BLOOMER FINANCIAL PLANNING

Retirement Distribution Strategies

As more and more baby boomers retire, they are discovering the need to develop a "Retirement Distribution Strategy." This is not something many of our parents worried about because many large employers (in the past) offered generous pensions which required no strategy on the pensioner's part. For most of our parents, their pensions and social security was all they needed. As we all know, an open pension plan is now rare and social security will provide only a fraction of required income. Therefore, most investors/retirees now must figure out a way to monetize their assets, investments, and retirement accounts to last a lifetime.

To make matters even more complicated, it will not be unusual for the typical investor to have numerous accounts to draw from in retirement, including brokerage accounts, 401ks, IRAs, Roth accounts, HSAs, annuities, real estate, and inherited assets. All will have different tax implications. The retirement accounts will have distribution rules imposed by the IRS.

One potential solution that will be appealing to some is purchasing an annuity. In fact, the 2019 SECURE act made it easier for employers to offer annuities within 401k accounts. Annuities act very much like a pension plan, removing the burden of creating a distribution strategy. However, annuities have many downsides. For one, they are expensive; the fees that investment and insurance companies charge for annuities take a large chunk of your investment. Secondly, when one buys a traditional annuity they assume the risk of dying early and missing out on future annuity payments, and not having the option to leave assets to heirs (annuities can be purchased with death benefits and guaranteed payments, all of which serves to increase the fees). The good news is, with a thoughtful approach to distribution, retirees can avoid the high cost of purchasing an annuity.

This paper explains how to set up a retirement distribution strategy.

Sources of Retirement Income and their Taxation

In general, the goals of a retirement distribution strategy are to:

- Derive the highest possible value from assets and;
- Attain the maximum tax efficiency.

Since most investors will draw funds from many different accounts with different tax treatments and return characteristics, the distribution strategy should be designed create the greatest value possible from the accounts while keeping taxes to a minimum.

A retiree will typically draw income from the following four categories:

1. **Taxable Income**. This is any asset that generates taxable income such as part time employment income, pensions, interest, deferred compensation, etc. In some cases, some of the income may be tax free such as with treasury/municipal bonds. Social security is included in this bracket, even though it is taxable only above a certain level.

2. **Taxable investment accounts**. These are typically brokerage investment accounts funded with after tax dollars. They tend to be tax efficient due to preferential capital gains rates on appreciation.

3. **Tax-deferred retirement accounts.** This category includes retirement accounts such as 401ks and IRAs which have been funded with pre-tax contributions, so income taxes are deferred on both contributions and appreciation. This category also includes annuities where the retiree has invested post tax funds, which can grow tax free until withdrawn, and then only the appreciation is taxed as income.

4. **Tax-exempt retirement/savings accounts**. These are accounts where no taxation will be due on contributions or appreciation on distributions if they are qualified distributions. A Roth IRA fits into this category (funded with after tax dollars) as do Health Savings Accounts or HSAs, which are funded with pre-tax dollars but also tax free if used for health care expenses.

A retiree's real estate (e.g. primary home) is often included in potential assets to fund retirement. However, one always needs a place to live and this strategy assumes that the retiree will downsize at some point and use proceeds from a real estate sale to fund retirement. While this is certainly an option, the conservative approach is to not include potential real estate sales in retirement assets and/or include only a portion.

Approaches to Distribution Strategies

There are two different approaches to establishing a distribution strategy; the "phased" approach and the "proportional" approach.

The "phased" approach has been popular for recent retirees due to its simplicity. The primary goal of the "phased approach" is to delay withdrawing tax-deferred and tax-exempt retirement accounts as long as possible to avoid taxation and enable the assets to continue growing tax free. This approach tends to work best when the younger retiree has ample cash flow in the early years from non-deferable taxable income sources (e.g. pensions, part time income, taxable interest and dividends, and deferred compensation) which puts the retiree in a high tax bracket. This assumes the current cash flow covers all or most of income needs. Any shortfall in cash flow is typically covered by selling brokerage assets (generating favorable capital gains taxes or taking advantage of offsetting capital gains and losses).

A potential problem with the phased approach is that it can increase the ultimate tax bill. The reason is required distributions. Current law requires retirees to withdraw a specified level of funds beginning at age 72 (so called Required Minimum Distributions or "RMDs"-See "About RMDs" below). If these accounts have accumulated a high amount of assets, through the retiree may face higher income tax rates on RMDs, higher Medicare and Social Security premiums which are based on income, and higher tax liabilities to heirs when they inherit the accounts. The other issue with these retirement accounts is that all distributions, including appreciation, are taxed as income, and thus may not benefit from preferential capital gains treatment.

The other issue with the phased approach is that it does not take advantage of tax-exempt retirement accounts (which, of course, have no income tax). In other words, when a retiree in a high tax bracket is in need of additional cash flow (say, for a big purchase such as a wedding, second home, or medical procedure) tax-exempt accounts such as Roth IRAs and HSAs can be excellent sources of non-taxable cash flow.

The "proportional" approach to distribution strategy is a more dynamic, flexible approach. In this strategy, the retiree may draw on **any and all** investment accounts **every year.** This approach will be more appropriate for a younger retiree who does NOT have a high level of non-deferrable taxable income in the early years of retirement. In this case, the proportional approach can both reduce the lifetime tax bill and maximize asset value. For example, in a year in which the retiree (under age 72) is in a relatively low tax bracket it could make sense to draw down one or more retirement accounts, or execute a Roth conversion, to take advantage of the lower tax bracket. Even though the tax is being paid sooner rather than later, it might be a much lower tax bracket than the one ultimately used later distributions. Most retirees should follow the proportional approach, even though it requires more work to plan and execute, due to the flexibility it provides.

Developing a Distribution Strategy

The process of developing a distribution strategy requires both a comprehensive plan and annual adjustments. The retiree should create a hypothetical lifetime model and then make annual adjustments based on the current cash flow, market conditions, and taxation.

The first step in developing a retirement distribution strategy is to document the retiree’s sources of retirement income and understand their rules and taxation. Many retirees will have a “base” of earnings sources such as pensions, interest, Social Security, etc. Once one has a solid understanding of baseline cash flows and their resulting tax impact, one can build a successful strategy for withdrawing money from other retirement accounts.

The next step is to create a hypothetical distribution map covering one’s expected expenses, tax liability, and cash flow/income over his/her lifetime. It will be based on an assumed return of the underlying assets. There will typically be consistent income (e.g. pensions, Social Security) and variable income (e.g. from investments). RMDs from 401ks and IRAs should be added when they are due. This analysis will also highlight the impact of delaying the taxation of tax-deferred or tax-exempt accounts. This is a particularly important step and will predict the adequacy of one’s assets to last at least their lifetime.

One side note. The retirement literature often explains a “short cut” approaches to developing a distribution strategy; i.e. the “4% rule” that claims one can withdraw 4% of assets annually and those assets should last 30 years. This simple approach, however, will not truly reflect reality which is that income and expenses may vary significantly from year to year and that the underlying assets may be invested differently depending on the investor. It is much more accurate to create a lifetime income/expense assumption.

As mentioned earlier, the “proportional” distribution approach will typically emerge as more effective than the “phased” approach because the retiree will have more tools with which to achieve tax efficiency and or generate higher returns. Some of the tactics that can be deployed include:

- Drawing on tax-deferred accounts to “fill up” a lower tax bracket, but just avoiding the higher tax bracket.
- Withdrawing investments with large capital gains when the corresponding capital gains rate is 0% (or 15%), avoiding the 20% capital gains rate if possible.
- In years when cash flow is not important, but the retiree can absorb more taxable income (to fill up a desirable tax bracket), consider converting some tax deferred accounts to Roth. This has two significant benefits
    - Roth accounts do not have RMD requirements which can potentially also save heirs from tax liabilities.
    - 401k and IRAs do not provide preferential capital gains treatment on appreciation. Converting to Roth accounts early, or establishing Roth accounts, removes this disadvantage.

- Have a liquid “safe” account invested in money markets or other cash funds that you can use tax efficiently for cash flow. This can be used to avoid having to sell securities with large capital gains, or alternatively to avoid having to sell securities at lower values during market drops.

- Donate RMDs to charities through tax-deferred accounts to avoid the taxes on those distributions.

About Social Security

The question of **when** to take Social Security is an important one and once made, cannot be reversed. One can take the benefit as early as age 62, but it makes sense to wait if cash flow at age 62 is sufficient and the retiree is relatively healthy (and expects a long life). For example, the difference between claiming your benefit at age 62 and 66 (the full retirement age for those born before 1960) is about 25%. Waiting until age 70 adds another 8% annually from age 66 to 70.

About RMDs

You can generally start taking withdrawals from an IRA, 401k or other qualified retirement plans as soon as you turn 59½ without incurring a 10% additional federal tax for early withdrawals. But waiting longer could mean a larger nest egg to draw upon. Those who turn 70½ in 2020 or later must take their first RMD the year they turn 72. They may defer that first distribution until Apr. 1 of the year after they turn 72, but will then have to take another distribution by Dec. 31 of that year — and pay income tax on both distributions.