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28: Lifetime Distribution Strategies for Your Client's Retirement Benefits 2009-2

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WRERA

In December 2008, the **Worker, Retiree, and Employer Recovery Act of 2008** added § 401(a)(9)(H) to the Tax Code. § 401(a)(9)(H) provides that, notwithstanding all the rest of § 401(a)(9), no "minimum required distribution" will be required from any IRA or other defined contribution retirement plan for the year 2009! So, throughout this outline, references to minimum required distributions generally do not apply for the year 2009.

4. Introduction

This outline offers information and suggestions regarding how to get money out of a retirement plan in later life. The goal is to assist planners who are advising clients who are approaching retirement or approaching (or past) age 70½. This outline does not discuss estate planning, financial planning, or investment aspects of retirement plans. It focuses on the income tax consequences of distribution decisions. This outline does not address concerns of beneficiaries, or of participants who are under age 59½.

The structure of the outline is to lay out a particular question or decision or situation that faces retirees, near-retirees, and other older participants, then provide various possible answers to the question or planning ideas for that person's situation, usually followed by detailed text explaining the tax rules. Most of the text is taken from two sources: *Life and Death Planning for Retirement Benefits* and *The 194 Best & Worst Planning Ideas for Your Client's Retirement Benefits*, both by the author; see "Resources" (above).

This outline is written for experienced estate planners, financial planners, investment advisers, trust officers, life insurance professionals, and others who advise individual clients regarding their retirement benefits. The outline assumes that you are familiar with the income and estate tax rules applicable to retirement benefits.

5. What's the best financial plan for retirement?

Retirement means the end of compensation income. You are no longer supporting yourself through current work. You are supporting yourself, you hope, through pension and investment income representing the fruits of your prior work. The financial element of planning for retirement tends to focus on having a plan for generating a post-retirement stream of payments to yourself that will cover your expenses while still leaving enough for all your future years of life and your estate planning goals.

There always seems to be lurking just beyond the horizon the Grand Plan that will provide this stream of payments and eliminate all future worry and fussing about the subject.

One Grand Plan is to live on the "income" (interest and dividends) from your investment portfolio, preserving the "principal" to generate future income, protect against inflation, and leave to your heirs. But many people conclude do not have sufficient capital to live on the income alone in the style to which they have become accustomed—especially in an era of zero percent interest rates! So some way to tap the principal without exhausting it is required.

Another Grand Plan, the one most often recommended, is to have a diversified balanced investment portfolio, which you rebalance periodically, and withdraw 4.5% (or 3%, or some %) of the value of that portfolio the first year; then in each succeeding year you withdraw the same amount increased by a cost of living adjustment (COLA). And your financial planner's Monte Carlo projections show that you have a 90% chance of not outliving your money with this approach. The trouble with this Grand Plan is that it is too complicated and scary for most people. Waking up every day knowing that there is a 10% chance you will outlive your money does not make for a worry-free existence. Who can close his eyes to the stock market roller coaster, knowing that every downtick could mean you can't afford to live as long? What happens to the projections the year you need to take out a few extra dollars to replace the roof?

Another major flaw of this particular Grand Plan, in my opinion, is that it requires every retiree to reserve enough capital to cover living expenses for his longest possible lifespan, even though only a small percentage of retirees, say 10%, will actually live for that longest possible lifespan. Thus if everyone uses this plan either 90% of the retirees are preserving capital unnecessarily to cover an extreme old age they will never reach (capital they could have spent to improve their living standard now), or 10% of the retirees will run out of money in extreme old age.

A Grand Plan that I am secretly drawn to is called the four legs of the table:

<u>Leg 1 is income</u>: You arrange for an annuity or a collection of annuities (with a COLA) sufficient to cover your basic living expenses. Social Security plus your company pension plus a privately purchased annuity contract, and you now don't have to worry about paying the utility and food bills, no matter what the stock market does. Your expenses include the insurance premiums involved in Legs 2 and 3. Plus you now don't have to worry about living too long. If everyone bought this form of insurance against living too long, the risk of excess longevity would be pooled and assumed by insurance companies, and spread over the entire population, as it should be, and much of retirees' capital would be freed up for other purposes.

<u>Leg 2 is medical care</u>: Get the best health insurance you can afford, plus a Health Savings Account, plus Medicare, plus long-term care insurance. Also eat healthy, don't smoke, exercise regularly, and that's the best you can do to corral that monster.

<u>Leg 3 is your estate plan</u>: Buy life insurance to provide whatever you want to provide for your heirs in excess of the estate tax exemption amount, if anything (inside an irrevocable trust of course).

<u>Leg 4 is the emergency fund/inflation backstop/estate plan core</u>. That would be assets (house(s)s plus an investment fund) equal to the federal estate tax exemption amount. These equity investments provide inflation protection, plus can be tapped when your expenses exceed your annuity income, plus provide an inheritance for your heirs. This money is available for fun if it gets to be worth more than the estate tax exemption.

So what's wrong with the Four Legs of the Table Plan? The main sticking point is Leg 1, buying an annuity, which has two issues, only one of which is legitimate.

First, for some people, turning over cash to buy an annuity contract is too scary and unacceptable. You are parting with capital. One day you have $500,000 and the next day you just have a life income of $x. And if you die the day after that your heirs get nothing, your $500,000 was "wasted."

I agree you shouldn't put ALL your capital into an annuity contract. But the idea that the annuity investment is "wasted" if you die early is false. This is liking saying that your homeowner's insurance premium is wasted if your house doesn't burn down. You are buying the annuity to insure against living too long. If you live too long it's a very good investment.

The most likely scenario is that you live to your life expectancy. If you don't buy an annuity, and you live to your life expectancy you will spend that $500,000 on your living expenses, and *your heirs won't get it anyway*. So we are NOT talking about the money you should be looking to leave to your heirs. This is the money you are going to SPEND. You have other money for your heirs.

What's really stupid is to buy an annuity (insurance against living too long) then reduce your annuity payments to provide a death payment to your heirs. The death benefit under an annuity contract is subject to most unfavorable estate tax treatment. See Part I(3), ¶ 10.3.01. If you want to provide for your heirs buy a separate life insurance policy.

The second worry is more real. Viewed from one perspective, the annuity with a COLA is the ideal way to provide retirement income. From another perspective, it's nothing more than an i.o.u. from an insurance company. If AIG can go under, no insurance company is safe. There's no way to eliminate all risk. Perhaps the best you can do is spread the risk by buying smaller contracts from multiple insurers, and if possible buy contracts that are within the state guarantees as a backup.