



A WHITE PAPER BY
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PLAN PROTECT PROSPER

Beyond the 401(k)[®]

From 401(k) to 7702

A New Path for Retirement Security



*Same
Questions.
A Brighter
Tomorrow.*

Executive Summary

For generations, employer-sponsored retirement benefits have evolved whenever the old model stopped fitting the realities of the workplace.

The traditional pension solved one enormous problem for employees: it promised retirement income. It also solved an important problem for employers: it gave people a powerful financial reason to stay. But pensions came with long-term funding obligations, investment risk and costs that became increasingly difficult for many employers to carry.

The 401(k) changed the bargain. Employers gained a far more predictable cost. Employees gained portability and ownership of vested retirement assets. But responsibility for the retirement outcome shifted dramatically. The employee now had to decide how much to save, how to invest, how to survive market declines, how to turn an account balance into income, how long the money had to last - and how much would be left after taxes.

And one important feature did not evolve very much at all: retirement income remained largely taxable as ordinary income. Pension income was generally taxable when received. Traditional 401(k) money is generally taxed as ordinary income when distributed - whether the retiree wants the money at that moment or eventually is required to take it under the Required Minimum Distribution rules.

We changed who carried the risk. We changed who owned the account. We did not fundamentally change the tax character of retirement income.

That raises a different question than the one retirement planning usually asks.

What should the next evolution look like?

If employers could keep the predictability they gained with the 401(k), while employees could build retirement resources designed around tax-free access, protection from market losses, living benefits and income options, would that deserve a place in the retirement conversation?

That is the premise of Beyond the 401(k).

Retirement Benefits Have Already Evolved

The Pension Era

For much of the twentieth century, the traditional defined-benefit pension represented the retirement promise. Work for the company long enough, satisfy the plan's requirements, and the employer would provide a defined retirement benefit.

The arrangement reflected a very different employment culture. Long careers with one employer were common, and the pension rewarded that loyalty. The longer an employee stayed, the more valuable the future benefit could become.

That was useful to the employee - but it was also useful to the employer.

A pension was not only a retirement benefit. It was a retention strategy.

Leaving the company could mean giving up the opportunity to earn a much larger future benefit. Vesting rules and benefit formulas gave employees a significant financial reason to stay put. The phrase "golden handcuffs" captured the bargain rather well.

But the employer carried the heavy side of the retirement risk. The company had to fund the promise, manage investments and remain responsible for an obligation that might extend decades into the future. As costs and liabilities grew, many employers looked for a different model.

The 401(k) Era

Section 401(k) entered the Internal Revenue Code in 1978. What began as a tax-code provision eventually became the shorthand for America's dominant workplace retirement account.

For employers, the appeal was profound: instead of promising a future retirement income, the business could make a defined contribution today. The cost was more visible, more controllable and more predictable.

Employees gained something important too: portability. Their own contributions belonged to them, and vested employer contributions could generally move with them when they changed jobs.

That fit a workforce that no longer expected to spend an entire career with one company.

But every improvement came with a trade. For employers, the 401(k) replaced the potentially enormous and unpredictable long-term obligation of funding a pension with a much more predictable contribution. For employees, the trade was different: the pension had promised a future stream of retirement income, while the 401(k) provided an account balance and placed much more of the responsibility for creating retirement income on the employee.

The 401(k) changed that relationship. Once employees are vested, their retirement assets are portable. They can change jobs and take those vested assets with them.

That was a significant improvement for employees. But employers gave up something in return: one of the most powerful retention features of the traditional pension.

The 401(k) solved the employer's pension problem. It solved the employee's portability problem. But it also transferred much of the responsibility for the retirement outcome from the employer to the employee - and weakened one of the employer's most effective retention tools.

The 401(k) Bargain

A traditional 401(k) is a tax arrangement wrapped around an investment account. The employee generally receives a tax benefit today, the money grows tax-deferred, and taxable distributions are generally treated as ordinary income later.

That bargain is usually described as "tax-deferred retirement saving." A more useful description may be:

Don't tax me now. Tax me later.

Suppose an employee earns \$100,000 and contributes \$10,000 to a traditional 401(k). Generally, current federal income tax is deferred on that contribution. The money may then grow for decades without current taxation inside the account.

But the tax bill was not eliminated. It was postponed.

Eventually, when taxable distributions are taken, those dollars generally become ordinary taxable income. And at a certain point, Required Minimum Distribution rules may force taxable money out whether the retiree needs it or not.

You accepted today's tax deduction without knowing tomorrow's price.

No one can know decades in advance what tax law will look like, what other income the retiree will have, what filing status will apply, or what income-sensitive costs may be affected.

The most important question therefore is not simply, "How much did I accumulate?" It is, "How much of it can I actually use?"

Retirement Can Create a Tax Collision

Retirement does not mean the end of taxable income. A retiree may receive Social Security, pension income, traditional IRA distributions, 401(k) distributions, investment income, rental income, business income and required minimum distributions.

Those income streams do not live in separate boxes. They meet on the tax return.

A traditional retirement-account distribution generally adds to taxable income. That can affect the taxation of Social Security benefits and, at higher income levels, may also contribute to Medicare income-related premium surcharges.

The question is not only: What tax bracket will I be in? It is: What else happens when I take the money out?

The Medicare Cost Nobody Calls a Tax

Medicare beneficiaries with income above specified thresholds can pay an Income-Related Monthly Adjustment Amount, or IRMAA, in addition to standard Part B and Part D premiums.

Traditional IRA and 401(k) distributions generally increase adjusted gross income. Large withdrawals, RMDs, investment income, rental income and other taxable income can combine to push a retiree across an IRMAA threshold.

Medicare generally looks back two years when determining IRMAA. An income decision made today can therefore affect Medicare costs later.

The exact thresholds and premiums change over time. The planning principle does not: taxable retirement income can carry costs beyond the income tax itself.

Eventually Needed - or Forced to Take

For decades, the traditional retirement message is simple: defer the tax.

Then retirement arrives, and the accumulated tax-deferred money has to come back out. Under current law, traditional retirement accounts eventually become subject to Required Minimum Distribution rules.

At that point, the retiree may lose some control over when taxable income appears on the tax return.

Successful accumulation can therefore create a second planning problem: how do you distribute what you successfully accumulated without unnecessarily increasing taxes, Medicare premiums or other income-sensitive costs?

The Surviving-Spouse Tax Problem

A married couple may spend retirement filing jointly. Then one spouse dies. The survivor may inherit the assets, but eventually file as a single taxpayer.

The retirement account may not be much smaller. The income may not have fallen proportionately. But the tax brackets have changed.

A retirement strategy should therefore ask not only, "Will we have enough while we are both alive?" but also, "What happens financially when there is only one of us?"

The Employee Inherited the Market Risk

The traditional pension promised an outcome. The 401(k) provides an account.

That difference matters most when markets are falling. A younger employee may have decades to recover from a major decline. A retiree who must withdraw money while investments are depressed does not have the same luxury.

Selling investments to fund retirement during a downturn can permanently reduce the number of shares available to participate in a recovery. This is commonly called sequence-of-returns risk.

The issue is not whether the market eventually recovers. The issue is whether your retirement can afford to wait for it.

This is one reason the next evolution of retirement planning should not be built around accumulation alone. It should be built around outcomes.

You Know 401(k). Now Meet 7702.

For decades, one tax-code number has become so familiar that most Americans no longer think of it as a section of the Internal Revenue Code. The term 401(k) has become part of our everyday vocabulary.

We say, "I have a 401(k)," or "My company offers a 401(k)," as though 401(k) were the name of an investment rather than the tax-code provision that created the structure.

But there is another tax-code number worth knowing: 7702.

Section 7702 establishes the federal tax rules that determine whether a contract qualifies as life insurance. That may seem like an odd place to begin a conversation about retirement. It is not.

A traditional 401(k) generally gives an employee a tax benefit when the money goes in. The employee defers income tax today, allows the money to accumulate tax-deferred, and generally pays ordinary income tax when taxable distributions are taken later.

A properly structured life insurance contract takes a very different approach. The money used to fund the policy has already been taxed. If the contract is properly designed and maintained, its cash value can grow tax-deferred and money may later be accessed through withdrawals and policy loans without creating current taxable income.

The difference can be expressed simply: the traditional 401(k) says, "Don't tax me now. Tax me later." The 7702 Structure says, "I've already paid the tax. Don't tax me again."

That distinction becomes increasingly important when the objective changes from simply accumulating the largest account balance to creating the greatest amount of spendable retirement income.

For decades, retirement planning has concentrated heavily on how much money employees can accumulate. The next evolution asks a different question: how much of the money you accumulate will actually be yours to spend?

That changes the retirement question from "How much can I defer?" to "How much retirement income can I structure so I have greater control over when - and whether - it becomes taxable?"

Life Insurance Isn't Just About Dying

Most people think of life insurance as a benefit for somebody else: pay premiums, die, leave money behind.

That is one purpose. It is not the only purpose of permanent life insurance.

Certain policies can build cash value while providing a death benefit. When designed and managed appropriately, the owner may be able to access that value during life. Withdrawals up to basis and properly structured policy loans can potentially create retirement cash flow without current income taxation.

Retirement tax expert Ed Slott has put the question more bluntly: "Why doesn't everyone do this? I DON'T KNOW!"

The important phrase is "properly structured." Policy design, funding, costs, performance, loans, withdrawals and long-term management all matter. A policy that is designed primarily to maximize death benefit can look very different from one designed to emphasize long-term cash accumulation.

For retirement-income purposes, the objective is not simply to "buy life insurance." It is to design a financial asset to accomplish a particular set of outcomes.

Start With the Outcome, Not the Product

The next evolution of retirement benefits should not begin by choosing a product. It should begin by deciding what the retirement dollars are supposed to accomplish.

For employees, that means more than accumulation. A useful retirement strategy should provide ways to manage future taxes, create access to money without automatically increasing taxable income, reduce dependence on market performance at the wrong time, address the possibility of long-term care, provide income that can last for life, protect a family if death comes early, and remain useful when employment changes.

Employers have a different set of objectives. They need predictable costs, benefits employees understand and value, flexibility in allocating benefit dollars, a meaningful retention story, and - where appropriate - ways to provide supplemental benefits for owners, executives or selected employees.

Once those outcomes are defined, the financial tools can be chosen deliberately. Permanent life insurance can address tax-free access, living benefits and legacy objectives. Annuities can address guaranteed lifetime-income objectives. Market investments can address growth and liquidity. The architecture can use more than one tool.

Pensions were income-centered. 401(k)s became accumulation-centered. The next evolution should be outcome-centered.

Why Tax-Free Access Can Matter

Imagine a retiree needs an additional \$30,000 one year for a roof, a vehicle, travel, medical costs, helping family or simply maintaining lifestyle.

If that \$30,000 comes from a traditional retirement account, the withdrawal generally increases taxable income. Depending on the retiree's circumstances, that additional income can affect other parts of the tax return and may contribute to an IRMAA surcharge.

If the retiree also has a properly structured source that can be accessed without creating current taxable income, the retiree has options.

That is the practical value of tax diversification. It is not merely about paying less tax. It is about controlling which bucket you use, when you use it and what else happens because of that decision.

The Long-Term Care Problem

Retirement planning has another enormous blind spot: long-term care.

Medicare is not designed to pay indefinitely for custodial care or ongoing assistance with activities of daily living. Traditional long-term care insurance can address that risk, but many people resist paying premiums for a benefit they hope never to use.

Some modern life insurance policies offer another approach. Depending on the policy and rider, benefits may potentially be accelerated during life for qualifying chronic illness or long-term care needs.

The question becomes: can one asset serve more than one purpose? If care is needed, benefits may be available during life. If care is not needed, the policy may still provide cash value and ultimately a death benefit.

Specific triggers, limitations, costs and tax treatment vary considerably by product and rider. This is an area where design matters.

The Legacy Difference

Traditional retirement accounts can be inherited, but inherited retirement assets may carry future tax consequences for beneficiaries.

Life insurance death benefits are generally received by beneficiaries free from federal income tax under current law.

That creates another difference in the retirement architecture: the same asset may provide financial flexibility during life and a generally income-tax-free benefit at death.

The Employer Opportunity

This entire discussion becomes more interesting when viewed from the employer's side.

The pension was expensive, but it helped keep people. The 401(k) made costs predictable, but it made the retirement asset portable. Employees can take their vested balances with them - which means the employer lost part of the retention value that had been embedded in the old pension system.

The structure described here is straightforward: the employee owns and controls an individual permanent life insurance policy, chooses the beneficiary and may contribute personal after-tax dollars. The employer may provide additional taxable compensation to help fund the policy. The employer does not own the policy, control its values or retain any right to its death benefit.

This is not key-person insurance, split-dollar insurance, group-term life insurance or an employer-owned policy. It is an employee-owned individual policy funded with the employee's own money, taxable employer compensation, or a combination of both.

Selective by Design

Unlike a 401(k), this arrangement does not have to be offered to every employee on the same terms. An employer may choose to provide additional taxable compensation to particular owners, executives or key employees based on legitimate business considerations such as responsibility, performance, length of service or retention value, subject to applicable employment law.

That flexibility allows the employer to decide whom to reward and how much additional compensation to provide. Once paid, however, the bonus is taxable compensation to the employee, and the employee owns the policy and its benefits.

The question is not necessarily how much more the employer should spend. A better question is whether dollars already being spent on compensation and benefits can do more.

The Cost of a 401(k) Isn't Just the Contribution

Employers do not simply contribute money to a 401(k). They sponsor a regulated retirement plan.

That can mean plan administration, recordkeeping, participant notices, fiduciary responsibilities, investment oversight, annual reporting, nondiscrimination testing and correction procedures - along with the professional fees required to keep the plan operating properly.

And then there is participation. An employer can spend time and money maintaining a retirement benefit that some employees never join, contribute too little to, or do not understand well enough to use effectively. Participation can also affect plan testing and design decisions.

The employee-owned taxable-bonus structure described here does not establish another qualified retirement plan. It therefore does not add 401(k) nondiscrimination testing, qualified-plan contribution limits, investment-menu oversight or qualified-plan administration.

The ordinary business responsibilities remain ordinary: the employer documents the compensation arrangement, reports the employer-paid amount as taxable compensation, handles the applicable payroll withholding and obtains appropriate tax and legal guidance. The employee may then add personal after-tax dollars to the individually owned policy.

Pensions created enormous employer obligations. The 401(k) reduced them. This approach gives an employer another way to support selected employees without creating another qualified retirement plan.

Rebuilding the Retention Benefit

Portability was one of the great advantages of the 401(k) for employees. It was also a loss for employers.

That does not mean employees should be trapped. It means employers should think deliberately about which benefits reward longevity.

Certain nonqualified or executive-benefit designs can use vesting schedules, ownership arrangements or employer-controlled benefits to create a meaningful reason for key employees to stay. Other strategies may emphasize benefits employees own directly and can take with them.

There is no single architecture for every workforce. But the old pension system teaches an important lesson: a retirement benefit can serve two constituencies at the same time.

A benefit can help the employee build a future - and help the employer keep the employee long enough to build it.

Where Annuities Fit

A 7702 Structure is not the answer to every retirement problem. Neither is a 401(k). Neither is an annuity.

Annuities become especially relevant when the desired outcome is guaranteed income. Depending on the contract, an annuity can transfer longevity risk to an insurance company and provide an income stream that cannot be outlived, subject to the guarantees and claims-paying ability of the insurer.

Life insurance and annuities solve different problems. That is precisely the point.

The next retirement architecture does not need to be organized around one product. It can be organized around the outcomes the employee actually needs.

Five Questions Every Retirement Strategy Should Answer

A retirement strategy should be able to answer five practical questions before the employee reaches retirement - not after.

What happens if taxes are higher?

A strategy built entirely around tax-deferred accounts leaves the retiree dependent on whatever tax rules exist when the money is withdrawn. Building a tax-free source alongside taxable and tax-deferred assets can give the retiree more control over which dollars are used and when taxable income appears.

What happens if the market is down?

A severe decline just before or after retirement can be especially damaging because withdrawals may force the sale of investments at depressed values. A retirement architecture that includes assets not directly exposed to market losses can provide another place to draw money while market-based assets have time to recover.

What happens if you need care?

Long-term care can consume retirement assets quickly. A complete strategy should identify in advance where those dollars will come from. Certain life insurance policies can include chronic-illness or long-term-care benefits, allowing one asset to help address both retirement and care needs, subject to the terms of the policy and rider.

What happens when one spouse dies?

The surviving spouse may inherit the same assets but eventually face single-taxpayer brackets, a changed income picture and different Medicare costs. Retirement planning should therefore consider the survivor's after-tax income, not simply the household income while both spouses are alive.

What happens if you live a very long time?

Longevity changes the question from how much was accumulated to how reliably those assets can produce income. Guaranteed-income tools such as annuities can transfer part of that longevity risk to an insurance company, while other assets can remain available for liquidity, growth, care and legacy needs.

Those are not five separate products. They are five tests of the retirement architecture. A plan that only answers, "How much can I accumulate?" has not yet answered, "How will I live on it?"

Getting to Zero

Financial author David McKnight, in *The Power of Zero*, describes retirement assets in three basic "buckets": taxable, tax-deferred and tax-free. The framework is useful because the balance in an account is only part of the retirement story. The tax treatment of the dollars when they are used can be just as important.

The taxable bucket

This includes money held in ordinary bank and investment accounts. Interest, dividends and realized gains may create current taxable income, depending on the asset and the taxpayer's circumstances.

The tax-deferred bucket

Traditional 401(k)s and IRAs live here. The tax is generally postponed while the money accumulates, but taxable distributions are generally treated as ordinary income later. Required Minimum Distributions can eventually force some of those dollars onto the tax return whether the retiree needs the money at that moment or not.

The tax-free bucket

This is the bucket McKnight argues deserves deliberate attention. Roth accounts are one example. Properly structured life insurance can be another source of tax-advantaged access when distributions are handled correctly and the policy remains in force.

McKnight's planning idea is not that every dollar must be moved into one bucket. It is that retirement assets should be deliberately allocated among the three so the retiree has greater control over the character and timing of income. As he explains, "The three buckets are taxable, tax-deferred, and tax-free."

That framework exposes a weakness in the traditional retirement conversation. For decades, employees have been encouraged to build an increasingly large tax-deferred bucket without spending nearly as much time asking what the eventual tax bill might do to spendable retirement income.

The objective of "getting to zero" is therefore not simply to chase a catchy tax number. It is to reduce unnecessary exposure to future tax rates by deliberately building sources of retirement income that can be accessed without automatically adding taxable income. In McKnight's memorable formulation, "If tax rates double, two times zero is still zero."

That is where the 7702 Structure belongs in this discussion. It can provide another way to build the tax-free bucket while also addressing needs a Roth account does not address by itself, including life insurance protection and, depending on the policy, living benefits.

Accumulation tells you what the account is worth. Distribution planning asks what the account can actually do for you - and how much of it you can keep.

Beyond the 401(k)

The 401(k) was a major evolution in American retirement planning. It solved real problems. But it did not end the evolution.

The workplace has changed again. Employees move more frequently. People are living longer. Healthcare and long-term care costs have become larger retirement risks. Employees carry far more responsibility for their own outcomes. And no one knows what future tax rates will be.

So why should the retirement-benefit model remain frozen in the last century?

The question for employers and employees is no longer simply how much can be accumulated in a tax-deferred account.

The better question is this: if we were designing a retirement benefit from scratch today, what would we want every dollar to accomplish?

That is where the conversation moves beyond the 401(k): from 401(k) to 7702, and from accumulation-centered to outcome-centered retirement planning.

Important Considerations

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