

How to Maximize Retirement Income, Minimize Taxes

More Retirement Money for You and Your Family

- **How Much Retirement Money Do I Have Now?**
- **What Will I Need and How Long Will It Last?**
- **How and When Should I Collect My Retirement Money?**
- **How Can I Lessen the Tax Burden?**
- **How Do I Use the Roth IRA in My Retirement Planning?**

Includes Retirement Cash Flow Model

The Steps to More Retirement Income and Cash Flow

It's the after-tax retirement income that's important, not just the gross amount you have set aside.

The first step in planning for your retirement is to project where you will be financially at age 65, based on (a) how much retirement money you have now, (b) how much will be added before retirement, and (c) what it will have grown to when you retire.

The next step is to project your retirement cash needs, how much tax will be due on retirement fund withdrawals, and when your retirement money will run out based on projected spending levels. To do that analysis, please see *Retirement Cash Flow Model* on page 9.

Retirement Withdrawal Options

Your goal is to maximize your annual after-tax retirement income. That requires careful research into all your options on distribution methods and payment terms and an equally careful projection of how each option is taxed.

- *Methods of distribution:* You can receive your retirement money using any one of the following methods: (a) total (lump-sum) distribution, (b) distribution over a specific period (e.g., ten years), (c) purchase of an annuity contract that gives you a specified annual income, (d) according to distribution methods provided by an insurance annuity contract held under your plan, or (e) according to IRS life expectancy tables.

There are many considerations involved in deciding whether you want a lump-sum distribution or monthly payments and whether you want to receive the money over 10 or 20 years after retirement, until your or your spouse's death, or until the death of both of you.

- *Selection of payment terms:* Be very careful; the selection decision is usually *irrevocable* and should not be made lightly. How you choose to receive the

payments can have a tremendous impact on how much you collect. There also are many financial, tax, and personal considerations, including the present health of you and your spouse, outstanding obligations such as a mortgage on your home, and your planned spending after retirement. The best approach is to get professional advice from two sources before making your selection.

- *Plan for potential taxes:* Your retirement withdrawal decision can involve financial and tax considerations. For example, receipt of a lump-sum payment (which is not rolled over) is *immediately* taxable so it's a large tax bill, but then you're done with it; annuity payments are taxed as you receive the income each year.

Older retirees: If you intend to take a lump-sum withdrawal, the tax may be calculated under a 10-year averaging method if you were born before Jan. 1, 1936 (at least age 71 now). If you use 10-year averaging, the older tax rates apply, i.e., the rates prior to the Tax Reform Act of 1986. If averaging is not available to you, make sure you understand how much the tax burden will be on each of your withdrawal options.

Before You Decide on When and How Much

Here are additional considerations and cautions to review before you tap into your retirement fund.

- Determine your personal tax rate, currently and in future years, and the taxes and penalties that would apply to *both* partial and lump-sum retirement plan withdrawals. Get these important estimates from your accountant.

- Establish and try to fully fund a Roth IRA each year to reduce taxes after your retirement. All of the monies withdrawn are received *tax-free* if held for at least five years, if you are at least age 59½ at the time of withdrawal, or if the money is used for a first-time home purchase.

In 2007, you can make a nondeductible Roth IRA contribution of \$4,000 a year if your income level is less than \$156,000 (married, filing jointly) or \$99,000 (single taxpayers). If you are age 50 or over, the \$4,000 annual limit increases to \$5,000.

- To further reduce tax payments, consider using your *personal* savings

and investments first since they carry no penalty or little tax liability. That's because these savings represent after-tax cash you've accumulated over the years. The same is true for retirement contributions made with your *personal* after-tax income, e.g., nondeductible Roth IRA and 401(k) contributions. These amounts, excluding income and investment growth, also are not taxable income when distributed to you since you didn't take a tax deduction on these retirement contributions.

Alerts: If you have both deductible and nondeductible IRAs, the amounts withdrawn at retirement are taxed proratably. If you have a Roth IRA, 100% of the amounts withdrawn are not taxable if you have held the Roth IRA for five years and are age 59½ .

- Time the withdrawals of your retirement money for years when your tax rate is low to minimize the tax consequences. *Best time:* When you have little or no other taxable compensation and are in the lowest tax brackets of 10% to 15%.

- Calculate the tax effect of *partial* distributions *every* time you withdraw money. You may be unknowingly giving up some tax-saving options on the *remaining funds* not distributed to you, or you may be able to withdraw more money without incurring additional taxes. That's the case in many situations. A call to your accountant is a must before taking any partial distributions.

- Estimate your projected income and the tax implications. To best accomplish that, you must know your current tax bracket and your future tax bracket during those years you will be receiving retirement income. For most married retirees, their federal tax bracket should be 10% and 15% on taxable income up to \$63,700 and 25% on the next \$64,800 of taxable income. For single taxpayers, the amounts are \$31,850 (15%) and \$45,250 (25%). *Note:* The first \$15,650 of taxable income for married couples is taxed at 10%; for single taxpayers, it's the first \$7,825. Familiarizing yourself with these tax bracket limits is critical to maximizing your after-tax income.

Example: Let's assume your post-retirement *taxable* income after deductions and exemptions is \$30,000 a year. Since the 10% and 15% tax rates apply to taxable income up to \$64,800 for you and your spouse, you can withdraw \$34,800 taxable retirement money *in addition to* the \$30,000 and still stay within the 15% tax bracket.

□ Follow the rules on all rollovers. The 60-day window to complete the rollover is usually firm unless there are unforeseen circumstances, such as an error by the post office or the financial institution receiving the rollover money. Furthermore, you can roll over each retirement account *only* once a year. (There's no limit on trustee-to-trustee rollovers.) Run afoul of these rules and there can be big taxes to pay, which can seriously affect your retirement cash flow and after-tax income.

Alert: Recent tax legislation stipulated that the IRS can waive the 60-day rollover period if failure to make a waiver is against *equity* or *good conscience*, e.g., serious illness or an error by the financial institution or brokerage firm receiving the rollover.

□ After you retire, you may consider moving to another state, but first check with your advisers on the new state's tax rates and rules. For example, some states don't allow itemized deductions and estate tax rates are high. So be careful; you don't want unexpected additional taxes.

Role of a Roth IRA In Your Retirement Planning

There are many complex tax and retirement planning considerations to be addressed before making the decision to transfer or convert part or all of your regular IRA money to the Roth IRA.

If your adjusted gross income is below \$100,000 (single or married), you have the option of making the transfer or conversion to a Roth. The big selling point is that you will *never pay tax* on any future increase in the value of the money deposited in the Roth. The downside is that you *must pay tax now* at your current income tax rate on the money moved.

Basically, you are trading a current, immediate tax liability on the full amount of the Roth deposit for an exemption from all future taxes on what that Roth deposit is worth when you finally start making withdrawals.

With that in mind, you have to start by crunching some numbers. *First*, you need to know how much immediate tax will be due on the money you move to the Roth, based on your current tax bracket. *Second*, you need to project the value of the Roth account at the time of your retirement or whenever you plan to begin withdrawals. Then, you project the tax savings on that value, based on your

projected tax bracket at that time. *Third*, you have to calculate the value of those future tax savings in terms of today's dollars and compare those tax savings with the immediate tax you would pay on the money transferred to the Roth IRA.

But the numbers are just the beginning. Here are some additional considerations in working through the Roth decision. Review *all* of them carefully with your advisers.

- **Your age.** The older you are, the less you will benefit from moving money to the Roth IRA since the tax-free growth will cover fewer years. You don't want to pay taxes in your *current* tax bracket (up to 35% tax rate) on the money moved to the Roth IRA when you expect to be in a much lower tax bracket (probably 15%) when you retire. That's a potential tax-savings difference of 20 percentage points.

- **The tax law.** There is always the possibility that Congress will change the tax laws regarding the Roth in the immediate future or, worse, 10 to 20 years from now, just when you begin withdrawing your retirement money. *And state laws:* Does your state recognize the Roth IRA and its tax-free withdrawals? Will you be living in a different state when you retire?

- **Current liquidity.** Do you have the personal financial resources available now to pay the tax on the money moved to the Roth IRA? How difficult will it be to raise the money to pay the current tax bill? You don't want to deplete retirement savings or sell other valuable personal assets that could increase substantially in value in the future just to meet the immediate tax liability.

- **Time until retirement.** Five years is the minimum holding period to have the Roth IRA money received tax-free. If you're going to be retiring within five years, you won't be able to tap into the Roth money without losing the tax advantage.

- **Your current tax bracket.** If you're currently in a low tax bracket or you expect to pay little or no tax for the year, this might be the time to move money to the Roth IRA. *Reason:* Converting to a Roth IRA in that year of low income (and low tax bracket) will result in a *permanent* tax savings since no or little taxes are payable on the money transferred to the Roth IRA.

- **Value of IRA holdings.** If the investments in your regular IRA are depressed, but you expect them to recover in the future, there are two benefits to switching to the Roth IRA: (a) the investment amount subject to personal taxes in the year you switch is low (i.e., the value of the depressed portfolio), and (b) the increase in the Roth IRA's value in future years (i.e., after your investments recover) is *not* taxable.

Don't rush into transferring your money to the Roth IRA until you have considered all of these factors. Keep in mind that for the same tax year, you can change your mind and switch back to your regular IRA, i.e., undo the Roth IRA. There are technical rules to follow, but it helps to know the Roth decision *is* revocable. Also, get expert advice from two sources. Ask each adviser to prepare a written memo for you that presents and analyzes the tax and cash flow consequences of moving your IRA money to the Roth IRA. The greater the amount to be transferred, the more analysis and advice you need.

Tax Law Changes: More Benefits and Options

#1 — *Contribution Limit Increases Made Permanent:* Increased retirement plan contribution and benefit limits due to expire in 2010 have been made permanent, and the limits will increase over time with cost-of-living adjustments. This affects IRAs, 401(k)s, and other retirement plans.

#2 — *Rollovers by Nonspouse Beneficiaries:* Beginning in 2007, nonspouse beneficiaries of employer-sponsored retirement plans can roll distributions directly into a *beneficiary* or *inherited* IRA, which enables them to keep the assets tax-deferred for longer periods than previously allowed. Both spouse and nonspouse beneficiaries will be able to stretch distributions and taxes over their lifetimes.

#3 — *Direct Roth IRA Conversions:* Beginning in 2008, individuals whose adjusted gross income (AGI) does not exceed \$100,000 and who are eligible to make a rollover can roll distributions from an employer-sponsored retirement plan *directly* into a Roth IRA. Currently, in 2007, the employee must roll the distribution into a traditional IRA, then convert the traditional IRA to a Roth IRA.

#4 — *Charitable Distributions:* For 2006 and 2007, individuals over age 70½

can make tax-free distributions of up to \$100,000 from their IRAs directly to a qualified charity and count the contribution toward that year's IRA Requirement Minimum Distribution. This provision does not apply to distributions from employer-sponsored retirement plans, including SEP IRAs and SIMPLE IRAs.

#5 — \$100,000 Eliminated: Starting on Jan. 1, 2010, the \$100,000 adjusted gross income requirement to roll over a regular IRA to a Roth IRA has been repealed; anyone will be able to convert their IRA to a Roth IRA. Also, you can make the required income tax payments on the converted amounts to the Roth IRA as follows: 50% in 2011 and 50% in 2012.

* * *

Don't wait until you retire to do this analysis. Collecting the most after-tax cash during retirement requires early, detailed, and careful planning. Get expert advice on contributions and withdrawals and precise projections on tax liabilities to assure that your retirement income is what you expect it to be. □

References —

Exhibit 1: Retirement Cash Flow Model — next page.

Exhibit 2: Free Information to Help You in Your Retirement Planning — page 11.

Retirement Cash Flow Model: **How to Project Your Retirement Money**

Shown on the next page is a sample *Worksheet* for projecting your retirement income *and* the money (withdrawals) needed to meet your annual cash needs. To simplify the mathematics and *Worksheet*, we have made the following assumptions:

- You are now age 64 and will retire at the end of 2007.
- Your annual cash need is \$40,000, which will grow by 3% a year. (The \$40,000 includes living expenses and income taxes. If you wish, you can separate and set up another column for income taxes.)
- Your liquid assets are projected at \$250,000 (\$150,000 retirement money and \$100,000 personal funds).
- Your after-tax return on the \$250,000 assets will be 8%. (Remember, your \$150,000 retirement money continues to grow tax-free until withdrawn.)
- Social Security income was projected at \$12,000 annually, which will grow by 3% a year. (Add your spouse's income if applicable.)
- No other income or cash was assumed, such as continued part-time employment, salary paid under a deferred compensation arrangement, or money received from refinancing your home.

In the projections, we intentionally have not considered other personal assets which can be converted to cash, such as the equity in your home and life insurance policies. All we wanted to do is illustrate how to perform cash inflow and outflow analysis. The *Worksheet* will help you do your own Retirement Model. See the *Deficit* column, which is the amount of money you need to withdraw from your retirement money each year.

Beginning Retirement Position is \$250,000. For our readers who are not ready to retire, determine where you are today and project how much money you will have at retirement. Then build your Retirement Model.

Projected Cash Inflow and Outflow Worksheet

| <u>Year (Age)</u> | <u>Income at 8%⁽¹⁾</u> | + | <u>Social Security</u> | - | <u>Living Expenses</u> | = | <u>Deficit⁽²⁾</u> | <u>Ending Cash Position</u> |
|-------------------|-----------------------------------|---|------------------------|---|------------------------|---|------------------------------|-----------------------------|
| 2008 (65) | \$19,667 | | \$12,000 | | \$40,000 | | \$ 8,333 | \$241,667 |
| 2009 (66) | 18,937 | | 12,360 | | 41,200 | | 9,903 | 231,764 |
| 2010 (67) | 18,076 | | 12,731 | | 42,436 | | 11,629 | 220,135 |
| 2011 (68) | 17,070 | | 13,113 | | 43,709 | | 13,526 | 206,608 |
| 2012 (69) | 15,904 | | 13,506 | | 45,020 | | 15,610 | 190,998 |
| 2013 (70) | \$14,564 | | \$13,911 | | \$46,371 | | \$17,896 | \$173,103 |
| 2014 (71) | 13,032 | | 14,329 | | 47,762 | | 20,401 | 152,701 |
| 2015 (72) | 11,290 | | 14,758 | | 49,195 | | 23,146 | 129,555 |
| 2016 (73) | 9,318 | | 15,201 | | 50,671 | | 26,152 | 103,403 |
| 2017 (74) | 7,095 | | 15,657 | | 52,191 | | 29,439 | 73,964 |
| 2018 (75) | \$ 4,596 | | \$16,127 | | \$53,757 | | \$33,034 | \$40,930 |
| 2019 (76) | 1,796 | | 16,611 | | 55,369 | | 36,962 | 3,968 |
| 2020 (77) | 159 | | 17,109 | | 57,030 | | 39,762 | -35,794 |

⁽¹⁾ We computed the 8% return on the average beginning and ending cash balances.

⁽²⁾ *Deficit Column:* This is the amount you must withdraw annually to meet your living expenses.

* * *

Summary. Your \$250,000 cash position is fully depleted in the thirteenth year after retirement, at age 77. The cash position at the end of year 2020 is a deficit of \$35,794. □

Free Information to Help You in Your Retirement Planning

To help in your retirement planning, you may want to obtain copies of the following *free* booklets from the IRS.

| <u>No.</u> | <u>Title of Publication</u> |
|------------|---|
| 525 | Taxable and Nontaxable Income |
| 530 | Tax Information for First-Time Homeowners |
| 552 | Recordkeeping for Individuals |
| 554 | Tax Information for Older Americans |
| 560 | Retirement Plans for Small Business |
| 575 | Pension and Annuity Income |
| 590 | Individual Retirement Arrangements |
| 915 | Social Security Benefits |

How to order: Call 800-TAX-FORM, or visit the IRS website at www.irs.gov.

From the Social Security Administration:

- Understanding Social Security (No. 05-10024)
- Supplemental Security Income (No. 05-11000)
- Disability (No. 05-10029)
- Retirement (No. 05-10035)
- How You Earn Credits for Social Security (No. 05-10043)

How to order: These publications can be obtained *free* at any Social Security office or by calling 800-772-1213 or by visiting www.ssa.gov.

Important: If you visit the website above, the Home Page will have a comprehensive listing and automatic access to all of the Social Security and Medicare booklets. **Click** Publications.

Verification of income: To verify the income credited to your Social Security account, review Form SSA 7004, *Request for Social Security Statement of Earnings*, which is automatically sent to you each year. *Important:* If you find errors in the income amount listed, which is indicated by year, you will need your W-2 forms from the years in which the errors were made in order to have them corrected.

Recordkeeping: If you haven't kept your W-2 forms, check your tax returns. A copy of your W-2 is usually attached to it. If you don't have a Social Security file yet, set one up now to keep track of all Social Security correspondence and copies of the benefits and checks you receive. □

Recent survey: 66% of employed persons ages 51 to 62 have not determined how much money they need to save for retirement.

About *The Business Library*

This **Report** is part of *The Business Library* (TBL), a collection of 90 Reports and Manuals on subjects of critical importance to business owners, executives, their families, and the professionals who advise them. TBL is produced by an editorial and research staff with an *average experience* of **28** years in helping businesses and individuals manage their finances better.

The company was formed in 1974 by Thomas J. Martin. Martin has written more than 900 articles and advisories and presented *hundreds* of workshops and seminars to *thousands* of business owners and executives on many of the subjects covered in *The Business Library*. He is an Investment Banker and an expert witness in Valuation and Succession Court Cases. He has helped *hundreds* of business owners and executives raise capital, refinance debt, prepare for succession, and value and sell their businesses.

The information in *The Business Library* has helped more than 300,000 business owners, executives, entrepreneurs, investors, and individuals manage their companies and finances better, using several million copies of our reports, manuals, advisories, books, seminar workbooks, and newsletters to guide them in their business and family planning.

Tricia Walsh, Publishing Director
The Business Library
16 Fox Lane, Locust Valley, NY 11560
516-671-8050 • Fax: 516-671-8077
E-mail: triciawalsh@yourbusinesslibrary.com

Copyright and Publishing Notice

All rights to *The Business Library* and its product lines are reserved under International and Pan American Copyright Conventions. The reproduction, sale, and distribution of this **Report: How to Maximize Retirement Income, Minimize Taxes** in whole or in part (in any form) is prohibited without the prior *written* consent of Thomas J. Martin, President, MW Business Solutions, Inc., 16 Fox Lane, Locust Valley, NY 11560, 516-671-8050. Copyright © 2007 by MW Business Solutions, Inc. and Thomas J. Martin, Author.

This Report is intended to provide general information and background in regard to the subject matter covered. It is sold and distributed with the understanding that the publisher, author, and any distributor are not engaged in rendering legal, accounting, tax, insurance, or other professional services or advice. If legal advice or other expert assistance is required, the services of a competent professional should be sought.