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Retirement income management

Some retirees have enough money coming in, from their pensions, Social Security and investment income, that they don't need to touch their principal to meet living expenses. Because Social Security payments are indexed for inflation, they also have that base covered to some extent.

Most retirees are not in so fortunate a position. For them, an important question looms. How much of my savings can I consume each year and still be reasonably confident that I won't outlive my money?

A starting point

Financial planner William P. Bengen addressed that question in an article published in the *Journal of Financial Planning* in 1994. Relying upon financial market performance data dating back to 1926, as compiled by Ibbotson Associates (now a Morningstar division), Bengen tested hundreds of scenarios. He assumed that the money would be coming from a tax-deferred savings account, which left the balance to grow without a tax drag. His models adjust the annual dollar amount of withdrawals by inflation every year for various 30-year periods. Given these parameters, how much should a retiree be able to draw down in the first year from principal?

Not more than 4.5%.

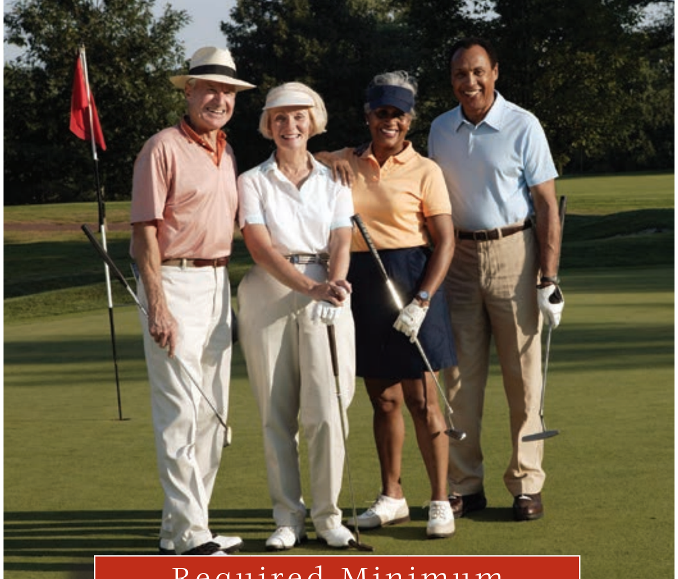
If the money is coming from taxable savings, the figure is just 4.1%. However, the income tax burden is likely to be significantly lower when one invades previously taxed

How large are the payouts?

Required minimum distributions from an IRA won't exhaust the account before the owner lives beyond age 100, even if the account has poor investment return. Accounts that enjoy even modest returns will keep getting larger in the early years of minimum distributions. This table shows the projected size of a required minimum distribution from a $1 million IRA at various ages, for various rates of return. It also shows total distributions and the balance remaining at age 100, if only required minimum distributions are taken each year. If a 6% annual rate of return can be achieved, the account balance won't dip below $1 million until age 92.

Age	2% return	4% return	6% return	8% return
70	$36,496	$36,496	$36,496	$36,496
80	$42,255	$51,750	$63,124	$76,700
90	$42,859	$64,606	$96,587	$143,259
100	$28,394	$53,269	$98,650	$180,439
Total payments through age 100	$1,233,056	$1,624,697	$2,387,026	$3,434,869
Remaining balance at age 100	$154,067	$295,750	$560,139	$1,047,272

Source: M.A. Co.
Rates of return are for illustration only and do not represent any particular investment.



Required Minimum Distributions		
Age	Distribution years	Percentage equivalent
70	27.4	3.6%
71	26.5	3.8%
72	25.6	3.9%
73	24.7	4.0%
74	23.8	4.2%
75	22.9	4.4%
76	22.0	4.5%
77	21.2	4.7%
78	20.3	4.9%
79	19.5	5.1%
80	18.7	5.3%
81	17.9	5.6%
82	17.1	5.8%
83	16.3	6.1%
84	15.5	6.5%
85	14.8	6.8%
86	14.1	7.1%
87	13.4	7.5%
88	12.7	7.9%
89	12.0	8.3%
90	11.4	8.8%
91	10.8	9.3%
92	10.2	9.8%
93	9.6	10.4%
94	9.1	11.0%
95	8.6	11.6%
96	8.1	12.3%
97	7.6	13.2%
98	7.1	14.1%
99	6.7	14.9%
100	6.3	15.9%

Source: IRS Publication 590; M.A. Co.

accounts—basis is recovered tax free, and the long-term gains still are taxed at preferential rates.

Before the recent recession, some people thought that 4.5% seemed rather low. In today's uncertain economy, some now think it too high. It is important to understand what the 4.5% figure represents. For all the 30-year periods that Bengen examined, there was money left in the account if the beginning withdrawal were 4.5% or less. In periods of strong financial performance, starting with a 4.5% withdrawal resulted in as much principal in the account at the end of the 30 years as at the beginning. But in all cases, the 4.5% beginning level turned out to be safe.

The IRA angle

Distributions from IRAs must begin when the IRA owner reaches age 70½. These distributions are geared to life expectancy, and so start out at less than 4.5%. Just 3.6% needs to be withdrawn in the first year, but the percentage grows as the owner ages. The 4.5% level is reached in the seventh year. See the table *Required Minimum Distributions* for details.

Minimum distributions won't exhaust the IRA for more than 30 years. In most cases, the account won't even start to get smaller until the owner reaches the mid-80s. *How Large Are the Payouts?* provides some specific examples, and shows total distributions from the IRA over 30 years for various hypothetical investment experiences.

Active investment management

Implicit in Bengen's program is a plan for active investment management. He generally recommends that at the beginning of retirement, one have as much as 75% of assets in stocks, which might be above the comfort level of many retirees. Over time, the portfolio will need to be rebalanced, a job that many prefer to delegate to professionals.

Individual factors should come into play for setting a withdrawal rate. A client with some health problems may not need to plan for 30 years, and so he or she could have a higher withdrawal rate. One whose family has a history of good longevity may want to consider a lower rate. Market prospects need to be taken into account as well. A stock market crash early in retirement, for example, can have a devastating effect on a retiree's financial security in the longer term.

To learn more about these retirement income strategies, see Bengen's 2006 book, *Conserving Client Portfolios During Retirement* (available for $47.66 from Amazon.com at this writing).

We can help with your investment choices

There are some retirees who enjoy managing their investments. Many others prefer to enjoy their retirement activities rather than pit their skills against investment professionals. Whichever camp you are in, we are at your service. We can help you to achieve financial security, so you can live your retirement to the fullest. ☐

Year-end tax considerations, 2013 edition

In contrast to recent years, when clouds of uncertain and various expiration dates hung over the tax code, this year taxpayers know what the rules are. For those with higher incomes, taxes will be higher. Period. Top tax rates are higher; itemized deductions are phased out for some taxpayers; new Medicare taxes apply.

Even so, there are steps to consider, as we approach the end of the year, that could make a difference next April 15.

AMT

Upper-income taxpayers have to calculate their income tax liability, in two ways. The regular way has a top marginal rate in 2013 of 39.6% and lots of allowable deductions. The Alternative Minimum Tax (AMT) has two brackets, 26% and 28%, and it provides for far fewer deductions. Taxpayers pay the higher of the two tax figures.

Just as taxpayers' circumstances vary from year to year, so does their exposure to the AMT. Their deductions and exemptions may trigger the AMT one year, but not in another. This fact can lead to some counterintuitive tax strategies.

If a tax review projects that you will be paying the AMT in 2013, but there is a chance you won't in 2014, then you might want to accelerate ordinary income into 2013 to take advantage of the 28% top tax rate, instead of having that income taxed at 39.6% next year. For example, if you own nonqualified stock options, they could be candidates for a 2013 exercise. However, take care not to exercise so many options that the AMT no longer applies.

In this situation you also may want to defer actions that generate ordinary tax deductions until 2014, when the deductions will be worth more. For example, you might defer payment of state taxes into the new year or delay some charitable gifts.

On the other hand, if you know that you will not pay the AMT this year, but you might in 2014, you would reverse these strategies.

Portfolio moves

Tax consequences shouldn't drive portfolio management decisions, but they do need to be taken into account. Tax efficiency matters.

Capital gains and losses for the entire tax year are netted against each other, according to these rules:

1. Short-term losses are netted against short-term gains.
2. Long-term losses are netted against long-term gains.
3. If one of these is a gain and the other is a loss, they are netted.
4. Any resulting short-term gains are taxed as ordinary income. Any resulting long-term gains from securities sales are taxed at 15%. At some income levels, the rate is boosted to 20%, and at still higher levels a 3.8% surtax applies, for a maximum capital gains tax rate of 23.8%.
5. Up to $3,000 of net capital losses may be deducted from ordinary income. Short-term losses are used up first, then long-term losses.
6. Unused capital losses may be carried to future years until death.

The conventional wisdom resulting from these rules is that long-term gains are better than short-term, because they have a lower tax rate. Short-term losses are better than long-term losses, because they shelter income at a higher tax rate. However true this may be in general, it shouldn't be applied to the next transaction until the full range of gains and losses for the year is understood.

Example. Wes needs to sell $100,000 of securities to raise cash. He can choose lot A, which will generate a $20,000 long-term gain, or lot B, which brings with it a $20,000 short-term gain.

In the absence of any other trading, Wes would prefer lot A, because the long-term gain brings less taxation. But if we add one fact, the picture changes. Wes already has incurred $20,000 in capital losses this year, and they will offset his $20,000 gain fully. In that case he may prefer to realize the short-term gain, and save the long-term gain for another day.

Wash sales. When harvesting capital losses, beware of the "wash sale" rule. If you sell a stock at a loss and reacquire substantially identical securities within 30 days of the sale (either before or after the sale), the loss will be disallowed. Instead, the loss will be added to your basis. Note that the rule applies even if the loss is incurred in a taxable account and the securities are reacquired in your IRA (traditional or Roth).

No one ever suggested that tax planning is easy. If you find these ideas of interest, see your tax advisors soon to learn more. ☐

Reconsidering a Roth conversion

Roth IRAs have two important advantages for retirees. Payouts are tax free, and there are no required minimum distributions at any age for the account owner.

These advantages often persuade taxpayers that a conversion of a traditional IRA to a Roth IRA will be worthwhile. But the conversion comes with an important cost: The entire amount converted to a Roth IRA will be subject to ordinary income tax in the year of the conversion. With a large IRA, that could push a taxpayer into a higher tax bracket, perhaps to levels triggering the new Medicare taxes. The large tax bill can take years to recover, even on a tax-free basis. The smaller asset base can leave the account owner feeling vulnerable.

That's why, as the tax bill comes due on a conversion, some taxpayers get cold feet. Fortunately, there is a safety valve of sorts in this area. A conversion to a Roth IRA may be reversed through a recharacterization of the account as a traditional IRA.

The recharacterization will be especially appealing if the value of the account has fallen since the time of the conversion. Paying high taxes on an already diminished account is doubly painful.

The best candidates for staying with a conversion to a Roth IRA are those with other resources for paying the tax bill and those who are hoping to leave a more substantial legacy for their heirs. A tax-free Roth IRA makes a terrific legacy. Also, if the account has experienced favorable investment returns already, undoing a Roth conversion may lead to much higher taxes in the future.

Minimum salaries

Sean McAlary's real estate brokerage firm was organized as an S corporation. With that approach, the salary he earned as an employee of the firm would be subject to payroll taxes, while the profits he withdrew as an owner would not be. In 2006 Mr. McAlary reported a salary of zero.

That caught the attention of the IRS, which believed that under the circumstances the salary should have been set at about $100,000. Mr. McAlary countered that he meant to draw a salary of $24,000, that the zero figure was his accountant's error. The Tax Court's "middle ground" was $83,200. That meant an additional $13,700 was due in payroll and unemployment taxes, plus $4,300 in penalties.

There is no hard and fast rule for minimum salaries for tax purposes. The IRS takes a "facts and circumstances," case-by-case approach. The issue may grow in importance in the future as payroll taxes increase. ☐