

Beyond the threshold: Financial management in retirement

How far along the way does your retirement planning strategy take you?

Over the years it's likely that you've built up a sizable nest egg through your participation in tax-deferred retirement plans offered by your employers. Or with a traditional IRA, Roth IRA, Keogh or other similar retirement accounts. After "maxing out" those tax-deferred vehicles, you've invested after-tax dollars in a personal portfolio or a deferred annuity.

That takes you to the threshold of retirement. Now what happens? Specifically, once you are in retirement, how should you deploy all those assets that you've conscientiously gathered in a manner that will provide you with a comfortable retirement that may last 20 years, 25 years or even longer?

It's not an easy question to answer. There are many variables to consider, and it's a decision as important as the investment choices that you've made along the way.

Tax considerations

One of your key goals in retirement will be generating the largest income stream possible. To that end, minimizing taxes will play an important role in your postretirement planning.

Income sources generally fall into these categories:

1. *Fully taxable income.* Withdrawals from tax-deferred retirement accounts, interest from taxable bonds and savings accounts, and dividends from equities and stock funds are, generally, taxed at your ordinary income tax rate.
2. *Partially taxable income.* The portion of your withdrawals from nondeductible IRAs and variable annuities attributable to your investment gains and earnings is taxable at your ordinary income tax rate, but the amount representing your after-tax investments will not be taxed a second time. Also subject to partial taxation, according to your income level, are Social Security benefits.

3. *Long-term capital gain income.* Only the appreciation on your investments is taxable and that at a maximum rate of 15%.
4. *Tax-free income.* Most interest from tax-free municipal bonds and tax-free bond funds is exempt from federal and, possibly, state income tax as well. (But keep in mind that there may be alternative minimum tax considerations.) Also untaxed are proceeds from the sale of assets on which you have no gain, as are all withdrawals from Roth IRAs once the account has been open five years, and the owner has attained age 59 1/2.

In many cases advisors recommend tapping savings and investments first. That leaves assets in retirement accounts more time to compound free of an annual tax bite. At the same time taxes may be minimized by taking income from tax-free bonds and bond funds.

When deferral runs out

The tax deferral on retirement accounts does not last indefinitely. You have to begin taking at least minimum distributions from traditional IRAs upon reaching age 70 1/2. (There's a severe tax penalty for failing to take timely withdrawals.) The same holds true of 401(k) plans and other employer-sponsored retirement plans, although you may delay withdrawals so long as you continue working. (This rule was suspended for 2009 only.)

The first distribution must be taken no later than April 1 of the year following the year in which you attain age 70 1/2. However, it may not be advisable to delay into that following year because a second distribution would be required before year-end. Two distributions potentially could push you into a higher tax bracket.

When not to wait

Sometimes there are good reasons for tapping tax-deferred retirement accounts before absolutely necessary. Once you have reached age 59 1/2, you can take as much or as little as you want with no tax penalty. (There's normally a 10% penalty on earlier distributions.)

You also might want to use tax-deferred assets if you believe that your future income tax rates would be significantly higher. That situation might not depend solely on changes in the tax law. You may find yourself in a low- or no-tax situation because of business losses, unusually high medical expenses, or a preponderance of income from tax-exempt resources. You also can use up to \$3,000 of net capital losses to offset ordinary income. In such cases, retirement plan distributions could be taken at little or no tax cost.

Estate planning considerations

The general rule to tap unsheltered accounts first also may be reversed when you intend leaving substantial assets to your heirs. IRAs and retirement accounts pass to those you leave behind, along with certain distribution requirements and potential tax liabilities. Assets that have appreciated in value will pass to your heirs with a stepped-up basis (their fair market value at your death). Thus, if the assets are sold promptly, there will be little or no tax on the proceeds. (Note: As the tax law stands now, in 2010, when the estate tax is suspended, just \$1.3 million of appreciated assets will qualify for a stepped-up basis.)

Estate planning considerations also may govern the deployment of a Roth IRA. If that tax-free income is not needed by the account owner, it can grow and compound throughout his or her lifetime and provide a long-lasting source of tax-free income for your beneficiaries.

Investing in retirement

There's a natural tendency to gravitate to income-producing investments in retirement. That impulse may arise from the feeling that it's necessary to reduce your investment risk, a reluctance to face an instance when you might have to invade your capital, or both. With today's market turmoil, your concerns are likely to be magnified. Why not just convert all of your assets to bonds, CDs and interest-bearing accounts?

The answer lies in the time factor. Years ago, with shorter life spans, most retirees considered themselves short-term investors, and, perhaps, rightly so. Today, living healthier and longer means that you're looking forward to 20 or 30 years of retirement. The picture is a bit different, then. Your needs are for the long term and you need to think like a long-term investor. Over time, with inflation and your living expenses, fixed-income investments may provide an inadequate income stream and tapping capital could well become a reality—the very result that you were trying to avoid

As a long-term investor, time is on your side, and your asset allocation strategy should reflect that status. You may, of course, increase your portfolio's allocation to bonds and cash equivalents. However, if you are looking for growth as well as capital preservation, you'll need to retain a significant exposure to equities.

Then, as the years go by, you gradually can reduce your stock market participation. In any event, you'll want to keep a year or two's worth of living expenses in liquid form—in savings accounts, CDs, money market funds and short-term bond funds. That way you won't have to sell stocks when market conditions are unfavorable in order to meet emergency needs.

As you can see, there's a lot to think about and important financial decisions to make as you approach retirement. You don't have to do all on your own. Call upon us. We will be glad to schedule a meeting to help you plan for the kind of retirement that you've been anticipating all these years.

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Any developments occurring after January 1, 2009, are not reflected in this article.