

Life & Leverage

Three challenges for tapping into a \$10 Trillion opportunity



by Gonzalo Garcia, CLU

Mr. Garcia is partner and head of advanced markets for AgencyONE – a solutions-driven boutique life insurance brokerage general agency that specializes in high-net-worth underwriting advocacy, advanced planning and product proficiency. Visit www.agencyone.net. AgencyONE is a LifeMark Partner Agency.

When I started my career in the early 80's, 401(k) plans were just becoming popular. Today they are the foundation of most people's retirement savings plan.

In fact, in a June 7, 2016, Time Magazine article "The Average 401(k) Account Holds \$96,000. How Does Yours Stack Up?", author Penelope Wang referred to these plans as "America's de facto national savings program."

401(k) Plans have been so successful that in a 2014 Federal Reserve report¹ it was noted that in the fourth quarter of 2013, defined contribution plans (the category into which 401(k) plans fall) totaled \$4.89 trillion, whereas IRA assets, including rollovers, amounted to \$6.16 trillion. To put this in perspective, this total of \$11.05 trillion is equivalent to the gross domestic product of China, the second largest economy in the world.

Challenge 1: Forced Distributions Eroding Retirement Account Values

Many financial advisors have robust investment management practices that include advising clients on how to invest and grow retirement assets, including 401(k), IRA and other tax-deferred saving vehicles. They have seen their assets and practices flourish over the last three decades as the Baby Boomer generation, such as myself, took advantage of the tax benefits of 401(k) plans and the ability to roll over funds without any tax implications into Individual Retirement Accounts as they moved between employers.

But, that is about to change as the first wave of Boomers reached the magical age of 70 ½ in 2016. According to an estimate by Edward Shane at Bank of New York Mellon Corporation, Boomers hold roughly \$10 trillion in tax-deferred saving accounts. The 70+ million Americans who are considered Baby Boomers will systematically reach age 70 ½ during the next 17 years, and due to the IRS's required minimum distribution rules, will have to begin to draw down on that \$10 trillion in ways that will have a meaningful impact on both tax revenue (a positive for the US Treasury) and on balances that are sitting in advised accounts (a negative for financial advisors.) It is finally time for the Boomers to pay the piper, whether they need the income to fund their lives during retirement or not.

So, here they are, arguably the most productive generation in the history of this country, sitting on almost the equivalent of the entire GDP of China in tax-deferred savings, and they are being forced to take distributions. To further compound this mass distribution from retirement accounts, the ability to stretch out the distributions inter-generationally is subject to disappear as well. In September of 2016, the Senate Committee on Finance passed a bill by 26-0 vote to kill the ability for taxpayers to stretch their IRAs inter-generationally, thereby accelerating the tax revenue for the US Treasury.

While the stretch IRA has been on the Congressional chopping block for the past five years, this most recent bill is widely speculated to be the one that makes its way into law in 2017.

Challenge 2: Regulatory Changes

In addition to assets under management dropping as a result of these forced distributions, the regulatory environment surrounding retirement assets continues to tighten.

While delays are expected and the final details of the DOL Fiduciary Rule continue to take shape, advisory fees and commissions will likely continue to face increased scrutiny for years to come. Additionally, the training and compliance steps needed to adhere to increased legislation will likely result in higher overhead expenses. It is no surprise that the DOL is looking to protect this massive transfer of wealth through disclosure and other regulatory guidance. Regardless of how this legislation continues to evolve, it may be a game-changer for retirement advisors.

Challenge 3: Losing Accounts to Generational Transfer

To make things even more challenging, retirement advisors face another risk on the generational transfer of wealth that could be even more impactful to their practice. Study after study has shown that beneficiaries change financial advisors at a rate of 80% to 90% upon the death of the primary account holder. This is a period of meaningful change in the financial advisor community, especially for those working with clients holding qualified plan assets.

And so, I see three distinct problems facing advisors as they work with clients who are no longer in an accumulation phase, but rather in a distribution phase, of their lives:

1. The confiscatory nature of the income and transfer tax system on retirement plan assets,
2. The regulatory policy on how advisors run their practice relative to retirement plan assets, and
3. The inevitable deterioration of the advisory practice's assets under management, hence the income potential and the long-term value of their practice.

The Solution: Diversify the Financial Advisory Practice with Life Insurance

One solution to these significant challenges that can benefit both advisors and their clients involves diversifying their practice to include advising on alternative forms of accumulation, distribution planning and generational wealth planning using life insurance.

Building a practice that focuses on beneficiary retention and maximizing generational wealth transfer that is augmented by life insurance is powerful

Consider the following six key advantages of life insurance, (and for the purposes of this discussion, the type of insurance, whether universal life, index universal life, variable life or whole life is irrelevant).

1. Tax-Advantaged Wealth Accumulation

From an income tax standpoint, while contributions to cash value life insurance (premiums) are not pre-tax, the cash value growth of life insurance is tax deferred. Furthermore, if the policy is not a modified endowment contract, this cash value can be accessed, via withdrawals and loans, income tax-free. Also, accessing this cash value during retirement does not count as taxable income for taxation calculations. This means that neither Social Security benefits nor Medicare premium calculations are affected by the income distributed from life insurance cash values. Since 85% of Social Security benefits are subject to income taxes and Medicare premiums can add up to an additional \$213 each month if income exceeds certain thresholds, this can be a meaningful benefit to retirees to help control taxes throughout retirement.

2. Accessible Benefits

An additional benefit of life insurance cash values is that they are totally flexible and can be timed to supplement, reduce or even replace qualified plan distributions in down markets; this strategy can protect 401(k) or IRA balances from taking or minimizing distributions in years in which market returns are negative – “selling into a down market.” As an example, in a down market year taking distributions from qualified plans (such as 401(k)s or IRAs) causes the client to actually realize the loss, and to potentially have a meaningful long-term impact on the longevity of his or her account. Sequence of returns is much more meaningful in the distribution phase of a client’s life than during the accumulation phase. Having the flexibility to time distributions from assets such as life insurance cash values can protect the long-term value of qualified plan portfolios.

3. Fewer Strings Attached (No Age or Income Limitations or RMDs)

While life insurance shares some tax-advantaged benefits with Roth IRAs, unlike Roth IRAs, life insurance premium contributions are not limited by income during the accumulation phase. This can make it an effective accumulation vehicle for clients of all income levels. Life insurance also does not have the age 59 ½ early distribution penalties for accessing the cash values prior to retirement. And, the cash value of life insurance does not have RMDs forcing income distribution during retirement. Ultimately, life insurance provides an environment substantially free from regulatory limitations.

4. Tax-Advantaged Wealth Transfer

From a transfer tax perspective, life insurance death benefits are income tax-free to beneficiaries and, if the ownership is properly structured, can transfer estate tax-free as well. When compared to the inheritance of qualified plans, which are fully taxed upon receipt (whether all at once or stretched), this is a huge advantage both in terms of net benefits to the recipient as well as logistics of the transfer.

5. Less Regulatory Restriction

From a regulatory perspective, the sale of life insurance products does not fall under the purview of the current DOL regulations unless (and there is still some uncertainty about this), the premiums are paid with qualified plan, after-tax distributions. For the most part, life insurance sales do not require a Best Interest Contract (BIC) Exemption under the DOL Fiduciary Rule and can be an additional revenue stream for the financial advisory practice.

6. Client Retention Between Generations

Finally, and maybe most importantly, investment advisors have spent years growing their practices and are facing meaningful risks in the deterioration of the value of their books of business through RMDs and what many call “money in motion.” Building a practice that focuses on beneficiary retention and maximizing generational wealth transfer that is augmented by life insurance is powerful. It enhances their book and the ultimate value of their business if executed in a way that involves the next generation.

Many “wealth advisors” are differentiating their practices from “investment advisors” by providing meaningful wealth transfer and legacy advisory services to families, paying particular attention to the next generation(s). The use of trusts or other planning vehicles funded with life insurance is generally for the benefit of the children and/or grandchildren. This next generation of clients, when involved, are likely to appreciate the fact that legacy capital was created by their financial advisor’s recommendation and be more likely to retain his or her services in the future.

In conclusion, a wealth management practice that includes life insurance planning can provide meaningful benefits to advisors, clients and beneficiaries alike during the accumulation phase and the distribution phase and, ultimately, the transition phase of a client’s life cycle. As we enter this unprecedented 17-year phase of RMDs, distributing \$10 trillion to the Baby Boomer and subsequent generations, a healthy wealth management practice will thrive by incorporating life insurance strategies into their recommendations for clients. ◇

Endnotes

1 (Federal Reserve Board, Flow of Funds Accounts of the United States, Table L.117.c, March 6, 2014.)

2 (WSJ 1/17/2017 wealth management article titled “Pulling Retirement Cash, but Not by Choice.”)