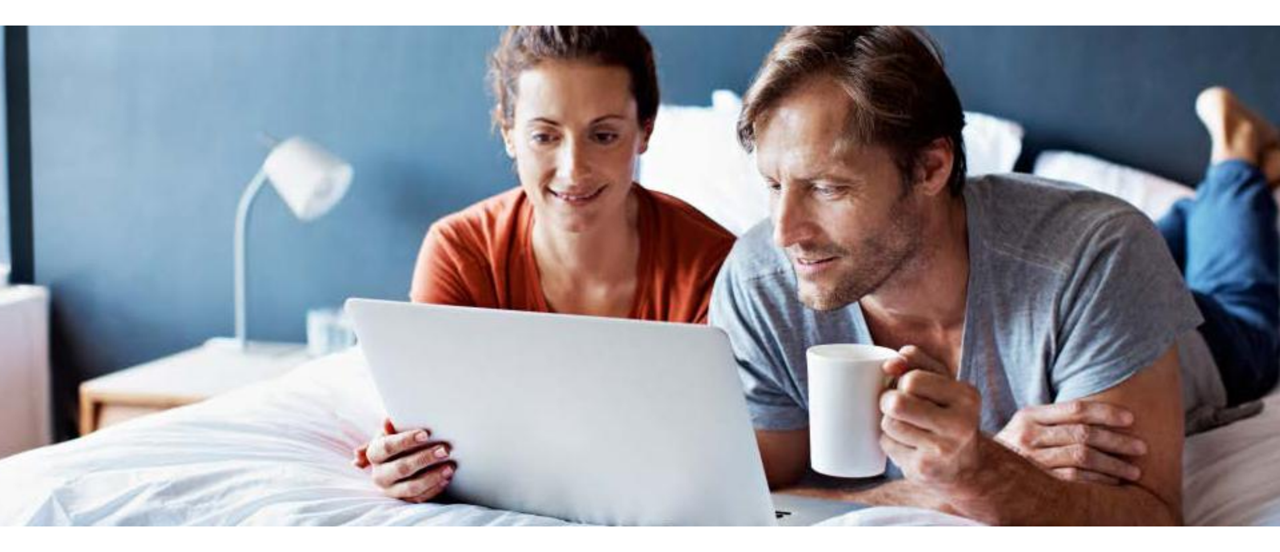
Northwestern Mutual

Retirement and Taxes: How to Maximize Your Savings

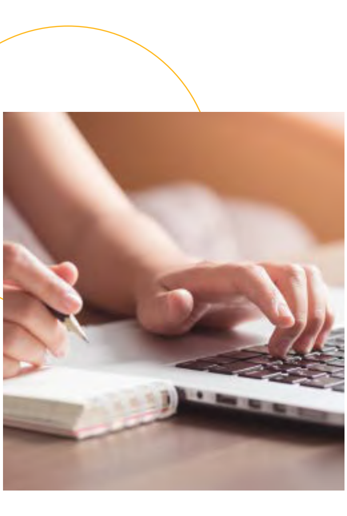
Not all retirement savings vehicles are taxed the same way.



So much of the retirement advice you hear is focused on how much to save and what to invest in. But if you're a truly smart saver, you'll also pay attention to how your savings and investments are taxed, both now and in the future. That way, you can help maximize your retirement income while minimizing what you owe to the government.

Part of this retirement and taxes strategy will likely include putting your money in various types of retirement accounts or investment vehicles that are taxed differently. The thinking behind this is similar to why you might diversify across a variety of stocks and bonds in your portfolio: Because you're not putting all your eggs in one basket, you're better able to minimize losses if one type of investment experiences a downturn.

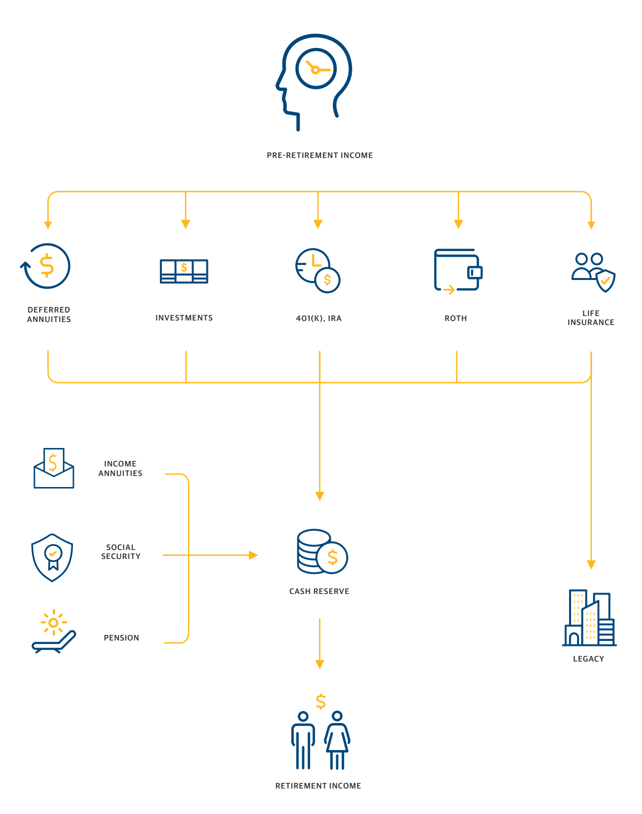
In much the same way, by not relying on just one type of retirement savings vehicle, you're not limiting yourself to one type of tax treatment — and thus have more flexibility to take advantage of the features, benefits and tax characteristics different types of retirement vehicles can offer. The more options you have, the more strategic you can be in your retirement planning and ultimately help minimize your tax bite.



> Maximize your retirement income while minimizing what you owe to the government.

UNDERSTANDING RETIREMENT INCOME SOURCES

This illustration shows some commonly used options to generate retirement income.



The primary purpose of permanent life insurance is to provide a death benefit. Using cash values to supplement your retirement plan will reduce benefits and may affect other aspects of your plan.

It might look like a lot, but it can be broken down simply. Income annuities, Social Security benefits and pensions are fixed or guaranteed sources of income. They are there to provide you with regular, steady payments in retirement.

DID YOU KNOW?
Since these income buckets are taxed differently, you'll have the flexibility to pull from different sources when you need to.

The other income sources listed — such as investments, 401(k)s, or Roth accounts — provide some more flexibility. Your savings — which you stash away while still working — grow based on the performance of their underlying investments. You control how much you'd like to put into each, and you can dial up or down what you want to take out in retirement as needed, which is why they are sometimes called discretionary sources of income.

Because these buckets of income are taxed differently, you have flexibility to pull from different sources depending on what your situation is.

For example, imagine you're one year into retirement and have been taking withdrawals from a traditional 401(k), which you're paying taxes on because your contributions were made pre-tax. Let's say you want to pull out extra income in order to make a big purchase in retirement, but you're close to the top of the 22 percent tax bracket. If you pull extra money from that traditional 401(k), you may inadvertently bump yourself into the next higher tax bracket — which would increase your overall tax liability. But if you pull that extra money from your Roth Individual Retirement Account (IRA) instead, you avoid moving to the tax bracket because your Roth withdrawals are tax-free (because your contributions were already taxed when you put them in).

HOW DIFFERENT INCOME SOURCES ARE TAXED

1

401(k)s, 403(b)s, SEP-IRAs AND IRAs

These are commonly referred to as traditional retirement accounts. 401(k)s and 403(b)s are typically offered through your employer. There are limits on how much you can contribute to traditional retirement accounts, which is set each year by the IRS.

HOW THEY'RE TAXED:

The money goes in pre-tax, meaning that if you earn $50,000 and contribute $5,000 to a traditional 401(k), your taxable income will actually be $45,000 for that year (or less, if you have other deductions). Your money grows tax-deferred in a traditional account, which means you won't pay taxes until you withdraw from the account later in retirement. At that point, you'll owe ordinary income tax.

If you take money out before you're 59½, you'll not only owe taxes but also pay an IRS penalty. You can't leave your money in a traditional account indefinitely, either, because the government wants you to pay taxes on it at some point.

59 1/2

The IRS will penalize you for withdrawing before the age of 59 1/2.

You'll be forced to withdraw a portion of money each year through a required minimum distribution, or RMD. Typically, this happens when you turn 72.

2

ROTH IRAs AND ROTH 401(k)s

These accounts are similar to their traditional counterparts in that they are subject to annual contribution limits, but they're taxed differently. Your ability to contribute to a Roth IRA specifically also phases out when your income reaches certain thresholds as set by the IRS.

HOW THEY'RE TAXED:

Here's a simple reminder of how the tax differences could play out between a traditional and Roth account. Let's say, starting at age 25, you put away $381 per month in a traditional 401(k), with the goal of accumulating $1 million for retirement by age 65. By the time you retire, assume you pay 25 percent to taxes — which means your $1 million will really net you $750,000. While you were still working, that monthly traditional 401(k) contribution helped lower your tax liability, but you ended up paying taxes — just later.

By contrast, if you had put the same amount of money ($381 per month) into a Roth 401(k) and accumulated the same $1 million, you wouldn't have to pay any taxes at 65 — that $1 million is worth the full $1 million.

> It's a good idea to have a mix of both taxable and non-taxable assets to draw from.

However, you wouldn't have received any tax breaks on your Roth contributions while you were still working.[1]

Neither of those options is necessarily better or worse, and in fact it's a good idea to have a mix of both taxable and non-taxable assets to draw from (more on that later).

3

DEFERRED ANNUITIES

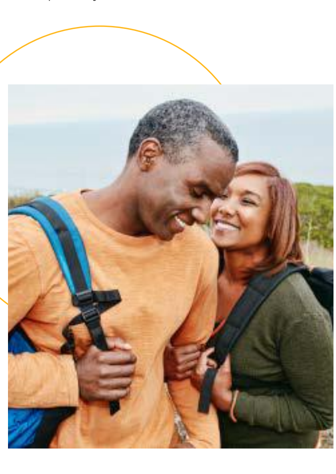
Deferred annuities are products sold by insurance companies. There are two main types: variable annuities, in which your investment is subject to the ups and downs of the market, and fixed annuities, in which you agree to a fixed rate of return with the insurance company.

When it's time to take distributions from your annuity, you can take either a lump sum or convert it into regular payments for a period of time or the rest of your life. This means annuities can be a good way to produce reliable income in retirement. They typically have higher fees than traditional investment products due to insurance and administrative expenses, and if you withdraw funds before age 59½ you could incur an additional 10 percent tax penalty.

HOW THEY'RE TAXED:

You can fund a deferred annuity with pre- or after-tax dollars, and the money will grow tax-deferred, much the way it would in a traditional IRA or 401(k). There is also no contribution limit for an annuity unless it is part of a retirement plan, like an IRA.

If you put pre-tax dollars into an annuity, any money you take out will be taxed as ordinary income. If you put after-tax dollars in, you'll only pay tax on the gains (i.e., interest or growth you earn).



4

INVESTMENTS (MUTUAL FUNDS, STOCKS, BONDS, ETC.)

Investments offer the most flexibility in that there is no limit on how much money you can invest, and you can typically withdraw your money at any time. Although investments can deliver higher returns than some other retirement income sources, there is also a greater risk that you could lose your investment if the market takes a downturn. Investments also do not grow tax-deferred.

HOW THEY'RE TAXED:

You buy investments with after-tax dollars. There are different ways that investments can be treated tax-wise, but generally speaking: If you have earnings from dividends or interest, that amount will be taxed at the time you receive them at your ordinary income tax rate.

When you sell investments, you pay capital gains tax, either at short-term or long-term rates. If you owned your investments for longer than a year, you pay long-term capital gains tax, which is lower than the short-term rate.

DID YOU KNOW?
If you sell investments at a loss (e.g., you sell a stock or bond for less than what you paid for it), you could write off some or all the loss and save on your taxes.

5

LIFE INSURANCE

The idea that life insurance only provides a death benefit is a misconception. In fact, permanent (also called whole) life insurance policies can build cash value over time. With whole life insurance, the cash value will never go down, which can make it a great tool to help weather market downturns in retirement. While you can access your cash value at any time, taking loans or withdrawals will lower your death benefit.

HOW IT'S TAXED:

Life insurance is funded with after-tax dollars. Your cash value grows tax-deferred. You can generally withdraw the basis (usually the amount you paid into your policy through your premiums) tax-free. If you take out more than what you paid in, that amount will be taxed like ordinary income. The death benefit is typically tax-free.

HOW TAX FLEXIBILITY WORKS

To show how having retirement and taxes flexibility can make a big difference, here's a deeper illustration that looks at two fictional families' retirement savings. Both couples have amassed $1.4 million in retirement assets by age 70, and both are comfortable withdrawing $100,000 each year in pre-tax retirement income.

THE MURPHYS
$1.4M
RETIREMENT ASSETS

THE DELGADOS
$1.4M
RETIREMENT ASSETS

ASSET MIX FOR EACH COUPLE

Below is an overview of the mix of assets each couple has available to them in retirement at age 70.

THE MURPHYS

- **Social Security:** $45,000 (annually)
- **IRAs and 401(k)s:** $1 Million
- **Investments:** $400,000

THE DELGADOS

- **Social Security:** $45,000 (annually)
- **IRAs and 401(k)s:** $400,000
- **Investments:** $300,000
- **Roth IRA** $300,000
- **Cash Value Life Insurance:** $100,000
- **Income Annuity:** $17,060 (Annually, from a $300,000 single payment immediate annuity)

In the case of the Murphys, all of their assets are subject to tax (they only saved into traditional retirement accounts and hold taxable investments). The Delgados, meanwhile, have a mix of taxable and non-taxable sources, which results in them being able to keep more of their money, as you'll see in the next chart.

Take a look at how each couple will draw from their accounts to create $100,000 in pre-tax income based on their available assets.

THE MURPHYS

INCOME SOURCES	INCOME AMOUNT	TAX AMOUNT
TAXED AS ORDINARY INCOME		
Social Security Income Annuity 401(k)/IRA	$45,000 $0 $55,000	$9,409
TAXED AS CAPITAL GAINS		
Investments	$0	$0
TAX-FREE		
ROTH IRA Cash Value Life Insurance	$0 $0	$0
Total	$100,000	$9,409
Total After-Tax Income	**$90,591**	

THE DELGADOS

INCOME SOURCES	INCOME AMOUNT	TAX AMOUNT
TAXED AS ORDINARY INCOME		
Social Security Income Annuity 401(k)/IRA	$45,000 $17,060 $14,600	$2,932
TAXED AS CAPITAL GAINS		
Investments	$0	$0
TAX-FREE		
ROTH IRA Cash Value Life Insurance	$23,234 $0	$0
Total	$100,000	$2,932
Total After-Tax Income	**$97,068**	

Hypothetical example, assumes standard deduction, standard exemptions, and does not reflect dividend/interest income from investments. Any withdrawals of whole life cash value over the basis will be taxed as ordinary income.

The Murphys are supplementing their $45,000 in Social Security benefits with $55,000 from their traditional 401(k)/IRA. (They also could have sold investments to supplement their Social Security, and it would have yielded similar tax implications.)

The Delgados only chose to withdraw the RMD from their 401(k)/IRA, and supplemented the rest with money from their income annuity and Roth IRA. Because they have more flexibility in choice, they ultimately created less taxable income — and therefore get to keep more of their money.

Bottom line: Saving effectively for retirement is about more than just putting money away in one type of retirement vehicle, like a 401(k). By diversifying your sources of income, you could ultimately pay less in taxes in retirement — and give yourself more flexibility to live out your dreams.

[1] This is for illustrative purposes only and not indicative of any investment. © 2013 Morningstar. All Rights Reserved. 3/1/2013. Assumed 7% return compounded.

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Past performance is no guarantee of future results. Examples are for illustrative purposes only and not indicative of any investment.

No investment strategy can guarantee a profit or protect against loss. All investing carries some risk, including loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. They do not typically grow at an even rate of return and may experience negative growth.

Deferred annuities typically have higher fees than traditional investment products due to insurance and administrative expenses. All guarantees in an annuity are based solely on the claims-paying ability of the issuer.

Each method of utilizing your permanent life insurance policy's cash value has advantages and disadvantages and is subject to different tax consequences. Surrenders of, withdrawals from and loans against a policy will reduce the policy's cash surrender value and death benefit, and may also affect any dividends paid on the policy. As a general rule, surrenders and withdrawals are taxable to the extent they exceed the cost basis of the policy, while loans are not taxable when taken.

Loans taken against a life insurance policy can have adverse effects if not managed properly. Policy loans and automatic premium loans, including any accrued interest, must be repaid in cash or from policy values upon policy termination or the death of the insured. Repayment of loans from policy values (other than death proceeds) can potentially trigger a significant tax liability, and there may be little or no cash value remaining in the policy to pay the tax. If loans equal or exceed the cash value, the policy will terminate if additional cash payments are not made.

Policyowners should consult their tax advisors about the potential impact of any surrenders, withdrawals or loans.

Although stocks have historically outperformed bonds, they also have historically been more volatile. Investors should carefully consider their ability to invest during volatile periods in the market.

You should carefully consider the investment objectives, risks, expenses and charges of the investment company before you invest. Your financial professional can provide you with a prospectus that will contain the information noted above, and other important information that you should read carefully before you invest or send money.

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