax-free while the assets remain in the HSA.
3. Withdrawals from the HSA to reimburse yourself for eligible healthcare expenses are also received tax-free.

If you have sufficient income or cash flow to pay healthcare out-of-pocket expenses without resorting to using the HSA, then you might want to do that. Just continue saving your receipts and invoices for eligible medical expenses and services, allowing your HSA to continue growing in a tax-free manner.

During retirement, when income and cash flow may be lessened, you can dip into your HSA to reimburse yourself for some or all of the past, accumulated eligible medical bills and services, thereby increasing tax-free cash flow. Thus, the HSA can act as another tax-advantaged savings account for retirement.

Conclusion

We just briefly described several financial products and strategies that provide you with tax-efficient savings and investments, while also allowing you to protect yourself and your family from life's uncertainties. A comprehensive financial plan includes tax-efficient investments and family protection.

Security Mutual Life Insurance Company of New York (SML) is a leading provider of life insurance, annuity products and retirement planning solutions. Contact your SML life insurance advisor today and start planning for the protection needs of you and your family with tax-efficient savings and investment products and strategies.

Sources

[1] https://constitutioncenter.org/blog/benjamin-franklins-last-great-quote-and-the-constitution
[2] *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934)

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