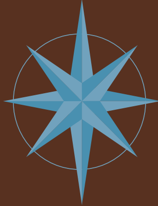

VESTPOINTEWEALTH MANAGEMENT

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5 Withdrawal Strategies For Retirement Savings

For most people, it's not enough to scrimp and save for the golden years. Once you've entered retirement, you have to figure out how to crack open your savings nest egg. The manner and order in which you withdraw funds from various accounts can make a big difference in your retirement lifestyle.

Let's assume you've covered all the bases. During your work career, you participated in a 401(k) plan or another employer-based plan, enabling you to accumulate funds on a tax-deferred basis. In addition, you established one or more IRAs, and perhaps even a Roth IRA and annuities, to provide more retirement savings. And you've invested in stocks, mutual funds and bonds in brokerage and other taxable accounts. Having done all of that, you have several options for where to get the income you need in retirement.

The conventional wisdom is pretty simple. Start by withdrawing funds from your taxable accounts, and then later tap your tax-sheltered savings. The reason is that this will let you continue to benefit from tax deferral for a longer period and thereby preserve more of your nest egg.

But that oversimplified approach fails to take into account all of the relevant factors—including rates of return, projected inflation, your tax brackets both prior to retirement and when you're retired as well as your personal objectives. These five strategies could help you fine-tune your game plan:

1. Fill up the two lowest tax brackets. Under the current federal income tax rate structure, the two lowest brackets for ordinary income have tax rates of 10% and 15%, while the top rate is now 39.6%. A common goal is to generate income in retirement that will be taxed at the 10% or 15% rate, but no higher. (The next tax bracket is 25%.) Thus, you might figure on taking short-term gains on stocks or mutual funds in taxable accounts that would be taxed as ordinary income or generating other taxable income only up to the top threshold for the 15% rate. For 2014, the upper limit is $36,900 for single filers and $73,800 for joint filers.

2. Consider a Roth IRA conversion. When you make withdrawals from a traditional IRA in retirement, the distributions are taxed on a pro-rata basis. Only the portion representing deductible contributions and earnings is taxed at ordinary income rates. But for qualifying distributions from a Roth in existence at least five years and made after age 59½, the payouts are 100% tax-free.

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It's Time To Do Those 2013 Tax Returns!

Here we go again, another tax season! As we get into the throws of preparing 2013 tax returns and seeing what the tax forms for 2013 look like, we have a number of observations. First of all, we knew things would be getting more complicated, and they have! Many tax forms have changed to accommodate the new 3.8% Net Investment Income Tax. This now is being referred to as the NII Tax. In some cases, drastic changes to tax forms have been made.

We also are seeing the effect of higher tax rates and the effect of the phaseout on itemized deductions and personal exemptions. All of these are causing some taxpayers to pay significantly higher taxes for 2013. The same thing will apply for 2014 and going forward.

This is a reminder that it is always helpful to do tax planning throughout the year and not just at the end of the year. There are many issues that come up while tax returns are being prepared and the sooner they are addressed, the easier it is to do something about them.

As a part of this newsletter, we have included an article that describes the various tax regimes that now exist. We hope this helps explain how you might be able to reduce your taxes.

Count On The Portability Provision

Though it's still true that you can't take it with you, a recent tax law change makes it easier to reduce or eliminate estate tax liability for your heirs. Thanks to a "portability" provision that's now part of the law, any unused portion of the individual exemption from federal estate tax that isn't used by the estate of the first spouse to die may be claimed by the surviving spouse's estate.

This special estate tax break, first enacted in 2010, was set to expire after 2012. However, the American Taxpayer Relief Act (ATRA) extended it for 2013 and thereafter. Barring drastic change, you can count on portability for the foreseeable future.

Under ATRA, the federal estate tax exemption is locked in at a generous $5 million that is increased annually to account for inflation. (The exemption for 2014 is $5.34 million.) As a result, a couple in 2014 can transfer up to $10.68 million without incurring a dime of federal estate tax.

Suppose a husband owns $4 million on his own, his wife has $3.5 million, and they hold $2.5 million in both their names—jointly with rights of survivorship, in legal jargon. Each spouse's will leaves his or her entire estate to the other spouse and, upon the death of that spouse, to the couple's children.

Now suppose that the husband dies first in 2014. Because all of his individually owned assets pass to his wife, his estate needn't use any part of his federal estate tax exemption. (Spouses normally can inherit an unlimited amount from each other without estate taxes.) So the wife now owns all of the couple's assets, worth a total of $10 million. When she dies, that $10 million in assets goes to the couple's children. Without portability, the wife would have only her own exemption, and that would leave her estate responsible for estate taxes on $4.66 million (the $10 million in assets minus her $5.34 million exemption). At the current 40% estate tax rate, the estate would owe more than $1.8 million—money that wouldn't go to the children. With portability, however, the combined exemption of $10.68 million more than covers the $10 million in the estate, and the heirs pay no estate tax.

As beneficial as the portability provision can be, it won't necessarily solve every potential estate-planning problem. For example, it still might be a good idea to establish a bypass trust, a tool that, before portability, could be used to maximize the estate tax exemptions of married couples. Although no longer needed for that purpose, a bypass trust still could be used to protect assets from creditors, guard against other tax consequences, such as the generation-skipping tax, and be especially helpful in allocating assets when one or more spouse has children from a previous marriage. ●

Beware The NII Surtax On Trusts

Tax experts have warned that the new 3.8% Medicare surtax—which applies to "net investment income" (NII)—can be a formidable tax obstacle for upper-income investors. But the NII tax isn't just a concern for individual taxpayers. It also may affect trusts and estates. In fact, the overall impact on estates and trusts with substantial annual income might be even greater than the tax sting felt by wealthy individuals.

First, let's review the basic rules. For 2013 and thereafter, you must pay the 3.8% Medicare surtax on the lesser of your NII or your modified adjusted gross income (MAGI) above an annual threshold—$200,000 for single filers and $250,000 for joint filers. For this purpose, NII is defined to include interest, dividends, capital gains, rents, royalties, nonqualified annuities, income from passive activities, and income from trading financial instruments or commodities. However, certain items—such as wages, self-employment income, Social Security benefits, tax-exempt interest, operating income from a non-passive business, and distributions from IRA and qualified retirement plans—are excluded from the definition of NII.

But the 3.8% Medicare surtax also applies to trusts and estates. In this case, the dollar threshold for single or joint filers is replaced by the dollar figure that begins the top tax rate for trusts and estates. If all of the trust income is NII and the undistributed net investment income exceeds the dollar threshold by $10,000, the trust must pay a Medicare surtax of $380 (3.8% of $10,000).

As you might imagine, the tax cost can become pretty steep for a trust with an annual income of five figures or higher. Going back to our previous example, if the trust's NII

Shades Of Five Dimensions Of Income Taxes

There's more to the federal income tax system than just a single calculation. In fact, upper-income taxpayers—especially those generating income from investments—actually must cope with five "dimensions" of taxation: (1) ordinary income tax; (2) capital gains and losses; (3) the alternative minimum tax; (4) the net investment income tax; and (5) a reduction of itemized deductions and personal exemptions. Here's a quick rundown:

1. Ordinary income tax. This is the standard tax calculation we're all familiar with. The income you earn generally is taxed under a graduated rate structure with seven tax brackets: 10%; 15%; 25%; 28%; 33%; 35%; and 39.6%. If you're in the top tax bracket, any extra income you earn is taxed at the 39.6% rate. Tax deductions and credits can be used to offset your tax liability based on these ordinary income rates, but certain special rules may apply (see #5).

Furthermore, under the "kiddie tax," if investment income of a dependent child exceeds an annual threshold ($2,000 in 2014), the excess generally is taxed at the top tax rate of the parents. This can hike the overall family tax bill.

2. Capital gains and losses. The tax law provides separate tax treatment for capital assets such as securities and real estate. Generally, gains and losses from capital assets are used to offset each other. Long-term gains from assets held longer than a year qualify for a maximum 15% tax rate, but the rate increases to 20% for those in the top two ordinary income tax brackets. Qualified dividends also benefit from these preferential tax rates.

In addition, you can use excess capital losses to offset up to $3,000 of ordinary income, and you can carry additional losses over to next year. With that in mind, "harvesting" losses is a common year-end tax strategy.

3. Alternative minimum tax. The alternative minimum tax (AMT) runs on a track parallel to ordinary income tax. This complex calculation involves certain additions and adjustments before subtracting an exemption amount based on your tax filing status. However, the exemption is reduced for high-income earners. There are just two tax brackets—26% and 28%—for taxpayers with AMT liability.

At tax return time, you compare your ordinary income tax result to the AMT result and effectively pay the higher of the two. This "alternative" tax often catches unwary taxpayers by surprise.

4. Net investment income tax. The "net investment income" (NII) tax is a new wrinkle that taxpayers have to deal with for the 2013 tax year and beyond. You must pay a 3.8% Medicare surtax on the lesser of your NII or your modified adjusted gross income (MAGI) above an annual threshold—$200,000 for single filers and $250,000 for joint filers. For this purpose, NII is defined to include interest, dividends, capital gains, rents, royalties, nonqualified annuities, income from passive activities, and income from the trading of financial instruments or commodities. But some items, including wages, self-employment income, Social Security benefits, tax-exempt interest, operating income from a non-passive business, and distributions from IRA and qualified retirement plans, are excluded from the definition.

The NII tax is an add-on to the ordinary income tax calculation. Thus, your combined top tax rate can be as high as 43.4%!

5. Reduction of itemized deductions and personal exemptions. Two tax law provisions that were reinstated in 2013 may affect upper-income taxpayers adversely. Under the "Pease rule" (named for the congressman who originated it), certain itemized deductions, including those for charitable donations, state income tax, and mortgage interest, are reduced if your adjusted gross income (AGI) exceeds an annual threshold. For 2014, the threshold is $254,200 of AGI for single filers and $305,050 for joint filers. The total of your itemized deductions covered by the Pease rule is reduced by 3% of the amount above the AGI threshold, but not by more than 80% overall.

ï€†A similar rule phases out the tax benefit of personal exemptions. Under the personal exemption phaseout (PEP) rule, exemptions are reduced by 2% for each $2,500 (or portion thereof) of your AGI that exceeds an annual threshold. The PEP thresholds are the same as those for the Pease rule.

Beyond these five, a sixth dimension exists for most taxpayers—state income taxes. ●

exceeds the upper limit of the top tax bracket by $100,000, the surtax amounts to $3,800 (3.8% of $100,000), on top of the regular income tax.

What can you do about it? Depending on the terms of the trust, you might be able to arrange for distributions to family members in lower tax brackets during years when the 3.8% surtax is minimal or nonexistent for the trust. For example, suppose that you've established a trust to pay for a grandchild's college education and the grandchild is currently in the 10% tax bracket. By paying out distributions over several years while the grandchild is still in the 10% bracket, you might sidestep a hefty NII surtax on the trust when he or she is ready to enter school.

Of course, there are other factors to consider, so this strategy isn't for everyone. But don't ignore the potential tax erosion for a trust if it continues to pile up investment earnings.

What To Do When You're Suddenly Widowed

If your spouse should suddenly pass away, you could find yourself overwhelmed—not just emotionally, but also by a host of financial decisions. Your financial situation is probably about the last thing you'd want to be thinking about, and many things could wait, at least for a little while. Indeed, after such a dramatic event in life, it's probably best not to rush into anything. However, time isn't always on your side, and some decisions may be required immediately—especially if you have not planned properly. And sooner or later, you'll need to address certain financial issues. Here are some practical suggestions that may be helpful:

Deadlines. After losing a loved one, it can be easy to neglect deadlines. You'll generally need to file an estate tax return for your spouse within nine months of death, for example, and you still must file a federal income tax return for the year of death by April 15. Don't let letters from places like the IRS and financial institutions fall to the bottom of a pile. Missing deadlines can cost you dearly.

Retirement Accounts. Review benefit options for 401(k)s, pensions, and other retirement accounts. You'll likely need to decide between taking a lump sum or periodic distributions, rolling the funds into an IRA, or leaving the plan assets where they are. Each option has pros and cons.

Cash-Flow. Estimate your expenses for the next five to 10 years. Will you be paying for one or more children to attend college? When do you expect to retire, and what sort of lifestyle do you envision? This requires a thorough analysis of your finances and also might entail adjusting your investment strategy.

Insurance. Don't ignore insurance concerns. Typically, a surviving spouse inherits most, if not all, of the other spouse's assets and will be the primary or sole beneficiary of life insurance death benefits. This is a time to consider what you can do to protect your children's future. Meanwhile, in light of your changed situation, review all of your insurance policies. Be sure your health, disability, long-term care, umbrella and other polices still meet your needs.

Retirement. After losing a spouse, your retirement goals may change. You may want to consider retiring earlier or later. How much in Social Security benefits will you receive based on earnings history? Social Security is complicated, and you'll need to gather all of the facts to make good decisions.

Investments. Pull together all of the relevant records for your spouse's investments and any assets you held jointly. Once you know where you stand, be sure you understand all of the investments you own and are comfortable with the risk they entail. Set a long-term course for the future, but realize that adjustments may be needed now.

We're available to provide any assistance you need. ●

Strategies For Retirement

(Continued from page 1)

Accordingly, you might convert traditional IRA funds to a Roth, keeping in mind that the amounts you convert will be treated as taxable distributions. Building on the prior strategy, stagger conversions over a few years to maximize your use of the two lowest tax brackets.

3. Spend from taxable accounts first. Suppose you've taken all of the income you can that's taxed at 10% or 15% but you still need more funds. What's next? All things being equal, taking money from your taxable brokerage accounts may be preferable to raiding a 401(k) plan or IRA. You may generate mostly long-term capital gains, and they're taxed at lower rates than ordinary income.

4. Keep your bond holdings in IRAs. Although income from bonds is taxed at ordinary income rates, stock sales may qualify for preferential capital gain treatment. Currently, the maximum tax rate on gains from stock owned more than one year is 15%, and 20% for investors in the top 39.6% tax bracket. But you lose the benefit of these favorable tax rates for stocks held inside an IRA, because when you withdraw from an IRA much of the distribution may be taxed as ordinary income. As a result, it's generally better to keep bonds inside an IRA, to defer taxes on interest payments, and stocks on the outside.

5. Don't forget about life insurance. So far, at least, Congress hasn't reduced the tax benefits of life insurance. The death proceeds are free of federal income tax and you can easily arrange to avoid dire estate tax consequences. Thus, you can consider life insurance to be a supplement to 401(k) and IRA funds on the "back end" of retirement, particularly as a source of income for a surviving spouse.

Note that other factors may come into play that could affect how, when, and where you go for retirement income. For instance, upper-income individuals also may have to account for a 3.8% Medicare surtax on"net investment income" received during retirement. The best idea is to develop a comprehensive plan for building your retirement paycheck that considers the potential tax consequences of various approaches. ●

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