

## **Making Retirement Assets Last a Lifetime – PART 1**

### **The importance of a solid exit strategy**

During the working years, accumulating assets for retirement is one of the primary goals of the investing population. Once investors near retirement, they must shift their focus to how they'll use their wealth to afford the most comfortable retirement possible, while minimizing their lifetime tax obligations and retaining wealth to pass on to their heirs. In effect, they will convert their accumulation portfolios into “distribution portfolios.”

Typically, investors have their retirement assets in a variety of vehicles which include traditional IRAs, Roth IRAs, 401(k) plans, tax deferred annuities and taxable investment accounts. When the time comes to begin withdrawing income from these sources, the order in which that income is taken, from a tax perspective, can make a big difference in the amount of wealth investors actually retain. As an investment adviser, you can help your clients understand the importance of building a distribution portfolio that maximizes income in a tax-efficient manner. There are three key issues to consider when structuring a distribution portfolio:

- Which retirement vehicles, or tax asset classes, to include in the distribution portfolio
- The order in which tax asset classes should be withdrawn
- The maximum amount to be taken each year without depleting assets too early

### **(Beginning of side bar comments)**

#### **Taking taxes into account**

Each retirement vehicle has its own set of tax characteristics, which we refer to as “tax asset classes”. Investors can maximize their retirement income by learning how to use each these “tax asset classes” to build tax-efficient distribution portfolios.

**Traditional Individual Retirement Account (IRA)** - An IRA is a tax-favored account that defers tax and creates the potential for retirement funds to accumulate faster than they would in a taxable investment. Although all IRAs enjoy tax-deferral on appreciation and earnings, they have very different tax consequences on both contributions and distributions. In a traditional IRA, contributions may or may not be tax deductible, depending on the investor's Adjusted Gross Income (AGI) and coverage by an employer-sponsored retirement plan. Earnings, and any growth on the assets, accumulate on a tax-deferred basis. Distributions are 100 percent taxable as ordinary income if the investor takes a tax deduction for contributions. Earnings from non-deductible IRA distributions are taxed as ordinary income, while the non-deductible principal is returned tax free.

**Roth IRA** – With a Roth IRA the investor receives no income tax deduction when contributing. However, qualified distributions are generally not subject to tax. In certain instances an individual may be able to convert from a regular IRA to Roth IRA. For clients who are able to do so, a conversion to a Roth IRA may produce very favorable tax consequences.

**Tax-deferred Annuity** – A tax-deferred annuity is an insurance company contract that gives an individual the right to receive annual payments, typically for the rest of the investor's life or for the joint lives of the investor and the investor's spouse. These contracts may be purchased many years before retirement, but no tax is paid on the earnings until the investor actually starts receiving payments. In the meantime, the annuity enjoys tax-deferred growth.

**Taxable Investment Account** - A taxable investment account is simply a portfolio of securities, including mutual funds and municipal bonds, whose ownership is held outright by an individual. The income on municipal bonds is generally tax-free, but may be subject to the alternative minimum tax. Any gains or losses of securities sold prior to maturity could create a tax event. These accounts receive no special tax treatment, as a traditional IRA or Roth IRA does. Thus, most sales proceeds, capital gains and losses, as well as interest and dividend distributions, will be taxed to the account owner in the year of distribution. However, with proper planning, a significant share of the taxable income could be taxed as long-term capital gain.

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### **Taxable vs. tax-favored accounts**

Clients generally maximize the use of tax-favored investment vehicles like IRAs and 401(k) plans in their accumulation portfolio because these vehicles have the potential for more rapid accumulation of wealth. The distribution portfolio will usually include both tax-favored and taxable investments.

**As a framework on which to build the asset withdrawal plan, it's important to remember:**  
**Accumulated Income Goal - Taxable Income\* = Amount to Come from Retirement Assets**  
*\*from non-qualified earnings, business, wages and possibly Social Security*

### **Timing is everything**

The first decision retirees face is whether to withdraw funds from their taxable accounts, their IRA, or their Roth IRA. Invariably, the best result comes from withdrawing in the manner that produces the best overall income tax consequences, which is why it's so important to consult the client's CPA.

Clients generally should withdraw funds from the traditional IRA to the extent that they remain *within the 15-percent federal income tax bracket* and then focus their consumption on taxable investments. They must also remember to factor in Social Security benefits. This combination offers the investor the ability to maximize distributions at the low end of the marginal income tax rate schedule, while allowing the remaining assets to continue to accumulate tax-deferred.

Ideally, individuals should develop a five-to-nine year plan for withdrawing assets based on current income, current tax rates, Social Security benefits, and projected income.

Important ground rules for withdrawal strategy:

If taxable income is smaller than 15% tax bracket + deductions, the order for withdrawal of assets to consider:

1. Tax-deferred
2. Taxable
3. Tax-free

If taxable income is larger than 15% tax bracket + deductions, the order for withdrawal of assets to consider:

1. Taxable
2. Tax-deferred
3. Tax-free

Withdrawals should be taken to minimize income tax, taking into account the tax brackets for a married or single individual and determining how to best balance these brackets with the client's long-term strategic goals. The table below highlights both the married and single tax brackets for the year 2006:

2006 Ordinary Income Tax Table				
Single		Married Filing Jointly		Marginal Tax Rate
Over	But Not Over	Over	But Not Over	
\$0	\$7,550	\$0	\$15,100	10%
\$7,550	\$30,650	\$15,100	\$61,300	15%
\$30,650	\$74,200	\$61,300	\$123,700	25%
\$74,200	\$154,800	\$123,700	\$188,450	28%
\$154,800	\$336,550	\$188,450	\$336,550	33%
\$336,550	-----	\$336,550	-----	35%

**EXAMPLE** – Married Couple

- Andy and Anne (both age 60) are both retired and are seeking pre-tax income of \$80,000 annually.
- Assets
  - Traditional IRA \$1,500,000
  - Roth IRA \$500,000
  - Taxable investment account - \$500,000

For ease of analysis, let's assume a standard deduction of \$10,000 and personal exemptions of \$6,400.

Under these facts, Andy and Anne should do the following:

- Withdraw \$77,700 (\$61,300 which is the top of 15% bracket + \$10,000 standard deduction + \$6,400 personal exemptions = \$77,700).
- The remaining \$2,300 (\$80,000 - \$77,700) should come from their taxable investment account.<sup>1</sup>

In this example, and in most other cases, it is generally recommended that clients delay taking distributions from their Roth IRAs for as long as possible to preserve tax-free growth of the account. This example may seem inconsistent with the tax-deferral theory that many advisors and tax practitioners preach, specifically, withdrawing from taxable accounts first, then tax-deferred investments, and finally from tax-free investments. However, as noted in the ground rules already stated, there are instances when taking withdrawals from a tax-deferred account first makes sense. For instance, as shown in the following example, if the client believes their income tax brackets will be higher in the future than they are currently, they may wish to take initial withdrawals from the tax-deferred account to help reduce the taxes of future distributions.

**EXAMPLE-** Individual

Ron is a 68-year-old with an IRA worth \$1,000,000. He would like to be able to withdraw \$50,000 per year in retirement.

- Other pertinent facts:
  - Current income tax rate: 15%
  - Future “expected” income tax rate: 30%
  - Pre-tax growth rate of IRA: 7%
  - After-tax growth rate of taxable investment account: 5.75%
  - Time horizon: 10 years

In this example, Ron could either leave the \$50,000 in the IRA until he is required to take a distribution or take the \$50,000 withdrawal in the current year.

**Scenario 1 – Leave Assets in IRA**

Initial Amount	\$50,000
Total assets in ten years (at a pre-tax growth rate of 7%)	\$98,358
Less: Income tax in ten years (at a future rate of 30%)	<u>(29,507)</u>
Net amount remaining after taxes	<u>\$68,851</u>

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<sup>1</sup> Note: This illustration does not take into account any other taxable income, which would reduce the amount to be taken from the Traditional IRA.

## **Scenario 2 – Withdraw Assets in Current Year**

Initial Amount	\$50,000
Less: Income tax in current year (at a current rate of 15%)	<u>(7,500)</u>
Net amount remaining after taxes	\$42,500
Total assets in ten years (at an after-tax growth rate of 5.75%)	<u>\$74,335</u>

If Ron leaves the \$50,000 in the IRA, this amount would hypothetically grow to approximately \$100,000 in ten years. After paying taxes at an “expected” income tax rate of 30%, Ron would have approximately \$70,000 left. On the other hand, if Ron decides to take the \$50,000 in the current year, he would have \$42,500 after taxes ( $\$50,000 \times (100\% - 15\%)$ ) left to reinvest in his taxable investment account. At an after-tax growth rate of 5.75%, this \$42,500 would grow to approximately \$75,000 in ten years.

Given the facts in this example, it would make more sense for Ron to take the IRA distribution in the current year because of the “expected” income tax rate differential and the relatively short time horizon. However, Ron could also benefit by postponing his IRA distributions until later if he had a longer time horizon, an income tax rate differential closer to current tax rates, or if the difference in the after-tax growth rates were larger.

### **Social Security benefits may be taxable**

Many people do not realize that their Social Security benefits are potentially subject to federal income taxes. If the client’s total taxable income (wages, pensions, interest, dividends, capital gains, etc.) tax-exempt income, plus one-half of the Social Security benefits exceed a certain “floor” (\$25,000 for singles, \$32,000 for married filing jointly and \$0 for married filing separately), the IRS will tax a portion of the Social Security benefits. The taxable portion can range from 50% to 85% of the benefits. Thus, it is important for the client to consider the income tax ramifications of taking a larger withdrawal from a traditional IRA or other qualified plan in any given tax year.

### **EXAMPLE**

Tom and Mary have the following sources of income:

- Taxable interest - \$2,000
- Dividends - \$10,000
- IRA distribution - \$10,000
- Gross Social Security benefits - \$20,000

Now let’s further assume that Tom and Mary are contemplating taking an additional \$10,000 to \$30,000 out of Tom’s IRA before the end of the year. Under these facts, the taxable portion of Tom and Mary’s Social Security would be as follows:

	<b>No Additional IRA Distribution</b>	<b>\$10,000 Additional IRA Distribution</b>	<b>\$30,000 Additional IRA Distribution</b>
Interest income	\$2,000	\$2,000	\$2,000
Dividends	10,000	10,000	10,000
IRA distribution	<u>10,000</u>	<u>20,000</u>	<u>40,000</u>
Taxable income before Social Security benefits	\$22,000	\$32,000	\$52,000
Taxable Social Security benefits	<u>\$0</u>	<u>\$5,000</u>	<u>\$17,000</u>
% of Social Security taxable	0%	50%	85%

### CALCULATION OF TAXABLE SOCIAL SECURITY BENEFITS (FOR MFS COMPLIANCE ONLY)

	<b>No Additional IRA Distribution</b>	<b>\$10,000 Additional IRA Distribution</b>	<b>\$30,000 Additional IRA Distribution</b>
Interest income	\$2,000	\$2,000	\$2,000
Dividends	10,000	10,000	10,000
IRA distribution	<u>10,000</u>	<u>20,000</u>	<u>40,000</u>
Taxable income before Social Security benefits	\$22,000	\$32,000	\$52,000
Add: ½ Social Security benefits	<u>10,000</u>	<u>10,000</u>	<u>10,000</u>
Modified Adjusted Gross Income (MAGI)	<u>\$32,000</u>	<u>\$42,000</u>	<u>\$62,000</u>
Social Security benefits	\$20,000	\$20,000	\$20,000
“Floor”	\$32,000	\$32,000	\$32,000
“Ceiling”	\$44,000	\$44,000	\$44,000
Excess of MAGI over “floor” (limited to \$12,000)	\$0	\$10,000	\$12,000
Excess of MAGI over “ceiling”	<u>0</u>	<u>0</u>	<u>18,000</u>
Total MAGI excess	\$0	\$10,000	\$30,000
(1) 50% of excess MAGI over “floor” (limited to \$6,000)	\$0	\$5,000	\$6,000
(2) 50% of Social Security benefits	\$10,000	\$10,000	\$10,000
(3) 85% of excess MAGI over “ceiling”	\$0	\$0	\$15,300
(4) Add-in: Lesser of (1) OR (2)	<u>0</u>	<u>5,000</u>	<u>6,000</u>
(5) Sum of (3) and (4)	\$0	\$5,000	\$21,300
(6) 85% of Social Security benefits	\$17,000	\$17,000	\$17,000
TAXABLE SOCIAL SECURITY (lesser of (5) OR (6))	<u>\$0</u>	<u>\$5,000</u>	<u>\$17,000</u>

As evidenced in the example above, the additional IRA distribution causes a portion of Tom and Mary’s Social Security benefits to be taxable when it would not be otherwise. Thus, for every dollar of additional IRA distribution, anywhere from 50 to 85 cents of Tom and Mary’s Social Security would be subject to federal income tax. Another way of looking at this would be that each dollar of additional IRA distribution incurs taxation equal to \$1.50 or \$1.85 distribution from the IRA.

**A new perspective on the asset allocation decision**

Another technique to improve tax efficiency for distribution portfolios is to integrate tax asset allocation with overall investment allocation. For example, if a person had a portfolio that was designed to be 50 percent stocks and 50 percent bonds, to the extent possible, they would put the taxable bonds in a traditional IRA and the stocks in a Roth IRA, particularly those stocks expected to appreciate rapidly. The stock portfolio, based on historical stock market data, is hypothetically expected to have a higher compound return over the long-run than the bond portfolio and we would want that higher return to be in the Roth IRA. While the growth in the traditional IRA will be subject to income tax at ordinary income rates when distributions are made, growth of assets in a Roth IRA is ordinarily not subject to tax.<sup>2</sup> Keep in mind that past performance of any security is no guarantee of future results.

The same observation leads to another rule of thumb. Investments that potentially generate capital gains should either be in a Roth IRA or a taxable account. Capital gains aren’t taxed in a Roth IRA, and are taxed at a lower rate if generated in a taxable account. By contrast, capital appreciation in traditional IRA assets will end up being taxed at ordinary income rates when distributions are made. A final consideration is that assets that produce little or no taxable income should be in taxable accounts because there is no tax advantage to including them in an IRA.

<u>Asset</u>	<u>Preferred Vehicle</u>	<u>Reason</u>
Fast-Appreciating Assets	Roth IRA	Remove appreciation from tax base
Ordinary Income Assets	Traditional IRA	Defer recognition of ordinary income (all distributions from Traditional IRA taxed as ordinary income anyway)
Index funds, SPDRs Tax-exempt investments	Taxable account	Produce little or no taxable income
Actively managed Stocks	Roth IRA and/or taxable Account	Eliminate capital gains and/or enable client to offset capital gains with capital losses

The guidelines presented here are only suggestions. Clients should always consult their CPAs to determine the best course of action for their situation. Keep in mind that for some clients, IRA assets may be the largest portion of their retirement asset base.

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<sup>2</sup> Reg. § 1.408-6, Q&A 16 provides that the basis of property distributed from a Roth IRA is its FMV on the date of distribution

Therefore, it may not be desirable to invest the entire amount in ordinary income assets for reasons of diversification.

**END OF PART 1**

## **Making Retirement Assets Last a Lifetime – PART 2**

A crucial issue for many retirees is making the portfolio last through their lives. What is the maximum amount they can withdraw each year without running out of funds prematurely?

Calculating this maximum sustainable withdrawal rate is fairly straightforward. On a business calculator, enter the beginning value of the retirement fund (present value), the time horizon (number of periods) the assumed simple growth rate on the assets (%) and solve for the amount of the annual withdrawals (payment). If the client wants to leave something for their children, a fifth variable would be added--the amount left at the end of the time horizon (future value).

### **Factoring risk into the equation**

Unfortunately, the above formula cannot describe a key element—risk. There are three elements of risk that are important to a retiree: the unreliability of estimated returns, the volatility of returns and the order of performance.

### **Return estimates cannot predict performance**

The expected simple (average) return is merely an estimate based on historical data and an analysis of present market conditions. A given portfolio may produce a simple return that is either substantially higher or substantially lower than the estimate.

### **High volatility reduces returns**

Even if the estimated simple return were accurate it could not be used to predict how long the portfolio would last. The volatility of returns would also have to be taken into account. The effect of volatility, also sometimes referred to as “risk drag”, is to reduce returns. For any given simple arithmetic return, the greater the volatility the lower the resulting compound return. Compound return is much more significant because it reflects the investor’s terminal wealth from an investment at any given point in time.

To illustrate the effect of volatility, consider a simple example. Suppose that an investor has \$100 to invest for a four-year period. There are two investment choices, Investment A and Investment B. The investments have the same 10% simple (average) return, but Investment A arrives at that average by producing the same 10% return each year while Investment B produces returns of -20%, 0%, +30% and +30. Assume that the investor withdraws \$5 per year. This chart compares the amounts of the two investments at the end of each year.

<u>Year</u>	<u>Investment A</u>	<u>Investment B</u>
1	\$110.00	\$80.00
2	\$121.00	\$80.00
3	\$133.10	\$104.00
4	\$146.41	\$135.20

**Order of returns effects long-term performance**

The last element of risk is the order of returns. A portfolio that has poor investment returns early may be exhausted sooner than a portfolio that has the same poor returns later.

Consider the following example. An investor starts out with \$100 in retirement funds and withdraws \$5 from the account each year. The total after-tax return on the portfolio is 10% in most years, but there are five bad years when the return is – 20%. The chart below compares how much will be in the portfolio if the five bad years come at the beginning versus how much will be in the investment portfolio if the bad years come later in the period. In Scenario A, the five bad years are years one through five and in Scenario B the five bad years are years 13 through 17.

<b>Investment A</b>						
<u>Year</u>	<u>Beginning Value</u>	<u>Return</u>	<u>Withdrawal (\$5)</u>	<u>Ending Value</u>	<u>Return %</u>	
1	\$ 100.00	\$ (20.00)	\$ (5.00)	\$ 75.00	-20%	
2	\$ 75.00	\$ (15.00)	\$ (5.00)	\$ 55.00	-20%	
3	\$ 55.00	\$ (11.00)	\$ (5.00)	\$ 39.00	-20%	
4	\$ 39.00	\$ (7.80)	\$ (5.00)	\$ 26.20	-20%	
5	\$ 26.20	\$ (5.24)	\$ (5.00)	\$ 15.96	-20%	
6	\$ 15.96	\$ 1.60	\$ (5.00)	\$ 12.56	10%	
7	\$ 12.56	\$ 1.26	\$ (5.00)	\$ 8.81	10%	
8	\$ 8.81	\$ 0.88	\$ (5.00)	\$ 4.69	10%	
9	\$ 4.69	\$ 0.47	\$ (5.00)	\$ 0.16	10%	
10	\$ 0.16	\$ 0.02	\$ (5.00)	\$ (4.82)	10%	

<b>Investment B</b>						
<b>Year</b>	<b>Beginning Value</b>	<b>Return</b>	<b>Withdrawal (\$5)</b>	<b>Ending Value</b>	<b>Return %</b>	
1	\$ 100.00	\$ 10.00	\$ (5.00)	\$ 105.00	10%	
2	\$ 105.00	\$ 10.50	\$ (5.00)	\$ 110.50	10%	
3	\$ 110.50	\$ 11.05	\$ (5.00)	\$ 116.55	10%	
4	\$ 116.55	\$ 11.66	\$ (5.00)	\$ 123.21	10%	
5	\$ 123.21	\$ 12.32	\$ (5.00)	\$ 130.53	10%	
6	\$ 130.53	\$ 13.05	\$ (5.00)	\$ 138.58	10%	
7	\$ 138.58	\$ 13.86	\$ (5.00)	\$ 147.44	10%	
8	\$ 147.44	\$ 14.74	\$ (5.00)	\$ 157.18	10%	
9	\$ 157.18	\$ 15.72	\$ (5.00)	\$ 167.90	10%	
10	\$ 167.90	\$ 16.79	\$ (5.00)	\$ 179.69	10%	
11	\$ 179.69	\$ 17.97	\$ (5.00)	\$ 192.66	10%	
12	\$ 192.66	\$ 19.27	\$ (5.00)	\$ 206.92	10%	
13	\$ 206.92	\$ (41.38)	\$ (5.00)	\$ 160.54	-20%	
14	\$ 160.54	\$ (32.11)	\$ (5.00)	\$ 123.43	-20%	
15	\$ 123.43	\$ (24.69)	\$ (5.00)	\$ 93.74	-20%	
16	\$ 93.74	\$ (18.75)	\$ (5.00)	\$ 70.00	-20%	
17	\$ 70.00	\$ (14.00)	\$ (5.00)	\$ 51.00	-20%	
18	\$ 51.00	\$ 5.10	\$ (5.00)	\$ 51.10	10%	
19	\$ 51.10	\$ 5.11	\$ (5.00)	\$ 51.21	10%	
20	\$ 51.21	\$ 5.12	\$ (5.00)	\$ 51.33	10%	

When we add risk into the equation, the withdrawal decision involves the following factors--

- (1) The beginning value of the assets.
- (2) The time horizon over which the assets must last.
- (3) The expected total return on the assets.
- (4) The probability that the assets will be exhausted before the end of the time horizon.
- (5) The amount the client wants to have left at the end of the period to pass to children.
- (6) The amount of the annual withdrawals.

These factors are all interrelated and manageable to some extent. For example, if the client is willing to wait longer before retiring, he or she can increase the beginning value of the assets, decrease the time horizon over which the assets must last, decrease the probability that the assets will be exhausted prematurely, increase the amount left for the children and/or increase the amount of the annual payments. Investing more before retiring would have all the same effects, except for shortening the time horizon.

The client must also be aware of tradeoffs among retirement goals. For example, the amount expected to pass to heirs can be increased if clients are willing to shorten their time horizon, reduce annual payments or decrease the probability of running out of assets. The client's goal should be to achieve the best possible combination given his or her personal preferences. The best way to show the client the possible options is with a withdrawal rate calculator.

### **Customizing the plan**

The strategies we've described all involve setting up a fixed withdrawal amount for each year of retirement and staying with the plan. Many clients, however, might prefer an initial strategy that provides for varying payments during retirement. For example, clients may want to withdraw more in the early years, while they are still in good health, budgeting additional amounts for travel and entertainment. These discretionary expenses could be gradually eliminated as the client grows older. Other clients might take just the opposite approach, budgeting more for later years when medical and/or health care expenses might be higher.

It will be necessary to modify the withdrawal strategy over time. There are too many variables that cannot be predicted with certainty, including market returns, interest rates, tax rates, inflation rates, unexpected expenses, and time horizon. If investment returns are lower than expected or inflation rates are higher, for example, withdrawals may have to be reduced, except in the case of a life annuity.

### **Help your clients go the distance**

Preparing for retirement is a life-long activity. Many people don't realize that the way they manage their nest-egg after they retire is as important as the strategies they employ to accumulate assets during their working years. We hope the information provided here will be useful as you work with your clients to help them understand the importance of building a distribution portfolio that will last throughout their retirement.