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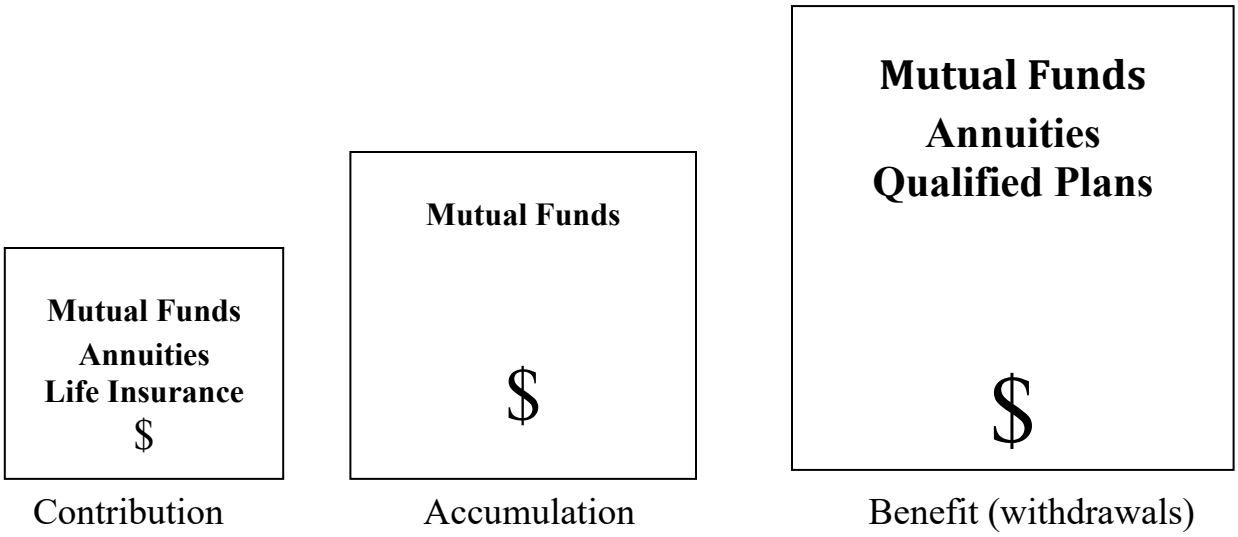
Taxation of Retirement Plans (3 Boxes) Script



There are really only two places you can put retirement money it's either in a Non-Qualified Plan or a Qualified Plan. The main difference between the two is with Non-Qualified Plans you are using after tax money and with Qualified Plans you are using pre-tax money. Both plans typically invest in the same type of investment vehicles: stocks, bonds, mutual funds, life insurance and annuities. Now there are three phases or "buckets of money" for every retirement plan; the contribution bucket, the accumulation bucket and the benefit bucket. Uncle Sam doesn't care which bucket of money you pay taxes on (small, medium or large) but you must choose at least one. When deciding on a type of retirement plan or retirement vehicle, it is important you understand how it is taxed. Let's first take a look at Non-Qualified plans and the most common investment vehicles used.

Mutual Funds (Stocks & Bonds): Give you the privilege of being taxed on all three buckets (contribution, accumulation and benefit buckets). Gains from mutual funds are distributed every year (whether or not you sold shares). Typically, the gains distributed are both long term and short-term gains. Keep in mind, many mutual funds have turnovers in excess of 100% (buy and sell all the stocks within 12 months). That means a large percentage of the gains distributed each year would be short-term gains. The tax you pay on mutual funds each year is typically between 15% - 50%* (federal and state taxes).

Annuities (Fixed, Indexed, and Variable): Annuities are taxed on two buckets (contribution and benefit buckets). Annuities are one of only two investments that turn capital gains into ordinary income. Annuities illustrate best if you don't use the money and don't die (both are taxable events). The tax you pay on Annuities is typically between 15% - 50%* (federal and state taxes).

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Qualified Plans (401-K, Pension, Money Purchase, Profit Sharing etc.): Qualified plans are taxed only on one bucket (the big benefit bucket). Qualified plans are really shells that allow you to invest into vehicles like stocks, bonds, mutual funds, annuities and life insurance using pre-tax money. The theory behind qualified plans is you put money in them when you are in a high tax bracket and pull money out at retirement when you are in a low tax bracket. This might work for some people but typically the tax bracket you are in mirrors your life style. Do you foresee yourself being in a lower life style at retirement? Historically we are in a low tax environment today (37% top federal tax bracket). It might be better to pay taxes now rather than to roll the dice to see what your tax bracket might be 20 or 30 years from now? Did you know the average top federal tax bracket in this country since the tax code started in 1913 has been 57.31%? Would you like to pay taxes on the $10,000 you invest today or pay taxes on the $1,000,000 you withdraw 20 years from now?

Qualified Plans are great plans but they are not always the best retirement solution for all people and as a business owner you get a new partner when you set up a Qualified Plan. Your new partner is Uncle Sam. Uncle Sam is going to tell who can be in the plan (you can't discriminate). He is also going to tell how much you can put into the plan. The most you can put in yourself each year is approximately $55,000 (it might take a couple of plans to do that). But if you put in $55,000 a year for yourself you will need to match somewhere between $15,000 - $20,000 for your employees.

Your employees need to be vested in 5-7 years so you will eventually lose that money. Uncle Sam also tells you when you can pull money out of the plan. If you pull it out before age 59 ½ you get hit with a 10% penalty tax and CA adds on an additional 2.5% (this is on top of income taxes). At age 70 ½ if you don't pull out the minimum out of your plan you get hit with a 50% excise tax. You also have administration costs that can range between $300 - $8,000 a year and about every 3-5 years Uncle Sam changes the rules with qualified plans. He has actually changed the rules 15 times since 1974. This takes time and money to deal with and the rule changes typically reduce the advantages of Qualified Plans for higher income earners. Lastly you always have the potential to be audited with a qualified plan.

*2018 maximum contributions to Qualified Plan: 55,000 (Profit Sharing Plan), 18,500 (401-k Plan)

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Where else can you put your money?

Life Insurance (Index Universal Life or Variable Universal Life): Life insurance is a Non-Qualified plan so you are using after tax money. Life Insurance is taxed only on one bucket (the small contribution bucket). The IRS code sections for life insurance is 7872 and 101A. Life insurance allows your money to grow tax-free, you can withdraw money out completely tax-free and your beneficiary's can receive an income tax-free death benefit. Using Index Universal Life, you can get the upside of an index like the S&P 500 and a guarantee to never have a negative return. Life insurance is similar to a Roth IRA with the exception of allowing you to put in as much money as you want (a Roth IRA* has a $5,500 a year limit). Life insurance offers several additional advantages over qualified plans especially if you are a business owner:

- No contribution limits
- No discrimination rules (you can select whoever you want or just yourself)
- No matching requirements for employees
- No vesting requirements for employees
- No penalties for withdrawals prior to 59 ½
- No minimum withdrawals required at 70 1/2
- No annual administration cost (qualified plan costs are $300 to $8,000 a year)
- No rule changes every 3-5 years (15 tax code changes regarding qualified plans since 1974)
- No potential audits

When you pull money from a life insurance policy you use FIFO accounting (first in first out).
There are two ways you can pull money out of a life insurance policy (a withdrawal and a loan). Withdrawals are a tax-free recovery of you cost basis in the policy are always tax-free. The way we beat Uncle Sam when you pull the gains out of the policy is we call it a loan. This is a loan you never have to pay back. Many insurance companies have zero spread loans (e.g. charge you 5% and credit you 5% on the loan). As long as you die with the policy Inforce all the loans are completely income tax free

*Your income must be less than $189,000 to be able to contribute $5,500 into a Roth IRA

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Federal and CA Income Tax Top Brackets 2018

Short Term Gains (Ordinary Income), Federal Top Tax Bracket:	37%
Short Term Gains (Ordinary Income), State (CA) Top Tax Bracket:	13.3%
Medicare Surtax (Obama care)	3.8%
	54.1**%**

Federal and CA Capital Gain / Dividend Tax Top Brackets 2018

Dividends & Long Term Gains, Federal Top Tax Bracket:	20%	(15% if AGI is <450k)
Dividends & Long-Term Gains, State (CA) Top Tax Bracket:	13.3%	
Medicare Surtax (Obama care)	3.8%	
	37.10%	

History of U.S. Federal Income Tax Rates

YEARS	Range of Rates (%)	Lowest: amount under	Highest: amount over
1913-1915	1 - 7	$20,000	$500,000
1919-1924	3 - 73	4,000	1,000,000
1930-1935	1 - 63	4,000	1,000,000
1942-1953	16 - 92	2,000	400,000
1954-1963	20 - 91	4,000	400,000
1965-1971	14 - 75	1,000	200,000
1972-1980	14 - 70	1,000	212,000
1982-1986	12 - 50	2,100	171,580
1988-1992	15 - 31	29,750	86,500
1993-2000	15 - 39.6	36,900	288,350
2001-2002	10 - 38.6	6,000	311,950
2004-2012	10 - 35	8,700	388,350
2013-2017	10 – 39.6	9,275	418,400
2018-	10 - 37	9,525	500,000

Avg. Top Tax Bracket 57.31%

History of Federal Individual Income Bottom & Top Bracket Rates