Tax Diversification

Situation

- In a "pass-through" entity like an S corporation, a limited liability company (LLC), or a partnership, the owners pay income tax on company earnings whether distributed or not.
- To the extent income is not distributed to the owners or used to run the company, pay expenses, etc., it can be invested for later use.
  - Taxes (e.g., on dividends, capital gains, etc.) can have a significant impact on growth.
- When cash is needed in the future, the withdrawal of funds or the sale of assets may generate income tax and/or capital gains tax.
- Just as spreading investments among different asset classes can help reduce risk, tax diversification can optimize income regardless of prevailing tax conditions.

Alternatives

- Many business owners find themselves in a very high marginal tax bracket and wish to reduce their currently taxable income with tax-deductible contributions.
  - A company-sponsored qualified plan can enable owners to reduce their taxable income by contributing on a "pre-tax" basis to their and their employees' retirement.
    - Though it may be possible to channel a greater than pro rata share to owners' accounts, contributions must generally be made to accounts of non-owners.
  - An individual retirement account ("IRA") can also allow for tax-deductible contributions.
    - Deductibility may be limited depending on whether a taxpayer or his/her spouse participates in a qualified plan at work.
- Because tax-deductible contributions may be limited, the "next best thing" for many business owners is to find alternatives that will not result in taxes while the asset is held, i.e., tax-deferred assets.
  - Deferring income and capital gains taxes means more dollars remain invested.
  - Any growth in the aforementioned retirement plans is tax-deferred.
    - So, too, is accumulation in a deferred annuity.
  - Certain non-dividend paying securities may increase in value without corresponding taxes along the way.
  - Real property might also be considered a tax-deferred asset.
    - Keep in mind that property or other taxes may be due periodically.
- Some assets not only defer taxes on earnings, but can provide tax-free income.
  - Examples:
    - Certain types of municipal bonds can provide tax-free payments to the owner.
    - Contributions to a Roth IRA are not tax-deductible, but any earnings are tax-deferred and qualified distributions are tax-free as long as certain conditions are met.

NEW YORK LIFE

- Where there is a need for the death benefit from a life insurance policy, permanent coverage can provide tax-deferred growth and tax-free access to policy cash value.
  - Policy cash surrender value can often be withdrawn income tax-free to cost basis (normally the amount of premiums paid), assuming the policy is not classified as a Modified Endowment Contract ("MEC").
  - When cost basis has been reached, loans can be taken against the cash surrender value.
    - Cash value and death benefit proceeds would be reduced by the total policy indebtedness, including accumulated interest.
  - This category may be especially valuable where – due to increases in income and/or changes in the rates – one's tax bracket may be higher in the future.
- Keep in mind that, while taxes play a part in income planning, planning should not be governed by tax issues.
  - Moreover, you should consult your Certified Public Accountant for a thorough analysis of the various tax consequences involved in any transaction.

This tax-related discussion reflects an understanding of generally applicable rules and was prepared to assist in the promotion or marketing of the transactions or matters addressed. It is not intended (and cannot be used by any taxpayer) for the purpose of avoiding any IRS penalties that may be imposed upon the taxpayer. New York Life Insurance Company, its agents and employees may not provide legal, tax or accounting advice. Individuals should consult their own professional advisors before implementing any planning strategies.

© 2020 New York Life Insurance Company. All rights reserved. SMRU 1747446 (exp. 8.31.2023)