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Special Issue

Life Insurance and Annuities

Life Insurance is Terrific . . . When it is Purchased for the Right Reason

Not So With Annuities!

Often Missed Tax Deductions That Should Not be Overlooked!

COLLIER & ASSOCIATES

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Young Doctors Seminar, Washington, D.C., April 28-30: Ideal for young doctors who are out of school for less than 10 years. Learn the things you wish they taught in graduate school . . . while you still have the benefit of youth to help maximize the benefits.

Practice Transition Seminar, Washington, D.C., April 30-May 1: This course will cover all aspects of transitions from both a "Dr. Senior" and a "Dr. Junior" point of view. Often both doctors attend together.

Aggressive Business, Tax and Practice Management Seminar, Asheville, NC, May 19-21: This will be the three-day "mini-week" which will highlight the major points of the week-long seminar, including taxes, retirement planning, practice management, investing and health care.

See the insert included with this Newsletter for more information. Register online at www.CollierAdvisors.com or by calling our toll-free seminar line at (888) 888-4840.

LIFE INSURANCE

General: I keep getting reader questions on this topic, so it must be time to cover the subject again. Since I will be giving my conclusions, it's only fair that you know my assumptions. If you disagree with my assumptions, you are free to disagree with my conclusions. My assumptions are:

1. Why I Buy Life Insurance: This is no different than why I buy any insurance (home, auto, disability, etc.). I buy insurance if there is a risk I cannot afford to carry myself. With life insurance, the risk I worry about is that I could die early, leaving behind a family with inadequate assets to support themselves. Term life insurance is cheap and typically fills that gap beautifully for doctors. Over the course of a doctor's career I typically see a point come when the gap is eliminated (i.e., savings will be more than enough to support the family if the doctor dies). The kids have been educated, debts are small, savings are high, etc. At that point, the risk is gone, and the insurance can be cut or eliminated.

2. Estate Tax Assumptions: Every individual now has the benefit of a large estate tax exemption amount, and

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it rises a little bit each year with inflation. For someone dying in 2016, he or she can exempt $5,450,000 of assets from estate tax. And both spouses will ultimately combine their exemptions to exclude almost $11,000,000 of assets from estate tax. Whatever amount is unused by the first spouse can be added to the exemption of the second spouse. The estate tax rate is indeed high at 40%, but I assume only parents with very large estates will have children paying estate taxes.

3. Life Insurance Is Not An Investment - If Viewed As An Investment, it Carries a High Cost That is Not Adequately Offset by the Tax Shelter Advantages Built Into the Policies: My goal is not to reduce taxes. My goal is to increase wealth. Usually reducing taxes will do that, but not if getting a tax advantage comes at a cost that outweighs the value of the tax benefit received. Consider Variable Annuities. These became popular years ago when the stock market started to boom and potential insurance buyers preferred to pass on traditional cash value policies that grew in value at what seemed to be too-tame interest rates (when compared to what was being earned in the stock market).

Variable Annuities

A variable annuity is like a mutual fund wrapped inside an insurance policy. Sellers often pitch them as the same as investing in mutual funds - but with tax deferral on the income and gains. **That's the truth but not the whole truth**. The tax deferral bait makes them seem attractive for doctors who have maxed out their retirement plan contributions and have money left to invest.

The basic reason I don't like variable annuities as a tax shelter device is because the cost of getting the tax advantage outweighs the value of the tax benefit. There are people who disagree - I call them "annuity salespeople." Consider:

A. High Fees: Extra costs strangle any tax advantage. Variable annuities typically have expenses of 1%-2+% per year above those of the equivalent mutual funds. Some people estimate that the tax deferral advantage can be overwhelmed by these extra costs until the annuity is held for 10-20+ years. That's way too long just to break even.

B. 5%-7% Penalties For "Early Withdrawals": Many insurance companies add a penalty if you quit the variable annuity before a specified (often 7) number of years. If annuities are such good deals, why is there a penalty to keep people in them? The insurance company has paid an up-front commission to the salesperson and doesn't want to let you out of the annuity before it has earned back that commission and has a nice profit. There are plenty of mutual funds without similar charges.

C. The Life Insurance in the Variable Annuity is Almost Worthless: To get the tax deferral, there has to be life insurance involved. Variable annuities insure that you will get the greater of what your account has grown to or your original investment. Big deal! Since over time you would expect the investment to rise, you would have to both die early and during a down market for the life insurance to pay anything.

D. Variable Annuities Have Several Tax Disadvantages: Investing directly (not via an annuity) in stocks gives us two major tax advantages: (1) the growth is already tax-deferred in that we do not pay tax on the gains until we choose to sell, and (2) when we do sell, the gains are taxed at our lower 20% capital gain tax rate. By comparison, investing in stocks inside an annuity has several tax **dis**advantages. First, since all income withdrawn from an annuity is treated as ordinary income, the variable annuity converts capital gains generated by stocks inside the annuity into higher-taxed ordinary income when withdrawn. A second annuity tax disadvantage compared to direct investments in stocks is that if one withdraws income from a variable annuity before age 59-1/2, there is an extra 10% tax penalty, as with IRA's. A third annuity tax disadvantage compared to direct investments in stocks is that if one dies owning the variable annuity, the heirs will pay income tax on the annuity's gains (at their

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higher regular tax rates as noted above). But if one dies owning stocks or stock mutual funds, gains as of the date of death escape all income tax because heirs get a "stepped-up basis" for investments they inherit. Because of these tax **dis**advantages, if I wanted a tax-deferred stock investment, I would skip the annuity and either buy individual stocks or a "low-turnover" mutual fund such as an index fund.

When I Would and Would Not Buy Life Insurance to Fund Estate Taxes

General: Once I'm wealthy enough that my family would be adequately provided for if I died, the insurance salesperson has to switch tactics to get me to buy a life insurance policy. One common approach is to say, "Congratulations. You're now wealthy. But do you want your children to have to pay all of those estate taxes? Buy my policy so that they'll have the money." I'm not impressed by that sales pitch. Here's why. Assuming that either my wife or I live to a normal life expectancy (and thus the estate tax won't be due until our late-70's or mid-80's), I believe the kids will be wealthier if I didn't spend the money on insurance and invested it conservatively in combination with good estate planning.

The problem is that the kids will wish there was insurance because that seems like free money to the recipient. Unless it's explained to them, they won't understand they got the better deal. After all, the insurance companies are not giving anything away. They set our premiums high enough so that they can first pull off a piece for the salesperson's commissions, a second piece to cover their expenses, and a third piece to give them a profit. They then take what's left and invest it conservatively and expect that they will have enough to pay off the face value of the policy when we reach our normal life expectancy. If I take all of the premium and invest it conservatively, in combination with good estate planning, my children should be wealthier. Of course, if I were considerate enough to die early, my children would come out ahead with the insurance. But my early death as astute family financial planning holds no appeal for me.

Second to Die Life Insurance: This is an insurance policy that pays off on the later death of two people. This is often sold as a way to provide money to pay estate taxes. The idea is that the wealthy couple does not need money on the death of the first spouse. But on the death of the second parent, the estate tax comes due, and the life insurance will provide cash so that the kids will not have to dip into their inheritance to pay the tax. For the reasons mentioned above, I would not buy the insurance for that reason. But there are two situations where a 2nd-to-die policy makes sense to me:

A. The Illiquid Estate: I would be interested in a 2nd-to-die policy if my assets were illiquid (e.g., land, art, etc.) and the kids would have to sell things - at possibly fire sale prices - to raise the estate tax. I wouldn't want them to have to sell in what might be a down market. Since estate planning can be structured so that the estate tax is not due until the second parent dies, I would consider buying a 2nd-to-die policy until such time as my estate has enough liquidity (stocks, bonds and cash) to fund the estate tax bill. Then I'd likely cancel the policy.

B. Two High-Income Parents With Young Children But Low Savings: In this case, the high income of either parent can support the family if one parent dies, but if both parents die, insurance is needed for the kids. A 2nd-to-die policy might fit this family perfectly.

I Am Not Anti-Life Insurance: As you can see, I like life insurance - but only when I feel there is a risk I cannot afford to carry myself. Of course, the insurance salespeople want to sell their policies in many other situations. How do I respond? I just say "No." We professionals, being cerebral by nature, often feel we have to be able to explain the reasoning behind why we are not going to buy the annuity or whatever else is being sold. That's a mistake. The salesperson's job is to explain things in a way that makes sense to you. If he or she can't do it, you need only say "No." It's not your job to explain why. The salesperson would love to keep the

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conversation going by engaging you in a debate you are likely ill-equipped to win. Don't fall into that trap.

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April 15th is Around the Corner - Here are Some Tax Deductions That Tend to Get Overlooked: If any of these apply to you, don't forget to mention them to your accountant.

Deduction for State Sales Tax: This is available to everyone, but is especially appealing to residents of states that don't have an income tax. You can deduct one or the other, and usually state income tax will be the bigger one. The IRS has a calculator that determines how much you can deduct if you don't keep receipts. If you keep receipts, that should give you the bigger deduction. If you purchased a "specified item" such as a car, boat, plane, then you can add the sales tax on that to the IRS's computer-generated figure.

Student Loan Interest Paid by a Parent: You can deduct the interest, up to $2,500 per year, if you are the one liable for the debt. If your parents are paying off your student debt, they cannot deduct the interest. But, you can. The tax laws treat the money as being given to you, and you are treated as making the debt payment. Remember, you cannot be claimed as their dependent on their tax return.

Job Hunting and Moving Expenses: These are treated differently. If you are searching for a new job in your same line of work (e.g., dentistry), then your transportation costs, cabs, food, lodging, resume printing, etc. are deductible as miscellaneous itemized expenses. You can deduct your car at the rate of 57.5 cents per mile driven. Job hunting expenses for your first job aren't deductible. The actual moving expenses for a first job are deductible if it is at least 50 miles from your prior home. This includes the costs of getting you and your things to the new location.

Military Reservists' Travel Expenses: The cost of travel to drills is deductible if the travel is more than 100 miles from home and an overnight stay is involved. Auto expenses, at the rate of 57.5 cents per mile, plus parking and tolls are deductible. Also, add the cost of lodging and 50% of meals.

American Opportunity Tax Credit: A child who has paid some of their college tuition should qualify for this $2,500 tax credit. This is available for the first four years of college. (The credit phases out as your gross income rises above $80,000, which is why the parents typically won't be eligible for it). The child cannot be claimed as the parents' dependent, which is OK. A $2,500 tax credit is far more valuable than a $2,050 personal exemption for a dependent. Plus, for higher earning parents, the personal exemptions now phase out anyway.

Lifetime Learning Tax Credit: This is an additional $2,000 tax credit that can be used for education following your first four years of college, including graduate school. The income phase-out range begins at $55,000 for a single person and $110,000 for a married couple. This and the American Opportunity Tax Credit are refundable, meaning that if the credit exceeds your taxable income, the government sends you a check for the difference.

Child Care Tax Credit: If the parents of young children both work outside of the home and their combined income is over $45,000, then they are entitled to a tax credit (a dollar for dollar reduction in their taxes paid) to help cover the cost of the child care expenses. The children must be under age 13. Where there is one child, the tax credit is $600. Where there are two or more such children, the maximum credit is $1,200. If your spouse does not work outside of the home, then you should hire your spouse in your practice to satisfy this requirement.

State Income Taxes Paid in 2015 for the 2014 Tax Year: If you owed additional state income tax last April 15th (for the 2014 year) and didn't deduct it on last year's federal income tax return, then remember to add it to the state taxes you paid in 2015 and deduct them on this year's federal tax return.

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