

Drawdown planning after tax reform

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When nearing retirement, it is important to review the various retirement savings vehicles within one's portfolio to develop a tax efficient strategy to secure cash flow. Numerous issues arise as part of this process; however, drawdown strategies generally begin with two primary questions to address:

1. Determining the optimal withdrawal rate of a specific account, and
2. Determining the optimal order for accessing various types of assets.

Optimal Withdrawal Rate

The following general withdrawal methods are commonplace.

CONSTANT DOLLAR AMOUNT. The first method to gain popularity was simply to have retirees withdraw a

fixed amount each year, based on the starting balance, with inflation adjustments. For example, suppose that an individual retires at age 70 with a \$1,000,000 retirement portfolio. She withdraws \$50,000 in the first year. If inflation is 2%, the withdrawal amount for the second year is \$51,000 ($1.02 \times \$50,000$).

The weakness of this strategy is that withdrawals are unrelated to portfolio returns. Poor returns in the early years could cause the portfolio to run out of money prematurely (i.e., portfolio failure).

CONSTANT PERCENTAGE. One could avoid the problems of withdrawing a constant dollar amount by withdrawing a fixed percentage instead. Under the constant percentage method, suppose that in the previous example the value of

the portfolio decreased to \$900,000 at the beginning of year 2. Instead of withdrawing a fixed \$50,000, the retiree might withdraw a fixed 5% each year, or \$45,000. If the value of the portfolio increased to \$1,100,000 at the beginning of the second year, the retiree would withdraw \$55,000.

CONSTANT PROBABILITY OF FAILURE.

Under this strategy, the retiree would withdraw enough to maintain a fixed probability that funds would run out over the expected or fixed retirement period. For example, a retiree might wish to limit the probability of failure (running out of money) to 10%. Each year, the retiree could withdraw the maximum amount that would limit the probability of failure to 10% or less. The higher the probability of failure the retiree was willing to accept, the larger withdrawals could be.

The weakness of this strategy is that it doesn't adjust for changing mortality expectations. For example, based on Table 2000CM (the actuarial data used by the IRS to determine present value for annuities), the life expectancy for a 65-year-old is 17.7 years, making the age at life expectancy 82.2 years.

For a 75-year-old, the life expectancy is 11.1 years, making the age at life expectancy 86.1 years, and for an 85-year-old, the life expectancy is 6.2 years, making the average age at life expectancy 91.2 years.

The effect of these changing mortality expectations is that withdrawal percentages increase as a retiree grows older, while life expectancy continues to increase.

Which method is best?

1

Research by Morningstar¹ suggests that the mortality updating failure percentage method is the most efficient strategy regardless of a portfolio's equity allocation.

2

The constant failure method was second best except in portfolios with no allocation to equity.

3

The RMD method was generally third best.

4

The endowment percentage method was generally fourth.

5

The constant dollar method was the least efficient except in portfolios with no equity allocation.

¹ Blanchett, D., Kowara, M., Chen, P., Optimal Withdrawal Strategy for Retirement Income Portfolios.

REQUIRED MINIMUM DISTRIBUTIONS

(RMDs). Under the RMD method, the retiree withdraws an amount each year equal to a fraction relative to the retiree's remaining life expectancy, taking into account changes in mortality expectations. This is the same method used to calculate RMDs for IRAs and qualified plans. For example, if a retiree has a \$1,000,000 portfolio and a 30-year life expectancy, the withdrawal amount would be \$1,000,000/30, or \$33,333 for the first year. If the value of the portfolio is \$900,000 at the beginning of the second year and the retiree now has a 29.2-year life expectancy, the second-year withdrawal would be \$900,000/29.2, or \$30,822. Note that this method adjusts for changing mortality over time.

MORTALITY UPDATING FAILURE

PERCENTAGE. This method involves withdrawing each year the amount necessary to maintain a constant probability of running out of money over the estimated survival period, adjusting for changes in investment performance and changes in mortality over time. Thus, it combines the advantages of the constant probability of failure method with the advantages of the RMD method. The annual withdrawal is first based on the number of years remaining, then calculated based on maintaining a constant probability of failure for that period.

Optimal Order for Accessing Different Classes of Assets

Investors typically have investments spread among:

- Taxable accounts,
- Tax-deferred accounts like traditional IRAs and 401(k) plans, and
- Tax-free accounts like Roth IRAs

or Roth accounts in qualified plans.

Due to the unique tax characteristics of each type of account, the order in which such accounts are accessed can be as important as the method of calculating withdrawal rates in determining how long retirement assets will last. Following are some general rules on how to order withdrawals.

TAXPAYERS WHO ARE RETIRED BUT UNDER AGE 70½.

The generally accepted rule of thumb is that individuals under age 70½ should withdraw money first from their taxable accounts, for two primary reasons:

First, taxable assets grow at a lower after-tax rate than assets inside an IRA or qualified plan. Therefore, higher future values of tax-deferred or tax-free accounts are preserved.

Second, withdrawals from a taxable account are generally taxed at a lower rate than tax-deferred assets. To access the value of taxable accounts, taxpayers typically sell the assets held in the accounts. Although a sale of these assets could result in short-term gains taxed at ordinary income rates, taxpayers will generally sell assets taxed at relatively lower long-term capital gains rates (capped currently at a federal maximum of 23.8%). Distributions from a traditional IRA, conversely, are taxed at rates up to 40.8% (federal).

Income Smoothing Strategy. Utilizing the rule of thumb approach may not be the best strategy, though, because it could increase the value of RMDs the taxpayer would be required to take later, pushing him into higher tax brackets. A better strategy in many cases might be to create a long-term plan that smooths income and keeps it out of the higher tax brackets.

Such an approach tends to be most favorable when a taxpayer has large

tax-deferred account balances relative to the overall portfolio. If account balances are small in relation, higher required RMDs tend to have less effect on tax rates.

There also may be an estate planning advantage to drawing down a traditional IRA and passing taxable assets on to heirs. If the taxable assets are highly appreciated, taxpayers can avoid recognizing the gain by transferring these assets to the heirs at death and giving them a basis step-up under Internal Revenue Code §1014(a).

Tax-deferred accounts vs. tax-free accounts. It is generally better to draw down tax-deferred accounts before tax-free Roth accounts.

If assets are left in a tax-deferred account such as a traditional IRA when a taxpayer dies, distributions to heirs after the taxpayer's death will be subject to tax.

By contrast, distributions from a Roth IRA will provide tax-free income. Roth-type accounts also provide an estate planning advantage. If the IRA owner doesn't need the money from the IRA, the Roth IRA is better for accumulating money to pass on to heirs at death because there are no RMDs for the Roth owner, and amounts can continue to grow at their pre-tax rate of return throughout retirement.

TAXPAYER HAS REACHED AGE 70½.

If the taxpayer has reached age 70½,

RMDs must be taken from IRAs and certain qualified plans. If the taxpayer needs additional income, the analysis outlined above would be applied to any additional amounts withdrawn.

If taxpayers are married and need to take more than the required distribution for living expenses, it may be better to take the excess amount from the account of the older spouse to maximize the years of tax deferral. Note that the optimal drawdown strategy always depends on a careful review of the taxpayer's specific situation.

It is best to review one's situation with one's financial advisor to design a strategy that fits one's goals and asset allocation.



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is a partner with Keebler & Associates, LLP, and a recipient of the prestigious Accredited Estate Planners (Distinguished) award from the National Association of Estate Planners & Councils. He frequently represents clients before the IRS in the private letter ruling process and in estate, gift and income tax examinations and appeals, and has received more than 250 favorable private letter rulings including several key rulings of "first impression." Keebler has been speaking at national estate planning and tax seminars for over 20 years and is a frequent presenter for New York Life's advisor webinars and company training conferences.

Watch Bob's interview with The Nautilus Group®'s Chief Counsel, Matt Pate, JD, LL.M., on the New York Life YouTube channel.

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