Financial Success
For Your Business

Narrative – How to avoid outliving your money: the value of a retirement income analysis. (Presentation 10-01-18 to the Advanced Institute of Estate Planning Source.)

Presented by
Scott T. Wait, CPA, AEP

This article summarizes the educational presentation which focused on the How to avoid outliving your money: value of a retirement income analysis.

Scott was introduced to the audience by Geri McHam, President of The Estate Planning Source, the sponsor of the Advanced Institute.

The presentation began with Scott commenting to the audience, Retirement is complicated, much more so than two generations ago… my grandfather was a successful banker who moved from the mid-west and worked in the western U.S. for four different banks in his career. He retired with a full, classic pension based on his years of service and compensation, AND his wife and he received TAX FREE full post-retirement health benefits. Retirement was simple planning for grandpa and grandma. Today, retirement is a complicated planning process that includes lifestyle spending plans, retirement income and estate planning components. The spending plans include a wild card… how to afford rising healthcare benefits.

What are the top fears?

Scott shared a recent, 2017, Transamerica survey of workers from ages 18 to age 65 years. The survey included Baby Boomer, Generation X, and Millennial generation workers including owners of businesses. Over 4000 workers were surveyed and a follow-up survey of 1100 workers were completed to confirm results.

The top fears of the respondents were-
Running out of money, 51% surveyed.
Rising healthcare costs; 45% feared long-term care needs.
Forced retirement; 20% feared early retirement due to health or layoffs.
Social Security fears; 47% feared that benefits would cease or be cut in the future.

The presentation outline had the following topics:

1) **Summary of the income analysis.**
2) **Lifestyle spending goals.**
3) **Source of income.**
4) **Prepare the optimal plan.**
5) **Case Study – exercise.**

The Summary of the income analysis

The summary of the income analysis forecasts client lifestyle spending trends over periods of time and lifetime, client investment performance and account values, and future taxes paid over the client's lifetime.

- Lifestyle spending includes overall annual budget based on periods of time, spending on events such as one-time capital spending for home improvement, large capital expenses for RV purchases, travel costs, and healthcare costs.

- The analysis includes sources of income such as Social Security, pension, nontraditional income such as rental and royalty income.
- The analysis forecasts investment portfolio and related annual and lifetime tax liabilities based on presumptions and best practices to invest with paying the least amount of tax annually and over the client's lifetime.

Lifestyle Spending Goals.

Lifestyle spending goals should include goals that are based on periods of time and events that are forecast. Scott mentioned that having goals for 5, 10, and 15 years forward assist clients with more detail analysis of their lifestyle expectations to compare to their income sources. An audience participant also commented that spending should include "events".

Scott mentioned that one-time or short-term spending goals should be included such as family events including marriage costs for children, travel, large capital expenses such as purchase of RV to travel, home improvement goals, and the great unknown costs such as estimated out-of-pocket healthcare costs.

Healthcare costs as noted in the Transamerica survey are a great fear of families in our country. They also are difficult to predict. Scott mentioned that the best estimates for healthcare costs for 65 year olds projected to end of life are on average $250,000 to $450,000 over their lifetime. Scott also shared that his mother needed significant home health care for the last two years of her life which included Certified Nursing Assistants and skilled Nursing care which amounted to $90,000 per year and the costs incurred were in 2002. The costs for her would be significantly higher due to healthcare inflation since that time.

Non-portfolio income.

Social Security (SS) income is the common non-portfolio source of income for many clients and is complicated for planning purposes. The rules for claiming the benefit change on a regular basis, and depending on the client and his or her family, there are strategies to consider before claiming the benefits.

For planning purposes, the first step for clients is to make sure that their SS records are correct. Clients can request updates and corrections from SS. The official guidelines are that one can request changes back to three years. It is worth requesting corrections as far back as possible, because the impact on client's benefits are significant. SS takes the highest W-2 records in a 35 year period and computes what is known as the AIME, Average Indexed Monthly Earnings. The higher your AIME will provide you a better lifetime benefit than passing on the request. Scott has seen significant mistakes on client's SS records.

Secondly, have clients go to their SS records and review the SS's projected benefit presuming early SS, regular FRA (Full Retirement Age) SS benefits and SS benefits by waiting to the age of 70. There are many SS experts who advocate waiting to age 70 for many people. Based on Scott's experience, one should do a thorough analysis to confirm the best strategy for taking SS if clients do not need the benefit early or at FRA, (Full Retirement Age – people born after 1960, age is 67). A few analyses that Scott had completed surprisingly showed that it was best to either take SS early or at FRA.

There is a cost of capital component in analysis of SS benefits per year. The latest statistics show that by waiting, there is a benefit of 8% until the age of 70. The analysis needs to include all sources of income and lifestyle spending to best forecast the optimal strategy over the client's lifetime. The optimal plan shows the estimated lifetime spending budget, the total taxes paid, and the forecasted estate value at end of life.

Third part of SS analysis should include spousal benefits analysis such as ex-spouse widow(er) benefits and widow(er) benefits. In many situations, it is a woman's issue since at this time, women live longer than men. The statistics are changing. Let's consider a situation. Husband earned 200,000 per year on average over a 20 year period. During that time, his wife earned 70,000 per year. After ten years of marriage, they divorce. Wife does not remarry. Husband passes. His ex-wife, could be eligible to claim widow benefits under these circumstances to the equivalent of 50% of his SS benefits. This is one example to keep in mind with clients. This benefit is basically found money for spouses in situations like this one.

Other issues to keep in mind with SS are consider clients who have modest income needs to monitor the taxability of benefits for single or joint filers. For Single filers, attempt to monitor and prevent tax bracket creep per year and over their lifetime. Monitoring portfolio income against SS and other non-portfolio income will allow clients to minimize their annual and lifetime tax expense. By minimizing the tax expense over their lifetime, they have higher probability of avoiding outliving their money.

Pension Income strategy should include the nuances of these agreements before clients retire. For example, for NV PERS recipients, the beneficiary should adjust the pension forecast to include adjustment for inflation every 3rd year. Also for PERS beneficiaries, their post-retirement healthcare plan benefits as PPO plans. These plans should be included as tax free sources per year.

Culinary and Bartenders Union in Las Vegas also has significant retirement fringe benefits that include disability and death benefits in addition to retirement and post-retirement healthcare plans.

Annuity income sources should be analyzed in several ways. For clients still in accumulation phase of the contracts, consider analyzing whether they should do an IRC 1035 to a more economical plan so that the annuity account will grow faster than in a more expensive contract. There are many Variable Annuity contracts that charge over 3% per year to administer that hold a guaranteed life insurance rider. The rider may or may not be worth continuing the contract or exchanging to a more cost effective plan. Also, in some cases, a Variable Annuity may not be appropriate for the investor as compared to the time they first enrolled in the contract. For example, I have a client that 20 years ago bought a $300,000 single premium Variable Annuity contract that has grown to over $600,000. She bought the contract to give her peace of mind on her retirement plan. Now she has learned that she will receive an inheritance with the next 5 years that makes the “peace of mind” on the annuity to be less valuable. I have suggested that she begin taking the income portion of the annuity and hold on receiving any pension or social security benefits until the contract is drawn down to a minimal income portion of $25000 and then collapse the annuity and re-invest in a more tax friendly investment for estate planning purposes.

Nontraditional income sources such as pass through entities that invest in real estate, royalties, or privately held businesses. The new tax law as of 2018 include benefits for clients who have these investments. There is a new pass through deduction of 20% for partnerships and S Corporations. There are specific rules that the client would need to qualify. If they do qualify, a pass through entity that reports income to the owner of $100,000 can benefit with a $20,000 deduction to client’s individual tax return. If the client has a marginal tax rate of 25%, the deduction is the equivalent of reducing taxes $5,000 which is substantial.

Portfolio income.

With regard to a withdrawal strategy from your client’s portfolio there are a number of factors to consider, one of which is to determine allocation of investment to risks, expected ROI, and tax planning on an annual basis and for their lifetime forecast.

The conventional wisdom in financial media and widely written is to withdraw retirement funds as follows: Take first amounts from taxable brokerage accounts, then traditional tax deferred IRAs, then ROTH IRA accounts, and then unqualified annuity accounts.

This strategy does not hold true in all cases from our office's experience. There are times where it is best to reverse this strategy or to consider various ROTH Conversion strategies taken as a whole for the client's withdrawal strategy. When our office reviews the withdrawal strategy, we review the client's lifestyle spending over time and taken with event plans and in tranches of 5, 10, and 15 year periods, then we review their non-portfolio and portfolio sources in conjunction with the optimal taxation impact. All three factors, lifestyle, income source, and taxation factors must be analyzed and integrated to provide optimal strategies to consider in the top choices. We review over 40 scenarios including conventional and nonconventional withdrawal strategies including possible ROTH conversions. We then narrow the strategies to the top 3 to 5 options.

Many cases show that a ROTH conversion strategy preserves wealth and minimizes lifetime of taxes paid for the client. Tax efficiency is vital to avoid outliving the client's money. ROTH conversions can be put in place in a few years, once every 12 month, or over an extensive time if the client qualifies for the series of conversions that also minimize the annual tax liabilities they pay on conversion.

With all withdrawal strategies one of the main goals is to avoid income tax bracket creep annually and over the lifetime of the income analysis. With certain ROTH IRA conversions there is a large tax bill associated with the conversion and over the lifetime, the client benefits tremendously even with the one or two year tax spike. With other client strategies the ROTH conversion strategy can be spread out over quite a few years that both limits the tax bracket creep over the years of conversion and over the client's lifetime.

I have example where ROTH conversion was not a good idea. I have a client who is 79 years old, has a taxable account, and traditional IRA account. The tax laws require that to convert to the ROTH IRA, the taxpayer must comply with two critical rules, have the ROTH open for 5 years and after opening and 1st conversion and after the 5 year rule, only convert once per 12 month period. In her case, we could convert by opening and making a conversion, yet she would have to wait 5 years for the 2nd conversion. She will be 84 years old at that time. The tax impact on the conversion strategy was not practical for her.

As noted in the non-portfolio segment, annuities may or may not be appropriate for certain retirees. Also, Long-Term Care policies should be considered in the income analysis as tax free distributions when clients need to access health care services that are covered under their long term care policy. Including these benefits as tax free sources properly accounts for the client's withdrawal analysis during their lifetime. For legacy planning Life Insurance should be included at the end of life portion of the withdrawal strategy. This inclusion will provide clients with legacy goals to see how they estate plan forecasts their wealth at the end of their lives and also could be a back up plan in case they need end of life healthcare assets to pay for medical care.

The portfolio analysis also needs to include realistic market expectations and the client's portfolio ROI during their retirement years. As a starting point, there are many economic models that attempt to forecast market expectations. For example, one of the more reliable long term forecast models for equity investments is the Shiller CAPE 10 Ratio, Cyclically Adjusted Price to Earnings Ratio. It has been a valid predictor of long term equity values. This ratio predicts 4.0% ROI in the long term going forward. This concerning and underwhelming. Bonds are predicted to be about 2%, an even worse prediction. A typical 60/40 client portfolio forecast is 4.6% ROI based on these two predictions. Most clients need a better ROI than 4.6% in retirement.

What are the options with these forecasts?
One option is to increase your client's international exposure.
Consider deferred annuity payout contracts such as QLACs in retirement accounts to plan for longevity needs. Typical QLACs are triggered after the age of 80. The problem with QLACs are that in low interest rate times, the payout is small.
Consider clients buying quality Long-Term Care health policies to offset healthcare costs when they are elderly, over the age of 80.
Consider having clients review their lifestyle goals or working longer than the average retirement age of 65.

Prepare the optimal plan.

The analysis needs to keep the family considerations in mind. For example, a client of mine had three top strategies and selected a strategy to take Social Security benefits at full retirement age rather than early. Taking the SS early would have provided larger net worth to the family presuming a 22 year forecast, $10,000 at end of the period. They decided to wait for concerns other than financial considerations. Having three to five top strategies is usually the best outcome due to the fact that the analysis is a forecast with various variables in play.

Charitable goals can be considered and factored into the analysis so that the contributions are included at a certain or at end of life. There are strategic options to clients with charitable goals that benefit the client's tax efficiency and the charity they are benefiting.

It is important to maintain a tax efficient portfolio. As an example, consider minimizing the sale of investments in taxable accounts by having a thoughtful Investment Policy Statement that only requires sale of investments when re-balancing is needed. Also, if clients have required minimum distributions, consider having clients take the distribution early in the year to prevent or minimize selling investments in other accounts and created higher tax liability in the year.

For end of life planning, consider holding a traditional IRA for end of life costs. For example, if a client is in a full nursing care facility that costs $90,000 a year, consider having her take IRA distributions to offset the medical expenses. Though the offset is not a 100%, it does minimize the tax impact of those costs with regular income against an itemized deduction.

For family gifting goals, there are considerations on how and what kind of assets to give to family legacies. For example, it is best to give assets that can benefit from the double step-up at death of the first spouse and the second spouse. Taxable investment accounts and real estate are a few examples. Gifting an Inherited ROTH IRA is tax efficient and requires heirs to with draw required minimum distributions; Gifting at death a traditional IRA is the least tax efficient method- it creates a tax liability for client's heirs in the future.

Case study - exercise.

The case study included a single lady, Claudine with the following summary information:

- Social Security information: Client, Claudine, is 63 years old is qualified to take SS and has not taken SS yet. Her early SS amount taken now is $1500.
- Most recent monthly brokerage statement, 9/30/18, report $750,000 in fair market value with asset allocation of 60% equity, 20% short-term fixed income and 20% insured cash deposits. Dividend income reported is $11,000 per year.
- Pension information: none.
- Annuity information: none
- IRA information other than Annuity(s): Most recent monthly statement, 9-30-18 report $65,000 in fair market value with same asset allocation as above. IRA Distribution is $2900 per year.
    - Roth IRA monthly statement at 9/30/18 reports $5,000 in fair market value.
- Other asset information: none.
- Life Insurance: none.
- Long-Term Care Insurance: none.
- Spending/ Lifestyle Spending Goals: Current monthly goals,

vacation goals, and 5, 10,

and 15 year goals: $4300 per month.

- Legacy Goals: Percentage of assets designated to your heirs is to provide for Grandson.

The presentation and exercise concluded with final questions from the audience and an offer to meet with any members of the audience to discuss confidentially their specific questions and then adjourned.

Contact information:

Scott T. Wait, CPA, AEP
scott@rswait.com

RS Wait Chtd. (775)825-7337