Retirement Plans

Caring for your portfolio during retirement is a higher maintenance activity than before retirement, and it requires a commonsense approach.

FAQs on Distributing and Investing Assets During Your Retirement Years

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FAQs—frequently asked questions—are popular on the Internet for dealing with common issues facing many individuals. The complexities of investing retirement plan assets can be some of the most daunting financial issues retirees have to face. In this article, we provide answers to some of the most frequently asked questions regarding investment strategies and income tax issues.

I've heard my IRA assets could be subject to a tax rate of more than 90% upon my death. Is this true? If so, shouldn't I take advantage of the temporary moratorium on the excess accumulations tax and take my money out right away?

When you consider the combined effects of federal and state income taxes, federal estate taxes, and the 15% excess accumulations tax penalty, some estates can end up paying nearly 90% in total taxes. This can happen when the taxable estate exceeds $3 million (55% tax bracket) and income is taxed at the top 39.6% tax rate.

Proper estate planning using proven wealth transfer strategies can save significant—and in some cases, huge—dollars for heirs, once your estate exceeds $600,000 (or up to $1.2 million if you and your spouse can split your combined estate into two separate pieces using trusts). However, wealth transfer strategies only make sense if you can afford to give up assets you may need for retirement.

If you plan to use these assets to fund your retirement, there may be little benefit to taking distributions early, even if it eventually turns out that your remaining IRA assets are subject to the full 90% combined rate.

Why is that?

First of all, unless you and your spouse expect to die in the next few years, the cost of paying income tax early and losing the benefit of tax deferral significantly offsets the "benefit" of avoiding the tax. The higher your tax bracket, the more true this becomes. If you are in the 15% income tax bracket there may be some payoff to your heirs to early distributions taxed at this rate, but let's face it, if that's your income tax bracket the excess accumulations tax is not likely a big problem for you. If you are terminally ill without a healthy surviving spouse, it may well pay to accelerate distributions; but this is in the realm of rather unique "contemplation of death" planning and not the norm.

It has been the experience of many planners, including ourselves, that in the majority of cases, the "cost" incurred in taking early distributions (acceleration of tax and lost deferral benefits) is not justified by the benefit of the avoided penalty in the future. This is similar to decisions concerning early withdrawals (before age 59½), which incur a 10% penalty—many articles have pointed out that the benefits of long holding periods in a tax-deferred environment and particularly at high rates of return eventually overcome the penalty. Table 1 indicates the number of years to "breakeven" that you would need to hold money in a tax-deferred account to overcome a 15% penalty at various rates of return and tax brackets, assuming a constant tax rate over the period. For example, if you are in the 28% tax bracket and you are earning a 10% rate of return, the benefits of tax deferral outweigh the penalty after about eight years. In reality, investors are likely to be in different tax brackets at the beginning and ending periods, particularly with constantly changing tax laws, and it is difficult to know in advance what your return is likely to be; however, the table provides a rough guide and illustrates the different results at different tax brackets and rates of return.

The second reason it may not pay to take distributions early (unless you can give the assets away and avoid the estate tax altogether) is because either way both income and estate taxes get paid. If you leave the money in your IRA it is subject to estate tax first, then income tax once distributed. Alternatively, if you take early distributions and pay income tax, *then* estate tax, the

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result is essentially the same.

Let's look at an example:

Barney has accumulated $1.5 million in his IRA as a result of 35 years of dedicated service on the force. He dies this year leaving everything to his wife, Thelma Lou. Fortunately, she wisely rolls over the proceeds into a new IRA (she has no other substantial IRA assets; if she did, this strategy could backfire, as you will see in a later example). Thus, at Barney's death, there is no income tax, estate tax, or excess accumulations tax on the IRA assets.

But let's assume that Thelma Lou forgets to name the kids or grandkids as beneficiaries (big mistake) and, as luck would have it, she dies not long after Barney. And let's further assume that the couple had accumulated over $3 million in non-IRA assets; that will subject the IRA assets to an estate tax rate of 55%. Given Thelma Lou's age at death and other factors, it is determined that $500,000 of the IRA is subject to excess accumulations tax (see the Retirement Plans column "Understanding the 15% Excess Distributions and Accumulations Penalties," in the June 1995 *AAII Journal* for specifics on how this is calculated). Total taxes on the $500,000 would be computed as follows:

Gross amount		$500,000
Excess accumulations tax (15%)	$75,000	
Estate tax (55% on $425,000)	233,750	
Income tax paid by heirs on IRA distribution (39.6% of $266,250)	105,435	
Total taxes (83% of Total)		$414,185

Note that, although the excess accumulations penalty tax is excluded in determining the estate tax, it is included as income in determining the income tax on the IRA distribution. Thus, the IRA distribution is considered to be $500,000 less estate taxes of $233,750, for a total distribution of $266,250.

Clearly, if they know they are going to die soon, early distribution of the $500,000 (assuming they could do so without triggering the excess distributions tax) would save Barney and Thelma Lou's heirs $33,750. This is the $75,000 excess accumulations tax that they would save, less the $41,250 extra estate taxes they would owe (55% of $75,000).

Table 1.
Overcoming the 15% Excess Accumulations Penalty

The number of years of tax-deferred growth necessary for the benefits of deferral to outweigh the penalty:

Tax Bracket	Average Annual Return: 6%	7%	8%	9%	10%	11%	12%
15%	22	18	16	14	13	12	11
28%	14	12	10	9	8	8	7
31%	13	11	10	9	8	7	7
36%	12	11	9	8	7	7	6
39.6%	12	10	9	8	7	7	6

Source: Adapted from "IRAs and the Breakeven Holding Period," by Donald Smith, AAII Journal, *March 1984.*

But, won't the estate tax be less because the income taxes paid would be excluded from the estate tax calculation?

Yes, but as you can see in our example, we are able to exclude the estate tax from the income tax calculation! There is a direct offset in benefit lost to benefit gained.

Let's take our example even further and look at the $1 million in the IRA that is not subject to the 15% excess accumulations penalty, and see how total taxes might differ under the two different scenarios.

At Thelma Lou's death, the $1 million in the IRA is subject to estate taxes of $550,000 (55% of $1 million). When the $1 million IRA is distributed (either to pay the estate tax or to be distributed to heirs), it is subject to income tax. However, an income tax deduction of $550,000 is allowed and therefore, the income tax payable is $178,200 (39.6% × $450,000, assuming the top income tax bracket of 39.6% is applicable). Total estate and income taxes equal $728,200. What if Barney had decided to take all the money out before he died? He would have paid $396,000 in income taxes and upon his death $332,200 in estate taxes (55% of the remaining assets, which would be $1 million less $396,000) for a total of $728,200! No, it's not a coincidence. The amounts are always the same when the same tax rates apply.

Okay, what if the grandkids were named as beneficiaries by Thelma Lou and they began to take the money out of the IRA over the next 50-some-odd years of their life expectancies, rather than distributing everything immediately?

If we assume the grandkids put the $1 million IRA in a non-interest bearing checking account so it didn't grow (obviously not recommended) and took out the required minimum distributions each year and they were taxed at a 15% tax rate, for example, now what would the tax be? Well, each distribution would be entitled to a pro-rata deduction for estate taxes paid, so the total income tax paid would be 15% × $450,000, or $67,500 for total estate and income taxes of $617,500—a lot less than the total paid by Thelma Lou and Barney if they had distributed the IRA assets before death. If, in addition, the *grandkids* invested the million dollars, they would further leverage the benefit of the IRA's income tax deferral for decades! (See the Retirement Plans column "The Rules for Required Minimum Distributions and Beneficiary Designations" in the April 1996 *AAII Journal* for more on naming beneficiaries.)

Okay, I see how the income and estate taxes are calculated, but go back and explain why things might backfire if Thelma Lou already has significant IRA assets before she receives Barney's IRA.

Electing to avoid the 15% excess accumulations tax at Barney's death means she must rollover the assets into her IRA; when Thelma Lou dies, her IRA assets will be a combination of the two IRAs. If she has no significant other IRA assets, this strategy allows for deferral of the excess accumulations penalty to the future when Thelma Lou dies, or better yet, elimination of the penalty as Thelma Lou spends down the asset balance. This strategy has virtually no downside if Thelma Lou has no other IRA assets (unless she is older than Barney and dies before any reductions in the balance can take place).

However, if Thelma Lou also has significant IRA assets prior to receiving Barney's IRA, at her death the combination of the two balances can cause additional penalty taxes to be assessed. Let's look at another example:

Thelma Lou has $1 million and Barney has $1.5 million in IRA assets. They are the same age and therefore, for purposes of calculating the 15% excess accumulations tax, both have an *assumed* threshold amount of about $1 million (in other words, based on their ages and other factors, it is estimated that IRA amounts above $1 million will trigger the excess accumulations tax).

Barney's excise tax:	
Total IRA	$1,500,000
Assumed threshold	1,000,000
Amount subject to penalty	$500,000
Excise tax rate	× 15%
Total penalty at Barney's death	$75,000
Thelma Lou's excise tax:	
IRA balance in excess of threshold	$0
Total penalties if treated separately ***(i.e., no IRA rollover upon Barney's death)***	$75,000

If Thelma Lou makes the election to avoid the penalty tax at Barney's death, rolls over his IRA, and then dies before distributions can be made, here's what happens:

Thelma Lou's excise tax	
Total IRA	$2,500,000
Assumed threshold	1,000,000
Amount subject to penalty	1,500,000
Excise tax rate	× 15%
Total penalty at Thelma Lou's death	$225,000

All right, I think I see how this works. Does your advice change given that the 15% excess distributions tax is waived from now until January 1, 2000?

No, not at all. This "tax holiday" was established to encourage people to accelerate large distributions—and remember, it only helps those with distributions in excess of the threshold—and pay income tax now rather than later. This can be beneficial for folks who are in contemplation of death and need to avoid a fairly certain excess accumulations tax in the estate. Otherwise, all the earlier cautions of accelerating taxes still apply.

In any event, if you decide acceleration does make sense for you, you may want to wait until near the end of the three-year "holiday" period to take distributions. This will ensure at least several more years of tax-deferred growth.

Here's a summary of the issues concerning the excess accumulations penalty:

- This isn't an issue unless you have *a lot* of money in your IRA. As a possible benchmark, figure more than $1million is "a lot."
- If you want to give assets away, and if you only have IRA assets to do it with, definitely accelerate taxable distributions, pay the income tax and avoid the estate tax, regardless of whether or not the excise tax applies.
- With few exceptions, don't take distributions just to avoid the excise tax unless you are very old or very ill and do not have a healthy spouse who can roll your IRA over into his/her own.
- Combined federal and state taxes can begin to exceed 90% if penalties and estate taxes apply. The problem is, just taking early distributions won't necessarily give you a better answer.

I believe in maintaining a diversified portfolio into retirement and have read conflicting advice on what to put in my IRA and what to keep outside my IRA. Is there truly a "rule of thumb" to help me decide?

A broadly diversified portfolio is a must if you are going to get through a 20- to 30-year retirement in good financial shape. Very few retirees are fortunate enough to be able to make it on bonds alone. So you'll have some cash, some bonds, some stocks and, if you're hard-core on diversification, you may have some "hard" assets as well (diversified real estate, precious metals, natural resources, commodities, etc.).

If all you have are IRA assets, the answer is easy—all the different kinds of assets go into the IRA. If, however, you have investments inside and outside of IRAs, the question becomes "what goes where." Unfortunately, there is only one "rule of thumb" when it comes to investment planning and that is "everybody's thumb is different."

Recent articles suggest that the rule of thumb is that you should put higher-returning assets such as stocks in your IRA and lower-return investments in taxable accounts. And it does make sense that, if you know in advance which of your investments will give you the highest rate of return, and the tax advantages of holding that investment outside the IRA are not significant, those investments belong in the IRA.

However, "rules of thumb" are often based on averages, as well as generalizations that ignore individual circumstances. In this instance, the rules of thumb are based on studies covering the last 20 years, an unprecedented time when stocks as a whole have relentlessly headed skyward.

But individual stock investments (including individual stock mutual funds) do go down in value as well as up. You may be unlucky enough to own a stock or stock fund that loses money and/or languishes. If your returns are not reflected in the averages, your dividends are different, your turnover is not average, and/or you don't believe the next 20 years will mirror the last 20, you may want to give more thought to the stock vs. bond decision.

The truth is, stock investing in the short run is risky, and given a one-year time horizon, the stock market should be avoided by a prudent investor. Yet this is the time horizon used for determining taxable gains and losses. If you lose money over the year in an IRA investment, you get no current year tax benefit. Lose the same amount in a taxable account and you may be able to get Uncle Sam to cover up to 39.6% of your losses in the current year.

Like anything else, when it comes to your financial and investment planning, don't follow rules of thumb blindly.

So what should you do?

- Understand all the various elements of the investment you are making—tax attributes, holding period, risk of loss, potential for return, your current regular and capital gains tax rates, your likely future tax rates (the rates the distributions will likely be taxed at). If you are older and in poor health, consider that appreciated stock investments outside the IRA will get a tax-free step-up in basis at death. This is not true with IRA assets.
- Decide which of your assets make more sense to shelter from tax given expected holding period, risk and tax attributes.
- Realize that every investment decision has some element of risk to it because the future is uncertain. Don't try to shortcut the thought process by trying to oversimplify.

Are there some investments I really should avoid putting into my IRA?

Absolutely. Municipal bonds (the income from which is exempt when earned outside the IRA, but fully taxable if distributed from an IRA), tax-deferred annuities (the insurance companies charge a hefty fee for tax deferral, which you already have in an IRA and shouldn't pay for) and certain limited partnerships and S Corporation interests which kick off business income (excludes rents, dividends, interest, etc.)

In addition, keep this list of reminders handy:

- Don't buy IRA assets with borrowed money; i.e., don't use a margin account to purchase stocks in your IRA.
- Don't put collectibles in the account—any purchase of collectibles in an IRA is considered a fully taxable distribution.
- Avoid "prohibited transactions," which includes the sale or leasing of any IRA property to yourself, family, trustees, or custodians of the account, as well as other "self-dealing" type activities.
- Avoid international investments that generate foreign tax credits, since the benefit of these credits are far greater outside the IRA than inside.

I need income from my investments to supplement my Social Security. I have IRA and non-IRA investments and would rather not touch my principal. How would you suggest I structure my portfolio?

One of the more challenging issues for an investor to deal with is this question. Many older Americans believe very strongly that it is bad strategy to spend principal if it can be avoided. But, when supplemental cash flow is required to make ends meet, how can you go about maintaining a well-diversified long-term portfolio when substantial cash needs to be paid out from interest and dividends? Seemingly good solutions in the short run may be disastrous in the long run.

One way is to forfeit your kids' inheritance and buy an insurance company annuity. As long as you live you will have an income stream from the insurance company. But this isn't diversified—you are dependent on one or two insurance companies—and you are not protected against inflation over the many years of your retirement.

A similar problem exists with an all-income portfolio. Some retirees put everything into income-generating securities such as bonds. While that may generate enough income today, the fixed-income stream can rapidly become inadequate since there is no growth in value. In addition, by only taking the income from both the taxable and IRA accounts, and leaving the principal outside the IRA intact, you are accelerating income tax unnecessarily.

The truth is, a dollar is a dollar, except for the taxes attributable to each. Typically, an interest dollar only differs from a principal dollar in that taxes are paid on one and not on the other. However, all dollars from an IRA are treated the same—as fully taxable income.

A portfolio whose major purpose is to generate income may not reflect the long-term need for growth most young retirees require. Risk and return factors should drive the asset allocation decision, not the desire to spend an income dollar versus a principal dollar.

Can you suggest an approach?

Since most allocation strategists agree that a five-year time horizon is a minimum requirement for stock investing, step one is to identify your cash requirements for the next five years. Set this aside in a safe portfolio of treasuries, CDs, money markets and/or municipal bonds if you are in the top marginal income tax brackets. Ladder the maturity dates to pay off at the appropriate times over this time period.

Approach the remainder of your assets as a mid- to long-term portfolio and allocate it accordingly between stocks, bonds, cash, and possibly hard assets. This allocation will tend to be less aggressive than if you were not retired, but should likely contain some allocation to growth-oriented stocks.

Each year you will need to address whether a reallocation from the long-term portfolio to the "income" portfolio is warranted. You may decide to pass in a year where your stock and bond values have been battered, waiting for a more opportune time to sell—you have given yourself a five-year cushion to do this.

When you do decide to transfer from long-term to short-term, you need to rebalance your long-term portfolio. Rebalancing is critical to maintaining the risk structure and growth potential of your investments.

To the extent possible, your long-term portfolio should be maintained inside your IRA or other tax-deferred plan. In other words, spend the non-sheltered assets first—all of them. Spend principal as well as interest from taxable accounts, to allow the maximum income tax advantages in the tax-deferred accounts. Your interest and dividends in the long-term portfolio will avoid the negative influence of Uncle Sam, at least for the time being. These are reinvested to replace the principal you are spending.

Balance this advice with your current income tax situation. Don't defer distributions from a 15% tax rate this year to a 28% tax rate next year. This can happen if you end up distributing a level of "income" next year that forces you into a higher marginal tax rate.

One way to create liquidity in the long-term portfolio is to direct interest and dividend payments to a money market fund over the course of the year. To the extent this does not meet the distribution needs, skim off amounts from the successful asset class as you rebalance back to your original allocation (buy low, sell high).

It should be clear by now that caring for your portfolio in retirement can become a higher maintenance activity than before retirement, if you need these assets to supplement pension and Social Security income. Balance cash flow requirements with the need for growth and an eye to minimizing the tax bite. Apply some common sense and adopt a strategy that works for you. Avoid risks you don't need to take, but remember that inflation can be an insidious cancer on your portfolio if you don't take steps to protect yourself from it.