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Get a handle on your retirement

Every day, roughly 10,000 Americans must decide whether they have achieved sufficient financial independence, enough to be able to leave the paid workforce. The questions of retirement preparation are easier to ask than to answer. They should not be taken for granted.

The website retirementincome-journal.com in October published "The Five Most Important Retirement Decisions," based upon a study done by the Stanford Center on Longevity. Here are their questions, and our thoughts on the answers.

When and how to retire?

It is a truism that the longer one works, the larger one's capital will be. The more one delays drawing upon retirement capital, the longer it will last.

Some hard numbers will put some perspective on that truism.

In the study, a hypothetical 62-year-old couple was assumed to have combined income of $100,000 and retirement savings of $350,000. A variety of retirement scenarios were considered. At the extremes, if both of them retired at age 62, they could expect an annual retirement income of $37,585. If they both worked full time until age 70, their annual income would then be $70,755. Options for retiring at age 66 or continuing part-time work instead of full time gave intermediate results.

In this example, the couple was assumed to consume their retirement capital very slowly, at the rates provided by the IRS for required minimum distributions from qualified retirement plans, using conservative investment assumptions. This approach makes it more likely that the couple will not outlive their resources.

Checklist of five key retirement decisions

- ☐ When and how to retire
- ☐ When to start Social Security benefits
- ☐ How to invade retirement savings to generate income
- ☐ How to adjust the retirement budget to fit within resources
- ☐ Whether to deploy home equity

Source: https://retirementincomejournal.com/, October 10, 2020

. . . a comprehensive budget for retirement expenses can be a vital first step to matching income with outgo.

Retirement . . . continued

When to start Social Security benefits?

To a substantial extent, the higher income achieved by the couple in this example came from their delay in starting their Social Security benefits. Early reduced benefits may begin at age 62, and an 8% benefit bonus is added for each year of delay beyond normal retirement age. For this couple, the normal retirement age was 66. No bonus accrues after age 70.

Social Security benefits are immune from market fluctuation, and they are automatically inflation-adjusted in future years. In fact, because the benefits are so valuable, some retirees build a savings bridge to temporarily cover living expenses in early retirement so as to maximize their Social Security benefits later.

How to deploy retirement savings to generate income?

In general, investing in equities during retirement provides more retirement income, but not without accompanying market risk. Investing only in equities at the start of a bear market, for example, runs the risk of exhausting the retirement capital.

The study included an example from the problematic period of 2000-2002 following the bursting of the Internet bubble, using the IRS table for required minimum distributions. In the first year, a 100% equity investment strategy provided $97,418 of retirement income, but that fell to $59,221 after just four years as the stock market contracted. A 100% bond investment offered growing retirement income, but starting from a much lower base—$28,712 in year one and $38,280 in year four.

The middle ground of 50% stocks and 50% bonds provided the steadiest income, going from $54,599 in year one to $50,446 in year four.

However, it should be noted that, during the time frame for this example, interest rates were not at the rock-bottom levels that we see today. Also, the economic uncertainty of the early 2000s, made severe by the 9/11 attack on the World Trade Center, was still perhaps not as imponderable as the unknowns associated with the COVID-19 pandemic.

We have just been through the shortest bear market in history, and 2020 may yet prove to be an up market for many stocks. But this much market volatility can disrupt a retiree's peace of mind.

How to adjust the retirement budget to fit within one's resources?

On the one hand, it is generally thought that as the costs of commuting and clothing are decreased during retirement, less income is needed to sustain the same standard of living as during the work years. Accordingly, some suggest that a 70% replacement ratio is a reasonable target for retirement income.

On the other hand, retirement may be a time for more travel, for expensive interests long deferred. Medical costs typically go up during retirement, though Medicare helps to ease that somewhat. Living costs may not go down so much after all.

That's why a comprehensive budget for retirement expenses can be a vital first step to matching income with outgo.

Whether to invade home equity?

Some of those who are about to retire have their home equity as their largest capital asset apart from employer retirement plans. That equity may be tapped by selling the home and moving to smaller quarters in a less-expensive environment.

Example. A married couple purchased a home years ago for $300,000, and it is now worth $800,000. If they sell it for that price, realizing a $500,000 long-term capital gain, they will owe no capital gain tax on the transaction. They can move to a retirement community or condo with a portion of the proceeds, and the balance may be added to their retirement capital.

The limits on tax freedom for home sales are $250,000 for singles, $500,000 for married couples. Some restrictions apply, so sellers should consult with tax professionals before making any final decisions.

Can we be of assistance in your retirement planning?

The moment chosen for retirement is an intensely personal decision, and there is no right or wrong answer. Even common-sense rules of thumb have so many exceptions that they serve as not much more than the beginning of a conversation.

If you would appreciate an independent point of view about your retirement readiness or how best to deploy your retirement capital, please give us a call. We will be pleased to put our experience at your service. ☐

Year-end retirement plan notes

There are a few new wrinkles in managing tax-favored retirement accounts this year.

Coronavirus-Related Distributions. The CARES Act loosened restrictions on penalty-free access to retirement plans this year. Those who were affected directly by COVID-19, either because they or a spouse became infected or they suffered financially from the quarantines and lockdowns, are permitted to withdraw up to $100,000 from an IRA or 401(k) plan.

Such a distribution will be subject to income tax, but there will be no 10% penalty tax for premature distributions if the account owner is younger than 59½. The income tax may be paid in full for the 2020 tax year (this could be the best choice if the taxpayer has fallen into a low tax bracket). Alternatively the distribution may be treated and taxed as if it were received 1/3 in 2020, 1/3 in 2021, and 1/3 in 2022. Deferring the tax bill is tempting, but one may be in a higher tax bracket in two years. Also, the state income tax treatment of the distribution may not match the federal rules.

Alternatively, the taxpayer may elect to repay the Coronavirus-Related Distribution over three years. Such repayments will be treated as if they were trustee-to-trustee transfers. What's more, the repayments will not affect the taxpayer's right to make future normal retirement plan contributions. If the first 1/3 of income tax is paid for the 2020 tax year and the distribution is later repaid, the taxpayer may file for a refund.

How many people have taken advantage of these distributions? The Wall Street Journal surveyed major 401(k) record keepers to ask what their experience has been to date. They reported that roughly 4% of plan participants have taken Coronavirus-Related Distributions, and about 1% have asked for hardship withdrawals, much lower rates than were expected at the time of the enabling legislation.

Direct charitable gifts from an IRA. Minimum retirement plan distributions are suspended this year under the CARES Act, and the age for beginning required minimum distributions (RMDs) has been lifted to 72. The "charitable IRA rollover" is still available to those who have reached age 70½. Up to $100,000 may be transferred directly by the IRA custodian to the charity. In ordinary years some affluent taxpayers have used the charitable IRA rollover to satisfy their RMDs. Such transfers are not included in income.

The philanthropically minded may want to consider a direct charitable gift from an IRA even in the absence of the RMD command.

- *Nonitemizers.* Retirees typically have lower incomes and are more likely to rely on the standard deduction. The exclusion from income of the transfer from the IRA to a charity comes in addition to the standard deduction.
- *Big donors.* The percentage limits on the charitable deduction for cash gifts has been lifted to 100% of adjusted gross income this year. The exclusion of up to $100,000 for the charitable transfer from an IRA comes on top of that.
- *Social Security recipients.* An IRA distribution could be made to the account owner, who then could take a deduction for a charitable gift of that amount. However, that approach would increase adjusted gross income, which may in turn cause an increase in the tax on Social Security benefits for some taxpayers. The direct gift from an IRA avoids this problem.

Unchanged limits. The IRS has announced that for tax year 2021, the limit for IRA contributions will be unchanged; that is, $6,000 plus a $1,000 "catch-up" contribution for those 50 and older. The limit on elective deferrals in a 401(k) plan continues at $19,500, with a catch-up of $6,500 for those 50 and older. ☐

Shifting tax burdens

It is a common charge in some quarters that the Tax Cuts and Jobs Act of 2017 was a "giveaway to the rich." Steve Forbes begs to differ, and he has the numbers to prove it.

According to Mr. Forbes, the top 1% of taxpayers paid $16 billion more in income taxes in 2018 than they did in 2017, while the bottom 99% paid $80 billion less. More significant is the share of total income taxes paid, which for the top 1% went from 37% in 2017 to 40% in 2018. Some tax cut! Mr. Forbes attributes the shift to the curtailment of itemized deductions for top earners coupled with the doubling of the standard deduction for the majority of taxpayers.

However, in fairness one ought to look at more than just the income tax. Because the economy boomed and unemployment fell to record low levels, the collection of Social Security taxes paid by the 99% also rose substantially.

Tax rates in retirement

Conventional wisdom has been that retirees will face lower federal taxes than they did when they were working, and so making maximum contributions to tax-preferred accounts is the way to go. However, the conventional wisdom may not prove correct for all taxpayers.

Additional Medicare premiums. Higher-income retirees must pay higher Medicare premiums, including for Medicare Part D drug coverage. This can amount to a five-percentage-point increase in one's marginal income-tax rate.

Required Minimum Distributions. Those who have income greater than $250,000 are subject to a 3.8% additional tax on investment earnings. A retired couple with pension and investment income of $250,000 does not have to pay that tax. But at age 72 they must begin taking minimum distributions from their retirement accounts, and that added income could push them into taxable territory.

Scheduled federal tax changes. The personal income tax elements of the TCJA mentioned by Steve Forbes have an expiration date of 2025. Beginning in 2026, itemized deductions come back, and the standard deduction will be cut roughly in half. Per Mr. Forbes' analysis, that will be a significant tax increase for most taxpayers, though it will be a tax cut for the top 1%.

State income taxes. Many states are in severe financial distress, and for some the distress started long before the COVID-19 pandemic. An increase in state income taxes looks very likely as an avenue for helping to bring budgets back into balance.

The fact that taxes may be higher than anticipated in retirement means everyone should be saving even more in order to be fully prepared. That fact also suggests that a meaningful portion of retirement savings might belong in taxable accounts for greater tax-planning flexibility. ☐