Prudential's Four Pillars of Retirement Series

Tax-Wise Retirement Distribution Planning

Why Traditional Distribution Theory May Not Always Be the Right Approach

By Robert A. Fishbein

Prudential Financial

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As the population ages in the United States, financial planners are turning their attention to helping clients manage the distribution of their retirement assets. While the investment strategies for this distribution phase have received a fair amount of attention, the tax planning side of the equation has been all but ignored. The tax planning associated with spending down one's retirement assets is usually limited to advising a client to use taxable investments first, then capital investments, and then tax-deferred assets. This traditional theory seeks to maximize tax deferral and, theoretically, how long the assets will last. This article explores alternative distribution theories that may be employed instead of the traditional theory and results in findings that are surprising and informative from the perspective of optimal tax distribution planning. These results, in turn, may provide a new opportunity for the financial planner to add value for a client at or near retirement.

What, specifically, are the conclusions drawn from our tax-based distribution modeling that present such planning opportunity? The first is that the traditional theory for distributing assets is not the best for asset longevity in some situations. While on balance, the traditional theory does quite well when compared to other distribution approaches. The idea that there could be a better approach under some facts suggests that a financial planner must do more than merely recommend the traditional theory. Moreover, since we have only modeled one fact pattern, it is likely that there are other situations where an alternative to the traditional theory is preferable.

Second, the traditional theory is not the best for maximum wealth transfer in many situations. Therefore, before choosing a distribution strategy, the financial planner must balance both the asset longevity and wealth transfer goals of the client. If a client has both asset longevity and maximum wealth transfer as goals, use of the traditional distribution theory may not be the best plan to meet both of these goals.

Third, individuals can significantly increase their chances of meeting their retirement goals by delaying Social Security and purchasing an annuity or annuity-type payout. These actions greatly reduce the chance of running out of personal assets while also increasing the amount of income that cannot be outlived. That is, the combination of delaying Social Security and buying an annuity can provide a safety net in the event that personal assets do not last as long as planned (or if the client outlives the duration of the financial plan).

Historic financial planning for retirement has focused primarily on the accumulation phase of retirement. Less attention has been given to the period after retirement when the individual must both manage the investment and distribution of the accumulated assets.

Recognizing that the traditional distribution theory fares well in many situations and that modeling one fact pattern is not conclusive research, we are nevertheless very excited by our findings. We believe that our modeling results open the door for more dynamic and client-specific tax modeling that will be able to pinpoint the optimal tax planning strategy for a client.

Before we start our detailed analysis of our tax modeling and conclusions, however, let's explore the retirement landscape in general and why distribution tax planning is so important. We will then be ready to compare and contrast the traditional and non-traditional distribution strategies with an eye towards determining which best meets a hypothetical client's goals. Finally, we will explore what impact there would be if the client used some retirement assets to purchase an annuity.

THE CHANGING RETIREMENT LANDSCAPE

Historic financial planning for retirement has focused primarily on the accumulation phase of retirement. That is, what is the amount that one must save for retirement in order to have enough wealth to stop working and live

on the accumulated assets? Whether based on replacing a percentage of current income, a multiple of the amount earned in the later work years, or some other rule of thumb, the financial planning charge has been to determine the amount that must be accumulated at the launch point for retirement. Less attention has been given to the period after retirement when the individual must both manage the investment and distribution of the accumulated assets.

Recently, though, interest in the distribution phase of retirement has increased. Why the change? One possible factor is the large number of individuals entering the distribution phase of retirement. There are approximately 78 million baby boomers,[1] and the oldest among those, born in January of 1946, started turning 59½ in July of 2005. There are several implications for the boomers attaining this age. One is that the boomers are becoming old enough to withdraw assets from their qualified plans, such as 401(k) plans and individual retirement plans, and non-qualified annuities without triggering the 10% penalty tax generally applicable to premature distributions.[2] Another is that many older boomers, or those born between 1946 and 1954, are already at or near their expected retirement age.[3] As we have seen in other areas, such as music and fashion, the boomers tend to dominate the domestic agenda and are doubtless influencing the slant of financial planning to address their income planning or decumulation needs.

Another reason that the retirement planning discourse has changed is in response to the evolving retirement landscape. The traditional three-legged stool, consisting of Social Security, an employer-sponsored plan and personal savings, has changed dramatically over the last decade or two. Most employers no longer offer a defined benefit plan to their employees, having replaced it with a defined contribution plan (for example, a 401(k) plan).[4] Unlike a defined benefit plan, which guarantees a payout for the life of the employee (or the joint lives of the employee and spouse) based on years worked and the average salary for a period prior to retirement, a defined contribution plan provides no guaranteed payout to the individual at retirement. Rather, the individual assumes both the investment risk and the longevity risk. The investment risk is the risk that the assets will not be invested in a way that allows for the growth necessary to fund the desired retirement payout. The longevity risk is the risk that the individual will live longer than planned for and that the accumulated retirement assets will be depleted before death.

The ongoing debate in Congress about future Social Security funding and benefits is another factor in the changing retirement landscape. While it is unlikely that the program will be dramatically altered for those in or near retirement, it is likely that there will be changes to the program to address long-term solvency and budgetary issues.[5] Past changes in the program to address an earlier solvency issue resulted in the extension of the full retirement age from age 65 to age 67. Assuming, then, that there are changes in the program, it is possible that some of those changes will impact the benefits paid under the system by delaying the commencement of benefits or reducing the assumptions used to calculate the growth rate of such payments. As a result, it seems less than certain that future Social Security payments will meet as large a percentage of one's retirement needs as they have in the past.

Yet another factor in the changing retirement landscape is the change in how people are retiring. For more and more Americans, retirement does not mean an end to work, but merely changing the nature or parameters of the work being done. One reason for working in retirement is to better manage the risks created by the changes in the employer and Social Security legs of our retirement stool (that is, the loss of a guaranteed lifetime payout and the possible diminishment of Social Security benefits). Another reason to work in retirement is to respond to under-saving during the traditional working years.[6] Yet another reason is that many of today's retirees see an opportunity in retirement to do the type of work that they could not have done earlier in life, including more charitable or humanitarian work. A final reason that many retirees are opting to continue working is that there are likely health benefits associated with continued mental stimulation in the retirement years.

The relatively new phenomenon of working in retirement can possibly be viewed as creating a new leg on the traditional retirement three-legged stool. Or, as Prudential Financial has described the new retirement landscape, there are now four retirement pillars, including (1) Social Security, (2) employer-based plans,

(3) personal savings, and (4) working and living in retirement issues (such as working in retirement, using home equity, and managing health and long-term care issues).

The central implication of the changing retirement landscape is that individuals now have more responsibility than ever for managing their financial assets and making sure that the assets are sufficient for their retirement needs. This new reality presents financial planners with a unique opportunity in that retirees, more than ever, need the planning and execution support of a good financial planner. But why does tax distribution planning matter and how does a financial planner go about advising a client regarding the distribution phase of retirement from a tax perspective? What is the traditional theory regarding distribution tax planning and how does such theory operate in practice? Are there alternative tax distribution strategies that may be preferable for some clients? If so, under what circumstances are the alternative strategies preferable?

financial planner should never forget that it is the after-tax net amount that matters. Individuals live on after-tax dollars, not pre-tax investment assets! The possibility that this view of the retirement assets, with a tax lens on, can also help better manage the longevity risk for the client is the premise of our research and this article.

The traditional theory regarding how to manage the imbedded tax liability in retirement assets is fairly straightforward. Access taxable accounts (such as a taxable savings account) first, partially tax-deferred assets (such as stock or a mutual fund held outside of a qualified plan) second, and tax-deferred accounts (an IRA, annuity or qualified retirement plan) last. The traditional theory is based on the premise that the continued deferral of income tax creates greater economic benefit for the individual. That is, by tapping the least tax-favored assets first, the benefits of delaying payment of income tax is increased with the result of greater after-tax benefit for the individual. This theory has been modeled under various assumptions to demonstrate the economic benefit of such distribution ordering.[7]

Why does tax distribution planning matter and how does a financial planner go about advising a client regarding the distribution phase of retirement from a tax perspective?

THE DISTRIBUTION TAX PROBLEM AND TRADITIONAL THEORY

During the distribution retirement phase the critical inquiry is how long the assets will be able to fund the retirement needs of the individual. That is, assuming a certain investment return and a certain withdrawal rate, how long will the assets last? Implicit in this analysis is the fact that retirement assets have an imbedded tax liability that reduces the apparent value of the assets. When considering how to make retirement assets last as long as possible, one must recognize the built-in tax liabilities in the assets and determine how best to manage the unlocking of the tax liabilities over time, so that the individual reduces his tax burden and increases the value available for meeting retirement living needs. In short, the

While prior articles and studies have amply demonstrated the viability of distribution ordering based on the traditional theory, there may be situations where the traditional ordering rules do not maximize the potential duration of retirement assets, or otherwise achieve the stated retirement goals of the individual. That is, since historic modeling has largely assumed a test-tube environment independent of many real-life variables, the introduction of those variables could change the ordering rules that should be applied to maximize retirement assets. For example, the traditional theory does not address what impact, if any, Social Security benefit payments will have on maximizing retirement assets. Given that the changing retirement

landscape will likely involve more and more working "retirees," another important variable that has not been considered is how working in retirement influences the traditional distribution theory. Also, since the tax law requires that certain required minimum distributions be made from IRAs, annuities and qualified plans, how do the RMD rules, when combined with working in retirement and the payment of Social Security, impact the choice of a tax-wise distribution strategy? Does the optimal tax distribution plan change if the client has ample funds to live on and wants to maximize the assets available to future generations?

TAX-WISE DISTRIBUTION MODELING – LIMITATIONS AND ASSUMPTIONS

At the outset, it is important to note that the distribution modeling that is the basis for this article is, at its core, simply a proof for the fact that tax factors greatly influence how retirement funds should be distributed to maximize payout. This modeling does not consider the reality that investment return is not constant and that any complete financial plan would need to add the element of stochastic modeling to more accurately reveal the longevity potential of retirement assets. For simplicity purposes and ease of comparison, we assume a constant 7% investment return for all asset classes. Growth on taxable investments is subject to income tax each year at ordinary income tax rates. Growth on capital assets, such as securities or mutual funds, has three components. The first component is dividend distributions, which are assumed to be 1% each year and taxable each year at ordinary income tax rates. The second is capital gain distributions, which are also assumed to be 1% and taxable each year at the capital gains rates. The third component is Net Asset Value (NAV) growth, assumed to be 5% per year, which is not taxable until withdrawn and then at capital gains rates.

The Required Minimum Distribution rules are always respected, such that RMD amounts are always forced out when required by law (regardless of the stated asset distribution model being demonstrated). Also, we have assumed that current ordinary income and capital gain tax rates, deductions and exemptions, as scheduled to change under current law, are not changed further by Congress for the duration of the modeling period.

Given the relative frequency with which Congress changes these rates, and the fact that these individual tax rates are at historic lows, a complete financial plan might consider the impact of gradually increasing effective tax rates on the distribution choices that a client makes. Our modeling does not do that. Nor does our modeling consider the Alternative Minimum Tax, a growing concern for many taxpayers.

We have assumed that the couples or individuals desire to retire on 80% of their pre-retirement income and further assumed that this translates, roughly, into 60% of the pre-retirement income on an after-tax basis. The use of an after-tax retirement income target is critical if this analysis is to be useful, since individuals live on what they can use to pay for housing, food, entertainment and travel, not the gross amount they earn. This after-tax lens is also central to our premise that income tax is a critical component of distribution planning, since the determination of how long assets last is only meaningful relative to how those assets can provide for an individual's needs (which is an after-tax analysis).

We also assume that the target retirement income need grows in amount equal to inflation (or the same amount Social Security is projected to increase each year).[8] While we are aware of the many different theories about what income needs exist at different phases of retirement,[9] the purpose of this article is not to describe the right retirement distribution strategy for our hypothetical couple but, rather, to demonstrate the differences in after-tax asset longevity and wealth transfer in light of income distribution tax planning. Accordingly, the fact that our target income is constant (as adjusted for inflation) is not meant to take any particular position as to how income needs may vary in retirement, but simply to have a constant target that may be easily compared.

Finally, with respect to the hypothetical fact pattern itself; we have tried to strike a balance between complexity and the use of a true-to-life scenario. For example, while many retirees may have significant equity in a personal residence, we have simply avoided the issue of how that equity could be tapped. Similarly, the ownership of investment real estate and assets generating tax-free returns (be it via tax-free bonds or a Roth IRA) have been excluded from the model scenarios due to complexity.

THE HYPOTHETICAL FACT PATTERN AND MODELING STRATEGIES

Our hypothetical fact pattern assumes a husband, age 65, and wife, age 63, with $25,000 in currently taxable savings, $250,000 in capital or equity investments (with a tax basis of $50,000), and $450,000 in an individual retirement plan (an IRA). While the husband has retired and will not be working, the wife has retired but still plans on working two more years making $25,000 per year. The couple is seeking a total of $75,000 of after-tax income (including any Social Security benefit) in the first year of retirement and then increasing each year by the rate of inflation. The couple would also like to maximize the assets left for their three children and are seeking to determine the optimal decumulation or income distribution strategy in light of these goals.

In order to determine the optimal approach for this couple, we will project how long the assets will last the couple if distributions are made under the traditional distribution modeling theory and then under other possible alternatives. Given the three variables of taxable investments, partially tax-deferred investments (such as stock, mutual funds or other capital assets), and wholly tax-deferred investments (such as a 401(k) or individual retirement plan), modeling all the possible permutations meant that we will need to consider six different distribution strategies (aptly named strategies 1 through 6).

We will then consider two variations on the six different distribution strategies. Strategy 7 is a proportionate withdrawal approach (that is, a pro rata withdrawal from all asset classes) but with an adjustment to possibly counteract the potentially adverse income tax impact of working in retirement. That is, if an individual's modified adjusted gross income plus one-half of his Social Security benefits exceed certain limits,[10] then a portion of the Social Security benefits are subject to income tax. Strategy 7 seeks to minimize this tax liability by increasing modified adjusted gross income in the years before receiving Social Security benefits so as to minimize the triggering of additional income tax. Or, more simply stated, this strategy preserves high-basis assets for disposition until after Social Security has commenced in order to reduce modified adjusted gross income and, in turn, reduce any additional tax that would otherwise be triggered due to working in retirement.[11] Strategy 8 is simply a proportionate withdrawal approach from all asset classes (without regard to any Social Security impact).

Finally, the eight distribution strategies are modeled assuming that the couple chose to start Social Security payments at age 62, at age 67,[12] or age 70. In total, then, we will model 24 distribution strategies.[13]

There are three critical questions to keep in mind when reviewing the modeling results. First, how long will the couple's personal assets last? Second, how are the assets positioned for a tax-efficient wealth transfer to heirs? And, third, how will the couple fare if they outlive their assets and become wholly dependent on Social Security benefits?

AGE 62 SOCIAL SECURITY PAYMENTS

When looking at the possible distribution strategies when

TABLE 1

Commencement of Social Security by Older Spouse at Age 62; After-Tax Annual Income Target of $75,000 (increased annually for inflation)

Strategy	Age	Duration	Depletion Year Income	SS Benefit	% of Target Income	After-Tax Assets for Heirs (Death at 85)	After-Tax Assets for Heirs (Death at 80)
1	84.00	19.00	$420	$46,201	35%	$0	$209,560
2	83.64	18.64	$78,700	$44,943	35%	$0	$205,522
3	83.76	18.76	$93,437	$44,943	35%	$0	$204,038
4	83.58	18.58	$71,119	$44,943	35%	$0	$204,528
5	83.46	18.46	$56,598	$44,943	35%	$0	$194,965
6	83.57	18.57	$70,645	$44,943	35%	$0	$199,554
7	83.60	18.60	$73,976	$44,943	35%	$0	$202,031
8	84.09	19.09	$11,793	$46,201	35%	$0	$221,725

the choice was made to start Social Security payments when the husband was age 62 (or three years prior to the beginning of the distribution modeling), there is a virtual tie between strategies 1 and 8 (see Table 1). Strategy 1, or the traditional distribution theory of taxable investments first, then capital assets, and then tax-deferred assets, results in the assets lasting 19 years, or until the husband is 84 years old. Strategy 8, or a proportionate withdrawal from all asset classes, results in the assets lasting slightly longer, or for 19.09 years. Although the after-tax income under strategy 8 is over $11,000 more than the income available under strategy 1 in the year the assets are depleted, this difference is relatively small. The significance of this result, though, is that it is possible for a withdrawal strategy other than the traditional theory to result in equal or greater asset longevity. While the difference under the facts modeled is not material, and a financial plan would probably not be altered on this result alone, what this demonstrates is that there are likely other fact patterns where an alternative theory would be materially better than the traditional theory. The determination of what facts would give rise to a materially better alternative distribution strategy is not entirely clear, but this modeling result is a clarion call for more analysis to develop the financial planning tools to do so. It does seem likely, though, based on this result, that a variation on the strategy 8 proportionate withdrawal approach could yield an even better asset duration result.

Having determined that, at least under these facts, the traditional theory is comparable to the alternative theories when the husband and wife live long enough to deplete their assets, we next considered whether the traditional theory would be optimal if the couple died prematurely (see Table 1). In the situation where both the husband and wife die within 20 years of retirement (or the year when the husband would turn age 85), there are no assets remaining for distribution to heirs. However, if the husband and wife both die within 15 years, strategy 8 results in a net after-tax amount of $221,725 for heirs. Strategy 1 is the second best alternative at $209,560. Here, the difference between strategies 1 and 8 is greater and, given that strategy 8 is also slightly better than strategy 1 for asset longevity, the financial planner should suggest a proportionate withdrawal from all asset classes rather than the traditional distribution approach. So, while the traditional theory certainly fares well in this hypothetical fact pattern, it is a close second when considering asset duration only, and more clearly less than optimal when considering the client's goals of maximizing after-tax income duration as well as the net after-tax assets left for their heirs.

Finally, it is noteworthy that once the couple's assets have been depleted, Social Security provides only 35% of the income target. As indicated earlier, both the projected Social Security benefits and the $75,000 of targeted after-tax annual income have been increased annually by the same estimated rate of inflation, which means that the benefits have a constant percentage relationship to the targeted income. Given these assumptions, Social Security will provide 35% of the income the couple wanted for retirement regardless of how long the assets last.[14] Of course, it is not optimal to be left with an asset that only provides for 35% of your expected retirement needs, and we will look at possible solutions for this problem later in this article.

AGE 67 SOCIAL SECURITY PAYMENTS

When looking at the possible distribution strategies when the choice is made to start Social Security payments at age 67, the longest and most optimal distribution pattern is accessing taxable investments first, then capital assets, and then tax-deferred assets (see Table 2). This is the traditional distribution theory and under the facts assumed the couple's assets last for over 23 years (or until the older spouse is age 88). The alternative distribution strategies 3 and 4 also result in the assets lasting for more than 23 years, but still not quite as long as the traditional theory. By delaying Social Security payments, the asset duration is also extended significantly when compared to the modeling where early Social Security benefits have been elected. This is likely because the delay in Social Security benefits both increases the amount of Social Security benefit and reduces the income tax paid due to the wife continuing to work. It is also possible that the delay in taking Social Security benefits forces the use of temporarily lower tax assets (e.g., the lower rates on capital gains are temporarily in effect through 2009) to meet the required annual target income.

When considering the posture of the assets for the couple's heirs in the event that they die within 20 years of retirement (or when the husband would have been age

85), the traditional theory (or strategy 1) also leaves the greatest after-tax amount of $154,090 for the couple's heirs (see Table 2). Strategies 3 and 4 are close behind, leaving $151,669 and $147,220 for the heirs. In the event that the couple dies within 15 years of retirement (when the husband would have been age 80), strategy 7 is clearly the best choice, leaving $346,360 of after-tax funds to heirs. Strategy 2 is close behind at $342,854, but strategies 1 and 8 significantly lag the other alternatives.

left with a Social Security benefit that provides 41% of the target income. It is notable that the couple did not adversely impact on their standard of living by tapping their personal assets earlier. In fact, they extended the period of time that the assets lasted, since the increased Social Security payments resulting from the delayed commencement date more than made up for the early tapping of their personal assets.

TABLE 2

Commencement of Social Security by Older Spouse at Age 67; After-Tax Annual Income Target of $75,000 (increased annually for inflation)

Strategy	Age	Duration	Depletion Year Income	SS Benefit	% of Target Income	After-Tax Assets for Heirs (Death at 85)	After-Tax Assets for Heirs (Death at 80)
1	88.34	23.34	$47,641	$59,780	41%	$154,090	$325,200
2	87.34	22.34	$47,103	$58,152	41%	$104,447	$342,854
3	88.31	23.31	$43,504	$59,780	41%	$151,669	$323,526
4	88.11	23.11	$15,591	$59,780	41%	$147,220	$327,469
5	87.10	22.10	$14,406	$58,152	41%	$85,260	$331,636
6	87.14	22.14	$19,019	$58,152	41%	$82,059	$326,923
7	87.39	22.39	$52,283	$58,152	41%	$109,374	$346,360
8	87.41	22.41	$57,007	$58,152	41%	$113,914	$326,153

The results here make the right choice for the couple less clear. If the goal is to maximize asset duration without regard to whether the approach will maximize the after-tax assets for heirs, then strategy 1 is the optimal distribution pattern. However, if the couple is concerned with leaving the maximum amount for heirs and if they have health concerns, they may be comfortable with strategy 7, since the assets are projected to last only one year less while maximizing what is left for their heirs. A financial planner may use these types of projections to engage in a dialogue with the couple to learn their financial planning goals and make sure that the decisions are made with the couple's goals in mind.

Under this age 67 approach, the couple is also left in a better position relative to their income target once their assets have been depleted. When they opted for early Social Security payments, they were left with a Social Security benefit that provided 35% of their target income. By waiting five years until age 67, the couple is

AGE 70 SOCIAL SECURITY PAYMENTS

Turning to the situation where the choice is made to delay taking Social Security benefits until the older spouse is age 70, the best modeling result for asset longevity is once again the traditional ordering theory of taxable investments, partially tax-deferred assets, and then tax-deferred assets (see Table 3). However, these results seem less advantageous than the age 67 Social Security benefit election approach, since the assets only last until the husband is age 85 (or 20 years from the start of retirement). This certainly compares favorably with the 19-year asset duration when Social Security is begun at age 62, but unfavorably with the 23 plus years that the assets last when the traditional theory is used and Social Security commences at age 67. However, under the age 70 approach, the couple is left with Social Security payments that equal 46% of their target income when their assets run out. In the case of the age 67 commencement of Social Security, the remaining Social Security benefit is only 41% of the target income. More simply stated, the

couple must choose between a 23-year payout and then live on 41% of their target income, or a 20-year payout and then live on 46% of their target income.

When considering the posture of the assets for the couple's heirs in the event that they die within 20 years of retirement (when husband would have been age 85), no assets remain for distribution to the heirs (see Table 3). Again, this compares unfavorably to the results when Social Security is started at age 67, since there would be significant assets left for heirs under those facts. In the event that the couple dies within 15 years of retirement, strategy 1 is the best choice, leaving $205,431 of after-tax funds to heirs. Strategy 4 is closest at $205,006, but strategies 3 ($203,444) and 8 ($201,716) are also relatively close.

Do the projected results for the couple's heirs inform the choice as to the best distribution methodology in the age 70 Social Security situation? Yes and no. It seems fairly clear that if the couple has no health issues and reasonably expect that one or both will live beyond age 85, then strategy 1 should yield the best results from both an asset duration and wealth transfer perspective. However, if the couple has health issues or a family history that suggest that neither will live long in retirement, then more modeling would be required to determine whether another strategy would yield a better result under other premature death scenarios.

POSSIBLE EXPLANATIONS FOR MODELING RESULTS

The modeling results described above demonstrate the central tenet of this article; namely, that following the traditional distribution theory is not an absolute rule and that there are instances when a different approach can yield better results. The success of other distribution approaches may be attributable to several factors. One is the currently low tax rate applicable to capital gain assets, which rates are scheduled to increase in 2009.[15] These temporarily lower rates

The modeling results described demonstrate the central tenet of this article; namely, that following the traditional distribution theory is not an absolute rule and that there are instances when a different approach can yield better results.

TABLE 3

Delayed commencement of Social Security by Older Spouse at Age 70; After-Tax Annual Income Target of $75,000 (increased annually for inflation)

Strategy	Age	Duration	Depletion Year Income	SS Benefit	% of Target Income	After-Tax Assets for Heirs (Death at 85)	After-Tax Assets for Heirs (Death at 80)
1	85.35	20.35	$45,721	$61,181	46%	$0	$205,431
2	84.42	19.42	$53,710	$59,514	46%	$0	$191,630
3	85.32	20.32	$41,833	$61,181	46%	$0	$203,444
4	85.14	20.14	$17,681	$61,181	46%	$0	$205,006
5	84.22	19.22	$28,185	$59,514	46%	$0	$180,571
6	84.26	19.26	$32,540	$59,514	46%	$0	$176,918
7	84.44	19.44	$55,281	$59,514	46%	$0	$192,722
8	85.06	20.06	$8,358	$61,181	46%	$0	$201,716

mean that this asset class will have a relatively low tax burden when compared to taxable savings today, but a relatively higher tax burden starting in 2009.[16] Therefore, the tax law is encouraging the liquidation of these assets before the liquidation of other taxable assets.

Another factor is that the couple's desire to maximize asset duration may conflict with the goal of maximizing after-tax assets for heirs. When wealth transfer is the paramount goal, it makes sense to liquidate and consume all assets that will not receive a step up in basis at death, such as an IRA. Therefore, while the traditional theory suggests holding a tax-deferred asset as long as possible to maximize the benefits of tax deferral, optimal wealth transfer theory indicates that such an asset should be used before a capital asset, since the latter will avoid income tax in the hands of an heir.

Another possible factor under our facts is that the wife is working for the first two years of retirement, which brings into play certain rules that increase the portion of the Social Security benefit that is subject to income tax.[17] That is, by selling low-basis assets before Social Security commences and leaving higher-basis assets for distribution after Social Security commences, the goal is to reduce modified adjusted gross income and the amount of Social Security benefit subject to income tax. By choosing an approach that reduces this Social Security-triggered income tax, it is hoped that the amount of time that the assets will last may be increased.

Another factor is how the couple's investments will perform relative to the benefit afforded for delaying Social Security benefits. If the assets will outperform such an increase in benefits, it may make sense to not delay Social Security benefits to age 70. Indeed, if the investment return is great enough, it may not make sense to delay commencement of Social Security at all, since the increase in Social Security benefit payments may be less than the return the client will have on the Social Security benefits received.

Given the success of the pro rata approach of strategies 7 and 8 in some circumstances, and the success of other "empty bucket" approaches (where assets are generally liquidated sequentially[18]) in others, the question is raised as to whether there might be a better distribution strategy not covered by the modeled approaches. Presumably, there is some asset depletion ordering more refined than the simplistic proportionate withdrawal or empty bucket approaches that would better optimize the timing of the payment of income tax and result in the retirement assets lasting even longer. There is also likely a distribution approach that could balance the sometimes-competing interests of asset longevity and tax-efficient wealth transfer. Such iterative type modeling is beyond the capabilities of the calculation tool that we have developed in support of this article. It would be, though, part of any complete distribution-modeling program.

The questions raised by this income distribution modeling suggest that the determination of an appropriate decumulation strategy can be fairly complicated.

Finally, the questions raised by the income distribution modeling suggest that the determination of an appropriate decumulation strategy can be fairly complicated. For example, if the client will be working in retirement, what impact will those earnings have on the Social Security benefits and the taxation of other income? What is the health situation and life expectancy of the client? What are the projected retirement costs (including the always-difficult yet critical projection about health care and drug costs)? Does the client value asset duration or wealth transfer more? What is the expected investment return of the client's investments and how does that compare to the increase in Social

Security benefits afforded by a delay in the commencement? How comfortable is the client in relying on getting the expected investment return, given market volatility? Does the client have a strong personal view as to when Social Security payments should commence? This last question is somewhat loaded, since we have seen that delaying Social Security benefits can make economic sense. However, in the real world, individuals frequently opt for early payments, presumably with the thinking that a bird in hand is more valuable. So, even if from a financial planning perspective we know that delayed Social Security benefits pay off in the long run, if the couple is unmoved by such projections or already has made the choice to start Social Security at age 62, the financial planner is left with starting point that may well suggest not using the traditional distribution method. The point, then, is that a complete financial planning analysis needs to consider alternatives to the traditional distribution theory in light of the current economic posture and goals of the client.

DISTRIBUTION MODELING WITH ANNUITY PAYOUTS

Depending upon when Social Security is started in our hypothetical fact pattern, after all personal assets are depleted, the couple will be left with benefits that cover 35%, 41% or 46% of their annual target income, depending on when they started Social Security. Given the age at which assets are depleted (as late as 88), this may not be a horrible result, particularly if you ascribe to the theory that income needs decline after the more active retirement years. We wondered, though, how our hypothetical couple would fare if they had used some of their assets to purchase an annuity payout. Accordingly, we assumed that $200,000 of the couple's $450,000 of tax-deferred assets were used to purchase an Individual Retirement Annuity[19] with a lifetime annual payout.[20] In the case of early commencement of Social Security at age 62 (or three years prior to the beginning of the modeling), asset duration is approximately 16½ years, or 2½ years less than the 19 years that the assets lasted where no annuity was purchased (see Table 4 and compare to Table 1). However, once assets are depleted,

A complete financial planning analysis needs to consider alternatives to the traditional distribution theory in light of the current economic posture and goals of the client.

TABLE 4

Commencement of Social Security by Older Spouse at Age 62; After-Tax Annual Income Target of $75,000 (increased annually for inflation) with Annuity Payout

Strategy	Age	Duration	Depletion Year Income	SS Benefit	Annuity Payment	% of Target Income
1	81.68	16.68	$79,738	$42,528	$13,211	46%
2	81.56	16.56	$65,696	$42,528	$13,211	46%
3	81.63	16.63	$73,485	$42,528	$13,211	46%
4	81.47	16.47	$54,720	$42,528	$13,211	46%
5	81.45	16.45	$52,616	$42,528	$13,211	46%
6	81.54	16.54	$62,433	$42,528	$13,211	46%
7	81.53	16.53	$62,179	$42,528	$13,211	46%
8	82.02	17.02	$1,975	$43,719	$13,211	46%

the couple will have both their Social Security and annuity payments to live on, which will meet 46% of their target income. This is a significant improvement when compared with the 35% of target income that Social Security, alone, would provide when no annuity were purchased.

Alternatively, if the couple decides to purchase an annuity and delay commencement of Social Security until age 67, they are left with 51% of their target income once all assets are depleted. This is a significant improvement over the 41% of target income if they were left with Social Security alone (see Table 5 and compare to Table 2).[21]

If the couple decides to delay commencement of Social Security until the delayed retirement age of 70, the percentage of target income maintained after all assets are depleted increases from 46% to up to 57% (see Table 6 and compare to Table 3). Again, this is a significant improvement and demonstrates the power of a guaranteed lifetime payout.

Like the other decisions the couple must make in the decumulation phase, the decision as to whether to buy an annuity-type payout is complicated and will depend on many factors. However, there are at least two compelling arguments for making such a purchase. One is that the annuity insures against poor investment return results. That is, while we assumed a 7% return for all investments, if the couple's investments did not perform that well, then, naturally, the amount of time their assets would last would be reduced. If the couple

TABLE 5

Commencement of Social Security by Older Spouse at Age 67; After-Tax Annual Income Target of $75,000 (increased annually for inflation) with Annuity Payout

Strategy	Age	Duration	Depletion Year Income	SS Benefit	Annuity Payment	% of Target Income
1	85.35	20.35	$45,733	$55,028	$13,211	51%
2	84.45	19.45	$57,458	$53,529	$13,211	51%
3	85.22	20.22	$28,905	$55,028	$13,211	51%
4	85.19	20.19	$24,350	$55,028	$13,211	51%
5	84.25	19.25	$31,776	$53,529	$13,211	51%
6	84.29	19.29	$36,847	$53,529	$13,211	51%
7	84.46	19.46	$58,420	$53,529	$13,211	51%
8	85.06	20.06	$7,705	$55,028	$13,211	51%

TABLE 6

Commencement of Social Security by Older Spouse at Age 70; After-Tax Annual Income Target of $75,000 (increased annually for inflation) with Annuity Payout

Strategy	Age	Duration	Depletion Year Income	SS Benefit	Annuity Payment	% of Target Income
1	82.24	17.24	$28,487	$56,316	$13,211	56%
2	81.33	16.33	$38,176	$54,782	$13,211	57%
3	82.23	17.23	$27,889	$56,316	$13,211	56%
4	82.06	17.06	$6,637	$56,316	$13,211	56%
5	81.20	16.20	$23,050	$54,782	$13,211	57%
6	81.31	16.31	$36,051	$54,782	$13,211	57%
7	81.31	16.31	$36,051	$54,782	$13,211	57%
8	82.02	17.02	$2,398	$56,316	$13,211	56%

has purchased an annuity, though, the percentage of target income guaranteed by the insurer should not change. In short, the insurance company will be assuming the investment risk with respect to the assets used to purchase the annuity payment stream.

Another compelling argument in support of purchasing an annuity is that the insurer is protecting the couple against the risk of outliving the financial plan. Assuming that retirement assets are not sufficient to throw off an income stream that can be lived off perpetually, a financial plan is always vulnerable to the risk that the client lives longer than the plan anticipates and the retirement assets are depleted prematurely. An annuity, of course, is the financial asset to manage this longevity risk. And, particularly in light of the changing retirement landscape and the demise of the defined benefit plan, and assuming that the client has no unusual health issues, the combination of delaying Social Security and purchasing an annuity can be a powerful planning solution to manage both this longevity risk and the investment risk previously described.

CONCLUSION

Traditional retirement distribution planning theory maximizing tax deferral is generally sound, but, in certain circumstances, a different non-traditional distribution strategy may yield better after-tax results. Depending upon whether the goals of the client are asset longevity, wealth transfer, or some balance between the two, the financial planner will need to consider the client's needs and which of the various distribution or decumulation strategies best meet those needs. Absent the client having significant health issues, the financial planner should also consider encouraging the client to delay starting Social Security benefit payments and to purchase an annuity or annuity-type payout. In general, delaying the commencement of Social Security benefits past age 62 and locking in an insured guaranteed payout for life will better position the client to manage the investment and longevity risks associated with the decumulation phase. There is no one-size-fits-all solution for the retirement planning issues raised by the distribution phase, and individuals will need professional support to determine the optimal distribution plan to unlock tax liabilities and maximize their retirement assets for themselves and their heirs. Such tax distribution planning for retirement assets, in turn, creates a need for more dynamic tax modeling and an opportunity for the financial planner to add more value for a client.

Footnotes

1) The US Census Bureau cites 78 million baby boomers, but the Employee Benefit Research Institute frequently refers to 76 million. Both numbers are commonly used. The baby boom generation is generally considered to include those born from 1946 through 1964. Some commentators have further divided the baby boom generation into the lead boomers, or those born from 1946 through 1954, and the tail boomers, or those born from 1955 through 1964.

2) The 10% income tax penalty is imposed under IRC Sections 72(q) and (t) and is intended to promote using these tax-favored vehicles for long-term savings.

3) According to the NAVA 2005 Retirement Horizon Study, 34% of Americans expect to retire between age 50 and age 64.

4) Confirming this trend, the January 2005 Employee Benefit Institute Research Issue Brief indicates that there has been a significant decrease in the number of individuals eligible for a defined benefit plan and a significant increase in the number of individuals eligible for a defined contribution plan over the 10-year period from 1992 to 2002. Specifically, in 1992, 40% of employees had only a defined benefit plan and 37.5% had only a defined contribution plan. By 2001, 19.5% had only a defined benefit plan and 57.7% had only a defined contribution plan. The percentage of employees with both types of plans remained constant during the 10-year period at 22%.

5) According to a Congressional Budget Office report released August 16, 2005, combined federal spending for Social Security, Medicare and Medicaid is expected to increase from around 8% of Gross Domestic Product (or GDP) in 2005 to 12% to 17% of GDP in 2030 to 13% to 28% of GDP in 2050. Assuming that the deployment of such a high percentage of GDP is politically undesirable or economically unsustainable, it is likely that Congress will act to increase revenues supporting these programs or limit future benefits.

6) According to a US Commerce Department report issued in January of 2006, in 2005 the personal savings rate for Americans dipped into the negative territory for the first time since 1933. The problem of insufficient saving prior to retirement is distinguishable from the problem created by the changes or potential changes in the employer and Social Security legs of the retirement stool, since the under-saving is an individual choice. Of course, one response to the changes in the employer and Social Security legs would be to increase personal savings, and it is possible that such a change in savings behavior will occur as the retirement landscape continues to evolve. To date, though, it does not appear that individual saving has increased as a result of the changes described.

7) An excellent article demonstrating the reasons why the traditional distribution theory has been so widely supported as the optimal distribution model is "Liquidating Retirement Assets in a Tax-Efficient Manner," by William A. Raabe and Richard B. Toolson. This article appeared in the May 2002 *AAII Journal*.

8) We have used the projected cost of living adjustment of 2.8%, which is the projected long-term cost of living adjustment in the Social Security Administration's 2005 Annual Statistical Supplement. Thus, both the original target income of $75,000 per year and the Social Security benefits payable have been increased each year by 2.8%.

9) There are, of course, many and varied theories about when retirees will need more or less income. Some commentators believe that most retirement spending occurs in the early retirement years when travel is likely to be greater. From this perspective, there is little need to build in cost of living adjustments, since expenses will diminish over time and make up for any loss due to inflation. Other commentators, however, point out that health care costs, which tend to rise at a rate greater than inflation, are likely to increase during retirement, and that end-of-life health care needs can be significant. From this perspective a cost of living adjustment may be inadequate to support to the ever-increasing health care costs. This article does not seek to address such issues.

10) The thresholds are $32,000 and $44,000 for the 50% and 85% Social Security exclusions, respectively, for married individuals filing jointly.

11) Please note that the decumulation modeling does not consider the impact of possible lost benefits due to working in retirement, since most modeling is done after the age of full retirement, when such reduction in benefits is not applicable. The 2005 earning limit with respect to benefit payments is $12,000 ($12,480 for 2006). One dollar in Social Security benefits is withheld for every two dollars in earnings above the limit. In the calendar year in which an individual attains the full retirement age, during the months prior to attaining full retirement age, one dollar in benefits is withheld for every three dollars in earnings above $31,800 in 2005 and $33,240 in 2006. There is no limit on earnings once an individual attains full retirement age (65 years and 6 months for retires born in 1940 and 65 years and 8 months for retirees born in 1941). See 2006 Social Security Administration Fact Sheet. Given that the wife is only working for two years and earning $25,000 annually, the risk of lost benefits is only relevant for the first two years in the scenario where the couple has chosen early commencement of Social Security benefits. There is no risk of lost benefits under the facts presented after that two-year period or where Social Security benefits are commenced at ages 67 or 70.

12) The age 67 commencement of Social Security is somewhat longer than the current full retirement age of 65 years and 6 months. Under current law, the full retirement age is scheduled to gradually increase to age 67 in 2027. It will increase in increments of 2 months per year until 2009, when normal retirement will be 66 years of age. It will remain 66 years until 2021 when it will begin increasing in increments of 2 months per year until 2027, when normal retirement will be 67.

13) The eight strategies modeled are described below. For each of the eight strategies, we modeled the hypothetical fact pattern assuming that the couple commenced Social Security at age 62, at age 67, and at age 70. Therefore, we modeled 24 different distribution patterns.

Strategy 1. Age 62, age 67 and age 70 Social Security commencement with distribution pattern A, B, C (where A is taxable investments, B is partially tax-deferred investments, and C is wholly tax-deferred investments).

Strategy 2. Age 62, age 67 and age 70 Social Security commencement with distribution pattern A, C, B.

Strategy 3. Age 62, age 67 and age 70 Social Security commencement with distribution pattern B, A, C.

Strategy 4. Age 62, age 67 and age 70 Social Security commencement with distribution pattern B, C, A.

Strategy 5. Age 62, age 67 and age 70 Social Security commencement with distribution pattern C, A, B.

Strategy 6. Age 62, age 67 and age 70 Social Security commencement with distribution pattern C, B, A.

Strategy 7. Age 62, age 67 and age 70 Social Security commencement with proportionate distributions from A, B and C (withdrawals adjusted to reduce Social Security penalty).

Strategy 8. Age 62, age 67 and age 70 Social Security commencement with proportionate distributions from A, B and C.

14) If one assumes that inflation will increase more than the increase in Social Security benefits, then our assumptions overstate the percentage of targeted income that the Social Security will provide. Regardless of the assumption made, and ours was based, in part, on the complexity of having two different inflation adjustment rates, the central hypothesis and conclusions in this article remain the same.

15) Under current law, the highest capital gains rate is 15% through 2008 and increases to 20% in 2009, which is the same rate that was in effect prior to enactment of the Jobs Growth Tax Relief Reconciliation Act of 2003.

16) The comparison is a 15% capital gains rate today and a 20% rate in 2009 versus ordinary income rates of 25%, 28%, 33% and 35% through 2010. The ordinary income tax rates are scheduled to revert to the higher 2001 rates of up to 39.6% in 2011.

17) See footnote 10 and related article text.

18) The asset depletion approaches other than the proportionate withdrawal approach, while generally sequential in nature, are not absolutely so, because we have recognized the legal mandate for taking Required Minimum Distributions from qualified retirement plans and individual retirement plans starting in the year the individual attains age 70½.

19) While generally referred to simply as an IRA, an Individual Retirement Annuity is a specific type of IRA that includes the ability to elect a lifetime payout. The other type of IRA, or an Individual Retirement Account, cannot provide such an insurance-based guarantee.

20) The annuity payout purchased was a joint lifetime payout for a male, age 65, and a female, age 63, who live in NJ, commencing one month from the date of purchase. The annuity payout continues at 100% unreduced during the joint lives of both husband and wife. We did not model the wealth transfer consequences of purchasing an annuity payment stream. Since the annuity payment modeled is a life payment with no period certain, it is clear that the wealth transfer position of the couple would be diminished. Of course, the couple could purchase an annuity with payments for a period certain (e.g., a life and 20-year certain annuity payout), which would better manage this wealth transfer risk.

21) In the case of all of the modeled annuity payouts, the percentage of target income replaced is not a constant number and will decrease, ever so slightly, over time. This is a function of the annuity payout being constant and not indexed for inflation. Therefore, while the Social Security benefit will keep pace with inflation, the annuity payout will gradually lose purchasing power and the combination will ever so slowly become a lesser percentage of the target income. This is the reason that the percentage of target income is different for some strategies in Table 6.

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