Foreword

The idea of creating a consumer awareness guide struck me when I realized just how widely our discussions with clients range over the entire spectrum of their financial lives. I came to realize that many people are simply unaware of all of the opportunities and possible pitfalls they may encounter throughout their lives when it comes to money. The process of financial planning is not simply, set up a 401(k) and start contributing 10% of your income. In fact, the breadth of financial planning should cover every aspect of a client’s financial wellbeing.

Beginning with the basics of BUDGETING and creating a foundation, to adequately protecting their current financial position with INSURANCE planning. Then addressing, INVESTMENT and ASSET ALLOCATION modeling to manage investment risk, TAX PLANNING strategies with which to minimize, avoid or capitalize on opportunities, RETIREMENT INCOME PLANNING to identify sources of income and expenses in retirement and securely providing for that retirement you’ve dreamed of and finally ESTATE PLANNING to be sure our client’s wishes are fulfilled.

All of these concepts have inherent opportunities or strategies associated with them.

**I believe the first step to motivate someone, to want to begin the process of financial planning, is to get them to understand that there are many things that they may not be aware of**

and the key is to simply recognize and be open to the idea of exploring possibilities. I hope this guide will offer some insight into your own personal financial planning, possibly enlighten you or encourage you to address those issues and finally, motivate you to take action to be sure to capitalize on every opportunity you have available. Some of these concepts are subjective and many times there is no right or wrong answer. However, this should offer a clearer understanding of the scope of what financial planning really is. Thanks for reading and hope you enjoy!

But I thought social security wasn’t taxable?

Interestingly, many people believe social security is not taxable. Well, the truth is, it may not be. Especially with some strategic planning. It all depends on, what’s known as your “PROVISIONAL INCOME”. Taxation of benefits is really based on a needs test. In other words, the more money you make in retirement, the less social security you need, right? Well, that’s the way the IRS feels about it. But for those of us that want to minimize taxation on benefits, we first need to understand how this provisional income is calculated.

To determine provisional income, you account for all of your pension, IRA withdrawals, CD and bond interest, dividends, W-2 income and ONLY ½ of your social security benefits.

**If that amount exceeds $32,000 for married filers, $24,000 for single, then as much as 50% of your benefits become taxable.**

Once it exceeds $44,000 for married filers and $34,000 for single, any amount over that would subject 85% of your social security benefits to become taxable. That doesn’t mean you pay 85% of your benefit back in taxes. It simply means you have to include up to 85% of your benefits in the calculation to determine how much tax you owe on them.

To better understand it, let’s look at an example. Mr. and Mrs. Smith have a pension of $10,000 and each have $1000 per month in social security benefits. In this case, their combined “provisional income” is $34,000 ($10,000 pension + $12,000 Mr. SS + $12,000 Mrs. SS). Right on the threshold of the needs test. Let’s now assume they decide to take a significant withdrawal of $10,000 from their IRA to buy a new car. This would push their provisional income up to $44,000, subjecting as much as ½ of the social security benefits above $34,000 to taxation.

**So a simple IRA withdrawal not only becomes taxable itself, but also could expose your social security benefits to taxation as well. A very costly mistake!**

So, in the previous example, let’s now assume instead of pulling $ from a traditional IRA, they withdraw it from a non-retirement CD or a Roth IRA, or even take a loan to purchase the new car. Since the withdrawal would not be treated as a taxable distribution, it would not increase the provisional income and would allow the social security benefits to remain tax free. Having investments structured in different types of accounts, such as IRA’s, Roth IRA’s, after tax savings, etc. gives you more flexibility to strategically plan around taxes through retirement. This is an important consideration as you are accumulating wealth for retirement.

Required Minimum Distribution Basics

I think most people are aware of required minimum distributions, at least if you’ve reached the magic age of 70 ½. However, I also believe there are some strategies that most people are unaware of with regards to the RMD. First off, the tax law regarding minimum distributions states, by the year in which you reach the age of 70 ½ , if you have not begun taking withdrawals from your IRA accounts or 401 (k)’s, etc. the IRS requires you to start. The first year distribution is equivalent to roughly 3.6% of your account balances. For most people, the calculation is based on a uniform life expectancy table. If your birthday falls before July 1, your RMD “divisor” is 27.4. If your birthday falls on or after July 1, your first year RMD divisor is 26.5. Let’s look at a quick example. A client whose birthday is March 20th reaches the age of 70 ½ this year. His total IRA balances as of 12/31 last year totaled $325,000. So in this example, he would have to divide $325,000 by 27.4 (since his birthday is before July 1). The answer is $11,861.31. So in this example he would be required to withdrawl $11,861.31, total, from his IRA’s. It could all come from one IRA or a combination of IRA’s.

**But the withdrawal would normally need to occur prior to year’s end (12/31) or he could be penalized as much as 50%**

of what was required to be taken, but was not. One thing to be aware of though, is if he has a couple IRA’s and still has a 401(k) from his old employer that he never rolled over, the IRS does not allow you to aggregate the RMD. So in plain english,

he would have to take an RMD from the 401(k) and also take an RMD from one or both of the IRA’s separately. So now that you have a basic understanding of how the RMD’s work, let’s look a few different planning opportunities.

Shifting assets out of IRA’s

What’s so frustrating to many clients is that they don’t want to take money out of their IRA’s. Unfortunately since you’ve never paid tax on this money, a portion of it is the Internal Revenue Service’s and they want payment at some point. However,

**just because the IRS forces you to take out money, doesn’t mean you have to spend it.**

You simply have to pay tax on it. So this strategy allows you (assuming you have IRA money invested in mutual funds, stocks or bonds) to “shift” those assets from an IRA into a taxable account without ever having to sell the investment. To really take advantage of this concept, you can shift assets that may be down at the same time (assuming you believe their values will eventually go back up).

During the great recession, there were lots of investments that had lost value. For those clients that had the foresight, they could have…

**shifted investments that had dropped 40% in value and paid tax on a much lower base.**

If those assets then appreciated in a taxable account, they would benefit from the more favorable capital gains taxes, but only when and if they sold them.

On a side note, this strategy doesn’t necessarily just apply to clients that are age 70 ½. Let’s assume you’re any age under age 70 ½, and for whatever reason have very little income for the year. Either you’re in between jobs, or maybe have been out of work sick, or possibly now retired and living very comfortably on just social security. From a planning perspective, it might make very good sense to pay income tax on some of your IRA money now assuming you are over 59 1/2, especially if you feel tax rates will rise in the future or those assets you’re paying tax on are temporarily down in value.

QCD’s and RMD’s

The QCD (Qualified Charitable Distribution) has finally been made permanent by congress in 2016. But first to understand the importance and value of the QCD,

**we first must understand how required minimum distributions (RMD’s) can be so destructive.**

For many clients, without any debt, living on $40,000 per year can be more income than they need. But once they are forced to recognize more taxable income due to the RMD, this could force them to not only pay tax on the money taken out of their IRA’s, but now also trigger additional tax on their social security, a real double whammy! If your provisional income (total IRA withdrawals, W-2 earnings from working, interest on bonds, etc. plus ½ of your social security benefit) exceeds $32,000 for a couple that is married filing jointly, then 50% of their social security benefits become taxable. If that provisional income exceeds $44,000, then 85% of the social security benefits are taxable.

So again the best way to really understand this double whammy is with an example. Let’s say Mr. and Mrs. Smith, now retired, just turning age 70 ½ this year are living very comfortably on a pension of $18,000 per year, and two social security incomes of $14,000 each. Their provisional income would be $32,000 so none of their social security benefits would be taxable. Now let’s assume that this is the first year they are taking their required minimum distribution and in the earlier article’s example, that would have been $11,861.31.

**Now their provisional income jumps over the $32,000 threshold, which triggers 50% of their SS benefit to become taxable!**

Assuming they are in the 15% tax bracket, they would now have to pay as much as $2,100 in tax on their social security and still pay tax on their RMD, another $1780. So you can see, the RMD can be a huge stumbling block and cause you to pay significantly more tax on your income.

So that leads me to the advantages of the QCD. Mr. and Mrs. Smith are active members of their church and believe in being philanthropic. Without the use of the QCD, they would first receive income from their required minimum distribution and receive a 1099 showing that as taxable, ordinary income. Then after they’ve made a donation to their church, because they have no debt and they have very little write offs, they are not able to deduct the charitable contribution because they cannot itemize. But with a little preplanning, they could direct the custodian of their IRA to make a check payable directly to a charity of their choosing

**and they would not ever receive a taxable 1099!**

This would immediately save them 15% of whatever they’ve already been giving and would go towards satisfying their RMD for the year. There are a few stipulations though. You have to be 70 ½ and the check absolutely has to go directly from your IRA to the charity and the gift cannot exceed $100,000. But for those that are or want to give, this is a great way to use your RMD to make those gifts.

How much income will I need in retirement?

Well the question really is not how much income, but how much do I need to spend in retirement? That leads me to calculating a retirement spending goal**.**

**Interestingly many financial professionals suggest 70% of your pre-retirement income is what you would need in retirement to spend to maintain your standard of living.**

However, every client’s circumstances are unique. That’s why it’s really important to get a clear picture of how much you will be spending. Having said that, there are a few things that will change right off the bat. Number one, you will no longer be saving for retirement, in retirement.

So if you were deferring 10% of your income into a 401(k), that will no longer be necessary. Something else that will change is your tax liability. When you’re working and earning income, you are paying into social security and medicare. However, once you retire,

**income from IRA withdrawals or pensions are not subject to social security or medicare taxes,**

which account for 7.65% of your pre-retirement income. Lastly, you may have paid off a mortgage, or credit card debt, or something that you don’t expect to re-emerge in retirement. So the 70% rule, is probably not too far off for most people. However, I have included a worksheet which should help you clearly identify your current spending habits and recognize what may change for the better or worse in retirement. As you build your retirement spending budget, you should be able to break down your basic needs like food, clothing, shelter versus your discretionary expenses like playing golf once a week, or going on that big trip to Europe. This exercise will give you a very clear picture into your retirement spending needs and wants, which is really what the foundation of a good financial plan should address.

**Personal and Family Expenses**

|  |  |  |
| --- | --- | --- |
| **Category** | **Monthly Budget Amount** | |
| **Current** | **Retirement** |
| Alimony |  |  |
| Bank Charges |  |  |
| Books/Magazine |  |  |
| Business Expense |  |  |
| Care for Parent/Other |  |  |
| Cash - Miscellaneous |  |  |
| Cell Phone |  |  |
| Charitable Donations |  |  |
| Child Activities |  |  |
| Child Allowance/Expense |  |  |
| Child Care |  |  |
| Child Support |  |  |
| Child Tutor |  |  |
| Clothing - Client |  |  |
| Clothing - Co-Client |  |  |
| Clothing - Children |  |  |
| Club Dues |  |  |
| Credit Card Debt Payment |  |  |
| Dining |  |  |
| Education |  |  |
| Entertainment |  |  |
| Gifts |  |  |
| Groceries |  |  |
| Healthcare - Dental |  |  |
| Healthcare - Medical |  |  |
| Healthcare - Prescription |  |  |
| Healthcare - Vision |  |  |
| Hobbies |  |  |
| Household Items |  |  |
| Laundry/Dry Cleaning |  |  |
| Personal Care |  |  |
| Personal Loan Payment |  |  |
| Pet Care |  |  |
| Public Transportation |  |  |
| Recreation |  |  |
| Self Improvement |  |  |
| Student Loan Payment |  |  |
| Vacation/Travel |  |  |
| Other |  |  |

**Personal Insurance Expenses**

|  |  |  |
| --- | --- | --- |
| **Category** | **Monthly Budget Amount** | |
| **Current** | **Retirement** |
| Disability for Client |  |  |
| Disability for Co-Client |  |  |
| Life for Client |  |  |
| Life for Co-Client |  |  |
| LTC for Client |  |  |
| LTC for Co-Client |  |  |
| Medical for Client |  |  |
| Medical for Co-Client |  |  |
| Umbrella Liability |  |  |
| Other |  |  |

**Taxes**

|  |  |  |
| --- | --- | --- |
| **Category** | **Monthly Budget Amount** | |
| **Current** | **Retirement** |
| Client FICA |  |  |
| Client Medicare |  |  |
| Co-Client FICA |  |  |
| Co-Client Medicare |  |  |
| Federal Income |  |  |
| State Income |  |  |
| Local Income |  |  |
| Other |  |  |

**Home Expenses**

**Description:**

|  |  |  |
| --- | --- | --- |
| **Category** | **Monthly Budget Amount** | |
| **Current** | **Alt 1 / Retirement** |
| First Mortgage |  |  |
| Second Mortgage |  |  |
| Equity Line |  |  |
| Real Estate Tax |  |  |
| Rent |  |  |
| Homeowner’s Insurance |  |  |
| Association Fees |  |  |
| Electricity |  |  |
| Gas/Oil |  |  |
| Trash Pickup |  |  |
| Water/Sewer |  |  |
| Cable/Satellite TV |  |  |
| Internet |  |  |
| Telephone (land line) |  |  |
| Lawn Care |  |  |
| Maintenance - Major Repair |  |  |
| Maintenance - Regular |  |  |
| Furniture |  |  |
| Household Help |  |  |
| Other |  |  |

**Vehicle Expenses**

**Description:**

|  |  |  |
| --- | --- | --- |
| **Category** | **Monthly Budget Amount** | |
| **Current** | **Retirement** |
| Loan Payment |  |  |
| Lease Payment |  |  |
| Insurance |  |  |
| Personal Property Tax |  |  |
| Fuel |  |  |
| Repairs/Maintenance |  |  |
| Parking/Tolls |  |  |
| Docking/Storage |  |  |
| Other |  |  |

**Vehicle Expenses**

**Description:**

|  |  |  |
| --- | --- | --- |
| **Category** | **Monthly Budget Amount** | |
| **Current** | **Retirement** |
| Loan Payment |  |  |
| Lease Payment |  |  |
| Insurance |  |  |
| Personal Property Tax |  |  |
| Fuel |  |  |
| Repairs/Maintenance |  |  |
| Parking/Tolls |  |  |
| Docking/Storage |  |  |
| Other |  |  |

Arbitrage for Income

That sounds complicated, but in it’s simplest form, Arbitrage is the “simultaneous buying and selling of securities, currency, or commodities in different markets to take advantage of differing prices for the same asset.”

**One strategy that may help generate more cash flow for a client is the use of two assets, an immediate annuity and a life insurance policy working together.**

An immediate annuity, provides guaranteed income for the life of a client regardless of how long they live. The annuity marketplace is very competitive and just like shopping CD rates at a bank, you could identify a company that offers the highest payout possible. However, many clients don’t like the use of immediate annuities because they are afraid if they die prematurely, all of that money is surrendered to the insurance company.

Therein lies the strategy of using life insurance to pay back the estate. In this case, we would want to find the lowest cost permanent life insurance to replace the annuity deposit in the event the client were to prematurely pass away. So by identifying the highest payout annuity, and incorporating the lowest cost life insurance, you are possibly able to generate a guaranteed monthly income that would exceed that of any CD or fixed investment without any risk. Let’s take a look at a real life example…

Mr. Client, age 65 is in very good health (that’s the key for this to work well). He would like to guarantee himself a certain amount of income to supplement his retirement expenses. In this case, he deposits $100,000 into an immediate annuity (single life payout) with an A rated insurance company with the highest payout ratio, that will provide him with $560.91 per month for the rest of his life, regardless of how long he lives. But before committing to this payout, he needs to secure life insurance in case he were to die early and didn’t want his spouse or beneficiaries to lose out on the $100,000 annuity deposit. After comparing policies, he agrees to a $100,000 life insurance policy with a different A rated company, one with a very low internal cost of insurance. Because of his good health, the premium for a preferred rating would be $163.93 that he continues to pay for lifetime. So that means that his net take home after the insurance premium is paid, would be $396.98 per month for the rest of his life. That’s equivalent to a 4.8% annual income from his $100,000 investment, after the insurance premium is paid! For very conservative investors, this is a great way to help supplement some of your long term retirement income needs without the risk of loss of principle. And in the future, if bond interest rates rise, this strategy may become even more compelling.

On a side note, you wouldn’t want to proceed with this strategy with all of your money, because the effects of inflation are not taken into account. In other words, your guaranteed income would remain the same for lifetime, but your expenses would continue to rise with inflation. But you could eventually add another annuity at some point down the road.

Avoid dipping into investments when they’re down

Anyone that has invested in the stock market knows, it doesn’t just keep going up, up, up. There are times when it drops, or “corrects”, as though there were something wrong with it in the first place. These are normal growing pains for the economy and many times, short lived. But for so many clients it prevents them from making prudent investment decisions or even worse, could lead to a knee-jerk reaction to sell, sell, sell at a loss.

**The concept of a cash reserve should help prevent you from sabotaging a very well thought out investment plan.**

In it’s simplest form, you first need to identify how much you will need to begin withdrawing from your investments to meet your retirement spending goals. So, let’s say you want to spend $60,000 per year and have $40,000 of direct income sources like social security and a pension. This means that you would expect to start withdrawing $20,000 per year from your retirement accounts. See why understanding your budget is so important? Looking at the next three years of withdrawals would lead me to believe you would want to maintain a “cash reserve” of $60,000 ($20,000 X 3yrs).

**So think about this, if the next three years of your retirement income has been satisfied, can’t you afford to weather some bumps in the stock market, assuming your investments are well diversified?**

Most likely the answer is YES. To put things into perspective, you could have invested your money into a 100% stock mutual fund in 2008 and within a year the value would have dropped about 45%! But by 2012, the value of most equity mutual funds had completely recovered to the pre 2008 crisis levels and that was the greatest financial crisis since the great depression! Hopefully we’ll never see anything that severe again in our lifetimes. But no matter what your age, having that cash reserve will buy you the time you need to allow your longer term investments to rebound.

How Investment Risk can work against you in Retirement.

We’re going to get a little technical with this concept but it’s very important to understand.

**As the next chapter of your life unfolds, it’s so important to understand how investment risk can make or break the best retirement income plan.**

Let’s first go back about 30 years, before the invention of the 401(k) or IRA. It certainly was a much simpler time, at least for investing. You spent your entire career working for one company and then finally get to retire, collecting a pension for the rest of your life without ever having to worry about running out of money. Today, on the other hand, most retirees don’t have that luxury. In the days of the pension, if you made a mistake and overspent, you could quickly adjust your spending to avoid a long continuous period of overspending.

**Today, though, having a lump sum of cash that you’re trying to juggle, many times it’s not as easy to recognize if you’re overspending until it’s too late and your investments have dwindled down to nothing.**

Remember, you don’t get a “do-over”, so making sure your money will last a lifetime is critical today in retirement income planning.

To add even more difficulty to the equation, you now also have 100% of the investment risk. Understanding how this risk can affect the longevity of your investments is just as important. This brings me to the concept of “Monte Carlo Analysis”. A good financial planner should take that into account when helping a client measure the likelihood of success or failure in meeting your financial goals. In a nutshell, Monte Carlo is a set of mathematical trials that looks at the historical volatility of your investment portfolio (the ups and downs it would have experienced) over a long period of time. There is sophisticated financial planning software that assumes a client retires 1000 different times and every one of those times, the sequence or timing of the ups and downs in a portfolio are different. It’s able to measure how many of those trials was the client successful in making their money last for a lifetime and how many times did they fall short. Because the future is unknown, through this process you can better “guestimate” how likely you are to fulfill your long term financial goals.

One very interesting fact is, you could have a portfolio that has a lower average rate of return over the long term, but also has a lower amount of volatility as well, that would have a much higher probability of successfully making your money last. For an example, through the planning process I’ve seen portfolios that would have experienced an average of 8% annual rate of return over a long period. Anyone investing in mutual funds or stocks and bonds, knows that the market doesn’t just go up every year. Some years you would have a 2% return, others a 20% return and others actually lose value. But over the long haul would have averaged 8%. Hypothetically, because of these ups and downs, the Monte Carlo analysis suggested a client would have only been able to meet their financial goals 60% of the time. Pretty scary to think that their life savings would only pay for 60% of their retirement! But, by simply adjusting the risk in the portfolio and cutting the standard deviation in half, they may be able to meet 85% of their goals based on these historical trials.

**This is really important to understand, because a higher rate of return doesn’t necessarily mean a client is more likely to meet their objectives.**This is why managing risk during retirement, especially when you are relying on your investments, is critical to a long term retirement income plan. Remember, there’s no “do-over”!

Should I start taking Social Security now, or wait?

There has been a lot of hype the last few years about maximizing social security benefits. So much so that Congress squashed two very recently popular claiming strategies in the Bipartisan Budget Act of 2015. You may have heard of the “file and suspend” and “restricted application” which essentially takes advantage of the social security rules by allowing one spouse to start a “spousal benefit” while allowing their own benefit to increase by the 8% annual deferred retirement credit each year. It’s sort of like the old adage, “You can have your cake and eat it too”. Regardless, there are still considerations when deciding timing of benefits.

For married couples, the spousal benefit is still intact. This means you could have never worked a day in your life, nor contributed to social security, and as long as you’ve been married to your existing spouse for more than one year, you could claim the “spousal benefit” as early as age 62\*.

<https://www.ssa.gov/retire2/applying6.htm>

The “spousal benefit” is equivalent to ½ of your spouse’s Primary Insurance Amount (PIA). This is the social security benefit based on their Full Retirement Age (FRA). The FRA for those retiring today is 66 through age 67 depending on the year of your birth. By taking the benefits early, it would reduce the monthly payout by roughly 5 ½% for each year under your FRA. So for an example, let’s say Mr. Smith’s PIA is $2400 per month with an FRA of age 66. Mrs. Smith, whose always stayed at home raising the kids, can file for benefits as a “spousal benefit” and by starting those benefits prior to her FRA, they would be reduced approximately 22%. So in this case, her benefit would be ½ of his PIA reduced by 22%, or $1056 per month. It’s funny because, generally speaking, social security has it pretty well figured out.

**Based on a large sampling of retirees, they will pay out about the same amount of benefits per person, regardless of when they decided to start those benefits.**

However, there are several considerations for an individual to address as to when they should start their own benefits. How healthy are you? If you aren’t in the best of health or your family history doesn’t tend to have longevity, then taking it as early as possible might make sense. If you have the lower of the two benefits as in the example above, you may want to start it as soon as possible because if either spouse would pass away, the surviving spouse loses the lesser benefit and retains the greater of the two. You may not have enough money set aside to bridge the gap between the age of 62 and 66 or 70, forcing you to start benefits as soon as you retire.

If, on the other hand, you have a longer life expectancy, for every year you delay benefits, you receive an 8% deferred retirement credit, permanently increasing your monthly benefits for lifetime for yourself and your surviving spouse.

**With the help of a financial planner, you should be able to calculate your own personal “break even” point to see just how long it would take to make up lost payments, if you decide to delay benefits.**

One final consideration is your perspective on the solvency of social security. Based on the most recent social security trustee’s report\*, it is expected that by the year 2020 there will not be enough social security taxes to support all of the benefits being paid out, forcing the government to begin redeeming special issue bonds within the social security trust fund. By 2034, it’s projected that the trust fund will be depleted and there will only be about ¾ of the benefits promised available. So with that in mind, there may be a real motivation to start benefits as early as possible. There is usually never a right or wrong answer when it comes to many financial planning decisions, but by having the knowledge to weigh out the good and bad and make fair assessments and comparisons, allows you to make the most informed decision possible. If our firm can assist you in determining when the right time to start benefits may be, please give us a call.

https://www.ssa.gov/oact/tr/

Final Thought

I hope, after reading these Post Retirement Strategies, you’re able to identify some opportunities that you may have been unaware of previously. I cannot stress enough how important it is to have a long range retirement spending plan so you can address, far in advance, whether or not your money will last a lifetime. Remember, when it comes to your investments, if you spend down too much early in retirement, **there is no do-over**. So plan carefully and thoughtfully.Best of luck on your journey and if our firm could be of assistance, please feel free to contact us for a complimentary financial evaluation.

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