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Guide...Protect...Preserve

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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Here's A Fast And Easy Way You Can Supplement A Will

Do you want to provide guidance above and beyond the terms of your will? You can use "letters of instructions" to fill the gaps. Although such documents aren't legally binding, they still can be helpful. Here are several issues you might address in this way:

- A letter could detail an inventory of your assets, including checking and savings accounts; safe deposit boxes; retirement plans; Social Security and VA benefits; stocks, bonds, and other investments; real estate holdings; and life insurance and other insurance policies.
- It also could specify where important papers are located—for example, disclosing where your income tax returns and credit card information may be found. This can ease matters for your executor.
- It also might address other personal matters, including funeral, burial, or cremation arrangements; addresses and telephone numbers of people and organizations to be notified when you die; and other specific instructions (for example, providing holiday gifts to caretakers).
- Finally, you could use a letter of instruction to indicate personal preferences, such as your wishes regarding a child's education. You also might explain the bequest each heir will receive and the reason for the choice.

Letters of instructions are meant to supplement, not replace, a valid will. Nevertheless, they can offer valuable guidance at a time of need.

Mary Jane Callaghan &
Mitch Glicksman

Crummey Gifts: Spring Into Action

Traditionally, the end of the year is the time when wealthy individuals give gifts to other family members, especially to children who are likely to be in lower tax brackets. Not only does such gift-giving coincide with the holiday season, it also lets you beat the deadline for using the annual federal gift tax exclusion. You now can give as many recipients as you like gifts of cash and property totaling up to $14,000 each without paying federal gift tax. If you give as a couple with your spouse, that amount is doubled to $28,000 per recipient.

And if you exceed the maximum annual gift tax exclusion? You're still likely not to owe any tax on the gift, thanks to a lifetime exclusion that is $5.34 million in 2014. Tapping the lifetime gift tax exemption reduces the amount available to offset possible future federal estate taxes, but the total amount is large enough to leave most people plenty of room to maneuver.

Yet there's no reason to wait until the end of the year to give away assets. Indeed, earlier gifts are usually better. The sooner assets find their way to the accounts of lower-taxed family members, the less tax erosion will undercut potential investment growth of those assets. If, instead, you postpone gifts until December, more of the income will be taxed to you in your higher bracket. An early gift also might help you avoid or minimize the impact of the 3.8% Medicare surtax on net investment income as well as reducing income tax liability on future sales of the property.

Gift-giving can take many forms, but one approach to consider is using a "Crummey trust" (named for the first person to use this technique in a court-approved case). With a Crummey trust, you transfer assets to a trust and name the lower-taxed family member as beneficiary. Typically, the trust provides a small "window" of, say, 30 days, during which the beneficiary has the right to withdraw the funds. If the window isn't opened, the assets become subject to the terms of the trust.

Usually, understanding your intention, the beneficiary won't attempt to use the funds during the 30-day period. But creating this withdrawal power lets the transfer qualify for the annual gift tax exclusion.

In most cases, a Crummey trust will be able to preserve funds for young family members until they reach the age of majority. Or you could set up the trust to last even longer and provide payments to beneficiaries at predetermined intervals. That could help alleviate concerns about spendthrift children and remove the assets from the clutches of creditors.●

Insurance Trusts Are Not For Everyone

In 1999, Rennie McDaniel owned assets valued at about $900,000. Rennie's attorney advised setting up an irrevocable life insurance trust (ILIT) to help shield the assets from estate tax. The idea was to ensure that the $500,000 death benefit from his life insurance policy would be removed from his taxable estate.

It was sound advice at the time. An individual back then could shield a maximum of only $650,000 from estate tax. The life insurance proceeds, combined with Rennie's other assets, would have created an estate valued at $1.4 million. And even though the estate tax exemption increased soon after that to $1 million, if Rennie had died back then, the $400,000 of the estate Rennie left his children still would have been taxed—at a top estate tax rate of 55%. The ILIT eliminated potential estate tax.

But things have changed. After years of debate, Congress finally approved a permanent estate tax exemption, indexed annually for inflation, and it currently stands at $5.25 million. Rennie's total assets, not counting the life insurance, are now worth about $1.5 million. Due to changes in family circumstances, he would like to adjust the allocations for the beneficiaries of his life insurance, but the ILIT prohibits such changes.

What are Rennie's options? His attorney believes that if he takes the case to court, he may be able to invalidate the trust, leaving Rennie free to divide his estate as he pleases. But there's no guarantee of success, and Rennie would be on the hook for additional attorney's fees.

The moral of the story is that an ILIT, as popular as it is, isn't for everyone. With this technique, you transfer ownership of a life insurance policy to a trust. Because you're no longer the policy owner, the insurance proceeds won't be included in your estate (unless you die within three

Same-Sex Couples Face New Tax Rules

On June 26, 2013, the U.S. Supreme Court handed down its landmark decision in *Windsor v. U.S.*, declaring that section 3 of the Defense of Marriage Act (DOMA) is unconstitutional. That section, which legally defined "marriage" for federal purposes as a union between a man and a woman, is now gone. Same-sex couples now have new financial and tax rules that they could benefit from significantly.

In the majority opinion, Justice Anthony Kennedy pointed out that the Supreme Court ruling affects more than a thousand federal statutes. We can't cover all of the implications of the new law, but here are five key areas where the change can have a significant impact:

1. Income taxes. Now, same-sex couples will be eligible to file joint tax returns and claim the same benefits as other joint filers. Although filing jointly may save tax dollars for some couples, others in high tax brackets likely will pay more tax, thanks to the so-called marriage penalty, which is a quirk of the tax code that can penalize joint filers. The new law also could affect state incomes taxes, although it's not yet clear how that will play out. Additional guidance from the IRS and individual states is expected.

2. Estate taxes. The same principles affecting federal and state income taxes also extend to estate and gift taxes, and the demise of DOMA opens new estate planning opportunities for same-sex couples. For instance, either spouse now may benefit from the federal marital deduction, which lets most spouses inherit an unlimited amount from each other with no estate tax liability. That provision leaves intact the generous estate tax exemption ($5.25 million in 2013) that can be used to transfer assets to other heirs. The "portability" provision of the federal law also now applies to same-sex couples, enabling the estate of a surviving spouse to use any remaining unused portion of the other spouse's exemption. Other provisions, such as a limited exemption for non-citizen spouses ($143,000 in 2013), also apply. State estate laws also will be affected, though not uniformly.

3. Employee benefits. The Windsor ruling will result in numerous complexities involving employee benefits, such as health insurance, for same-sex couples. For instance, a non-working spouse of an employee now may be eligible for insurance coverage or extended benefits under COBRA. While same-sex couples will be treated the same way as traditional married couples in terms of federal statutes, differences still may exist under state laws.

4. Retirement plans and IRAs. The ruling will create many changes relating to employer-sponsored retirement plans, IRAs, and Social Security. For instance, a 401(k) generally is required to pay a married participant's benefits in the form of a "qualified joint and survivor annuity," unless the participant elects otherwise. In addition, if a participant is married, funds in the account can be left to a non-spouse heir only with the consent of the spouse. Rules for "required minimum distributions" from retirement plans tend to be more favorable for married couples, and same-sex couples now should be able to take advantage of beneficiary rollover options when an IRA owner dies. Social Security benefits also will be affected.

5. Divorce. Like traditional married couples, same-sex couples who split up will face wide-ranging legal and financial consequences, and they may want to take precautions that could minimize the fallout. For example, spouses might decide to protect their retirement plan benefits with a qualified domestic relations order (QDRO). When a QDRO is used, a spouse has the right to share in benefits available to the other spouse, but the spouse who receives the benefits will be taxed on them. Otherwise, the spouse who earned the benefits would be liable for the entire amount of the tax.

Remember that the *Windsor* ruling applies only on the federal level—and that makes it essential to investigate possible implications under varying state laws. Under current rules, a marriage that is recognized in one state may not remain legally enforceable if a couple moves to a state in which same-sex marriages are not recognized—a confusing situation. Same-sex couples would do well to research the impact of DOMA and seek professional guidance because the rules are likely to be clarified in the months ahead and the financial consequences can be significant. ●

years of the transfer). But you must give up the legal right to name or change beneficiaries of the policy; to borrow against the policy, or pledge any cash reserve it may have; to surrender, convert, or cancel the policy; or to choose a payment option for beneficiaries.

The generous current $5.25 million estate tax exemption gives people plenty of leeway without having to use an ILIT. If you expect to be far below the estate tax exemption threshold at the time of your death, you might want to steer clear of an ILIT. This way, you won't have to worry about trying to break the trust in the future. Keep in mind that your life insurance owned "outside" of the trust will be counted toward the exemption amount. ●

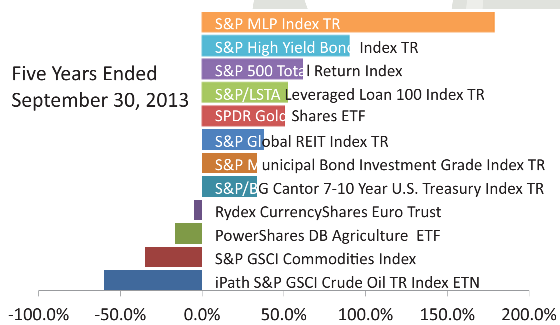
A New Asset Class To Watch — Carefully

For the five-year period that ended September 30, 2013, four of 12 major asset classes lost value while eight posted positive total returns. Master Limited Partnerships, an asset class that did not exist a decade ago and mainly invests in oil and gas companies, trounced all asset classes in five-year cumulative returns. What are they?

MLPS are considered an "alternative investment" that can help diversify a portfolio. They combine unusual tax benefits with the possibility of a favorable return. Like other "pass-through" entities, such as S corporations and most limited liability companies, MLPs aren't subject to corporate income taxes. Instead, MLP partners are personally responsible for their share of an MLP's income. That eliminates the "double taxation" problem of regular corporations, which are taxed at both the corporate and shareholder levels.

MLPs make periodic distributions to the owners of partnership units, much as a corporation may pay dividends to shareholders. However, MLP cash distributions aren't guaranteed. And all of the unit holders remain responsible for the taxes on their share of the MLP's income—even if it isn't distributed.

Your initial tax basis is the amount that you pay for the units. Subsequently, your basis will be adjusted downward for distributions and upward for allocations of income. Also, a portion of certain distributions may qualify as a return of capital, thereby reducing your basis. When an MLP pays more in distributions than it earns in taxable income, your basis is decreased by the difference between the cash you receive and your share of the MLP's taxable income. If you sell any MLP units, your gain is taxed at ordinary income rates. (Currently, the top tax rate on ordinary income is 39.6%.)



MLP income must be reported annually to the IRS on K-1 forms, which shows your allocated items of income, gain, loss, deductions, and credits. If you have negative taxable partnership income for the year, it will be treated as a "passive activity loss," which can only offset income from other passive investments. Thus, the losses may be less valuable tax-wise than other types of investment losses.

Although your personal liability for an MLP generally is limited, creditors may have the right to seek a return of distributions made to shareholders if the liability occurred before distributions were made. That liability remains in place even if you later sell your units.

Because MLPs have been huge outperformers, expect to see more of them. But past performance does not tell you about what will happen in the future. And before you invest, it's important to understand that MLPs have unusual tax characteristics that suit some tax situations but not all. Plus, they carry the risk of the underlying investment, which may be a good energy deal or not. MLPs are a new asset class to watch—carefully.

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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