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2022 Montgomery-Warschauer Award-Winning article…

(that most contributes to the financial planning profession in the *Journal of Financial Planning* last year)

"A Comparison of the Tax Efficiency of Decumulation Strategies"

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Other Tax-efficient Decumulation articles

- Rarely addressed well by the financial press yet it is a highly important financial planning issue.
- Why not addressed well? Geisler's opinion-too complicated!
- Exception: Kitces.com website. Two articles I recommend:
  - The Importance Of Finding Your Tax Equilibrium Rate For Retirement Liquidations
    - One Takeaway: Trigger income subject to low tax rate early in retirement
  - Harvesting Long-Term Capital Gains (taxed at 0%) versus Partial Conversions from IRA to Roth IRA (taxed at 12%)
    - My Takeway: Both strategies can be excellent early in retirement (especially before Social Security Benefits begin)

Tax-efficient Decumulation: Why important?

Client's nest egg can last significantly longer if done right!

- Rarely addressed well by most individuals.
- Proof - Kiplinger Oct. 2022 survey results to this question:
- *Which strategy do/will you follow for retirement withdrawals?*
- 50% answered either "Withdraw what I need" or "Not sure."
- ≈26% said "4% or less per year"
- Only 14% "Rely on professional financial adviser to tell me how much I can withdraw."
- Other 10% said either "Take out more when stock market is strong and vice versa" or "≥ 5%."

Conventional Wisdom: Tax-Efficient Decumulation/Withdrawals

- 1st) Decumulate (i.e., "Draw-down" or "Spend-down) all investments held outside retirement accounts (i.e., "Nonqualified")
- 2nd) Decumulate all Tax-Deferred Retirement accounts (e.g., 401(k)s, 403(b)s, 457s, Thrift Savings, IRAs—i.e., "Traditional")
- 3rd) Decumulate all Tax-Exempt Retirement accounts (i.e., all Roth retirement accounts)

- Of course, Required Minimum Distributions from 2nd source starting in year age 72 reached and Social Security Benefits starting between age 62 and 70—choice of taxpayer when.

Conventional Wisdom is WRONG!

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Intuition for why it is WRONG:

- **It's a waste to not use low tax rate brackets every year!**
  - **i.e., 1st and 3rd steps can result in not using 0%, 10%, and 12% tax rate brackets.**

- ***When you look at a moderate or higher wealth retiree (or retired married couple) tax return and Taxable Income is not at least at the <u>top of the 12% tax bracket</u>, you can do better!***
  - ***2023: <u>Married, Taxable Income =$89,450;</u> <u>Single, Taxbl. Inc. =$44,725</u>***

- **This mistake leads to far too much Income being taxed at much too high of a Rate in 2nd step!**

Big Fund Firm Advertising They Can do Better than Conventional Wisdom

<u>Schwab</u>: Take proportionally from 1st and 2nd steps until exhausted

- Save Roth accounts for last (just like Conventional Wisdom)
- *CONCLUSION: Pay too much tax earlier (i.e., waste low tax rates later) in retirement*

- *Conclusion: Can still do better* than Conventional Wisdom or "Schwab Intelligent Income" as shown in our article receiving Montgomery-Warschauer award

Another Big Fund Firm Advertising They Can do Better

Fidelity: Generally, take proportional withdrawals from all 3 steps every year

- *CONCLUSION: Does not defer tax on traditional retirement accounts. Also, pay tax on interest- and dividend- bearing investments for too many years*

- *Conclusion: Can still do better* than Conventional Wisdom or "Fidelity Tax Smart Withdrawals"
  - Not analyzed in our article because heavy advertising by Fidelity started after our article.

Tax-Efficient Decumulation

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Source: *Financial Analysts Journal (2015)* BY Cook, Meyer, Reichenstein and many other Reichenstein/Meyer articles:

- In the early years of retirement, decumulating taxable (i.e., nonqualified) account investments coupled with conversions from IRAs to Roth IRAs to fully use the 12% tax rate bracket (we will call it "Max_Out_12% tax bracket" is tax-efficient…

followed by, in the later years of retirement,

- Decumulating tax-deferred accounts (e.g., IRAs and 401(k)s) to fully use the 12% tax rate bracket coupled with withdrawals from Roth retirement accounts is tax efficient!

Summary: Every year use up 0%, 10% and 12% federal tax rate brackets

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How much total Income is the top of the 12% federal tax rate bracket in 2023 (assumes Standard Deduction)?

Married and both at least age 65: $118,150 Income

Single and at least age 65: $59,425 Income

Conclusion: If moderate or higher wealth, Income of at least this amount every year will lead to "nest egg" lasting longer (i.e., is more tax-efficient than LOWER Income)!

What about small or very small "nest egg"? Tax-efficient decumulation is:

Source: Geisler & Hulse (2018) article in Journal of Financial Planning:

"Max_Out_10% Tax Bracket" Strategy (i.e., Taxable Income only to the top of 10% rate bracket) works great for smaller "nest-egg"

What is 10% tax bracket? It's Income up to the Standard Deduction+ 10% bracket ($25,700 if Single, $50,700 if Married) if age 65 or over in 2023

"Max_Out_0% Tax Bracket" Strategy (i.e., Taxable Income only to top of 0% rate bracket) works great for significantly smaller "nest-egg"

What is 0% tax bracket? It's Income up to the Standard Deduction ($14,700 if Single, $28,700 if Married) if age 65 or over in 2023

Scenario:

Source: Geisler & Hulse (2018) article in Jrnl. of Financial Planning:

Single individual whose $1.5 million portfolio includes:

$450,000 Taxable account (tax basis is the same amount)
$825,000 Tax-deferred account (TDA) (e.g., IRA)
$225,000 Tax-exempt account (TEA) (e.g., Roth IRA)

Result:

Source: Geisler & Hulse (2018) article in Jrnl. of Financial Planning:

Scenario: Retires at Age 66. Starts Social Security Benefits at 70	% difference in portfolio life
	Tax Efficient beats Conventional Wisdom by:
Base ($1.5 M: .45 M taxable; .825 M IRA; .225 M Roth IRA)	+5.6%

i) Smaller and ii) Much Smaller Nest-Egg Scenarios (same proportions but i) $600K or ii) $300 K portfolio) and Results:

Source: Geisler & Hulse (2018) article in Jrnl. of Financial Planning:

	% difference in portfolio life
Scenario	"Max_Out_Low Tax Bracket" beats Conventional Wisdom:
i) Smaller Nest Egg ($0.6 M)	+8.6%
ii) Very Small Nest Egg ($0.3 M)	+8.5%

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Reasons why "Max_Out_12% tax bracket" for moderate nest egg is tax-efficient

1) After the 12% federal tax rate bracket is 22%, much higher!

Avoid this 10 percentage point higher federal tax rate!

2) Avoids the worst part of the Social Security "Tax Torpedo"!

Everyone collecting Social Security faces "Tax Torpedo" which is the higher *effective* federal tax rates as Soc. Sec. becomes Income

- It Avoids the 40.7% *effective* federal tax rate (ETR) on the phase-in of Social Security Benefits taxation, and
- Avoids 49.95% ETR if taxpayer has any long-term capital gain or qualified dividends

What are these 40.7% and 49.95% ***effective*** federal tax rates???
First, reminder of 2023 federal tax rates: Single

If taxable income is:	The tax due is:
Not over $11,000	10% of taxable income
Over $11,000 but not > $44,725	$1,100 + 12% of excess over $11,000
Over $44,725 but not > $95,375	$5,147 + 22% of excess over $44,725
Over $95,375 but not > $182,100	$16,290 + 24% of excess over $95,375
Over $182,100 but not > $231,250	$37,104 + 32% of excess over $182,100

BUT, when Soc. Sec. is phasing in as Income, 10%, 12%, & 22% rates effectively become the following rates:

Once social security benefits (SSBs) have begun, the federal tax rate brackets of 10%, 12%, 22%, 24% change to effective marginal federal tax rates (ETRs) of *15%, 22.2%, 40.7%*, then back down to 22%, 24%...

Further, if any qualified dividends or long-term capital gains income, an ETR of 49.95% is sandwiched between 22.2% & 40.7%.

Who do these higher (i.e., *15%*, *22.2%*, *maybe 49.95%*, *& 40.7%)* ETRs apply to?

EVERY taxpayer with taxable Social Security benefits!

- 60 M taxpayers collect Social Security benefits:
  - 40 M have 0% SSBs included in Income (i.e., none "taxable")
  - 10 M have > 0% and < 85% SSBs taxable. They are inside SS Tax Torpedo. i.e., ETR is either *15%, or 22.2%, or maybe 49.95%, or 40.7%*
  - 10 M have 85% (i.e., maximum taxable SSBs) included in Income.
  - They are above the SS Tax Torpedo ETRs—but such ETRs applied to them!

Some (not maximum of 85%) Social Security Benefits are taxable and "Max_Out_12%" tax bracket decumulation strategy implemented

Given these facts (i.e., top federal tax rate bracket of 12%), Effective marginal federal tax rate (ETR) is 22.2% *which* *Avoids the 49.95%, & 40.7% ETR!*

This is the 2nd reason Max_Out_12% tax bracket strategy works well!

A time to NOT follow strategy to "Max_Out_12%" tax bracket?

Yes. Possibly when retired early (pre age 65) and on ACA (i.e., "ObamaCare") health insurance and able to receive a large amount of premium tax credits (i.e., federal assistance) (i.e., "subsidy") to help pay monthly premiums

- *Reason: Lower Income can increase "subsidy" a lot!*

Alternative Strategy—obtain Lower Income:

- *Don't do any conversions from IRA to Roth IRA, Instead…*
- *Sales of relatively high basis taxable investments*
- *Roth withdrawals*

"Tax Alpha": What a CFP should look for to tell client (or prospective client) they can add value

If in FUTURE, taxpayer's Taxable Income is consistently going put them in federal tax rate bracket of 22% to 37% once they turn age 72 (i.e., and both Required Minimum Distributions and Social Security are being received),

AND

Taxpayer is NOT doing "Max_Out_12%" tax bracket decumulation strategy NOW, CFP can add value (i.e., provide some "tax alpha"!

$44,725 if Single ($59,425 total income). $89,450 if married ($118,150 totalincome)

How many retirees would this apply to?

A LOT! What do retirees and most tax return preparers think is a good idea?

Low Taxable Income and Low Tax for this year! – NOT a GOOD IDEA!!!

Montgomery-Warschauer Award article – Geisler, Harden, and Hulse (2021):

Case B's ASSUMPTIONS:

Single, SSBs begin at age 70. Retire at 65.

Nest-egg =$1M: $700K IRA; $100K Roth IRA; $200K taxable-basis 1/2

Strategy: Harvest long-term capital gains on taxable investments; partial conversion from IRA to Roth IRA; some IRA withdrawals -- pre age 70… up to the middle of the 22% tax rate bracket

NOTE: Social Security Benefits Tax Torpedo's Higher Effective Tax Rates does NOT apply the first 5 years… so Trigger Income!

RESULT: Avoid worst part of SS Tax Torpedo ≥ age 70!

Case B's RESULTS

***typo in article**, Tax Efficient strategy should be called "Avoid Worst Part of SS Tax Torpedo" but it is mistakenly called "Avoid IRMAA Bump"*

Case B scenario:	% difference in portfolio life
Comparisons: Tax Efficient versus Schwab and versus Conventional Wisdom	Tax Efficient Strategy beats Schwab & C.W. by:
Nest-Egg ($1 M: 20% taxable (tax basis is half); 70% IRA; 10% Roth IRA). Annual After-Tax Cash Flow = $75,000	9%, 11%, respectively

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What about client with higher than moderate wealth? What's tax-efficient Decum. Strategy?

Two important considerations:

- Avoiding or Reducing IRMAA Tax as long as on Medicare, if possible
- Avoiding being taxed at too high of a rate over the remaining years

    - Consider triggering Income (e.g., convert part of IRA to Roth IRA), before age 72 when RMDs start, to the top of the 24% federal tax bracket? Why?

    - The more Income triggered now (before age 72) at lower tax rates, the less Income taxed at significantly higher rate later (& longer the "nest-egg" lasts)!

Reminder of 2023 federal tax rates: Single
Married Filing Joint Taxable Income amounts double!

If taxable income is:	The tax due is:
Not over $11,000	10% of taxable income
Over $11,000 but not > $44,725	$1,100 + 12% of excess over $11,000
Over $44,725 but not > $95,375	$5,147 + 22% of excess over $44,725
Over $95,375 but not > $182,100	$16,290 + 24% of excess over $95,375
Over $182,100 but not > $231,250	$37,104 + 32% of excess over $182,100

Geisler, Harden, and Hulse (2021) again

Case C's ASSUMPTIONS:

Single, SSBs begin at age 70. Retire at 65.

Nest-egg =\$3M: 45% IRA; 10% Roth IRA; 45% taxable (basis ½)

Strategy: Harvest long-term capital gains on taxable investments; partial conversion from IRA to Roth IRA; some IRA withdrawals -- pre age 70 up to the TOP of the 24% tax rate bracket!

- Why some IRA withdrawals? That does not sound tax-efficient.
- Answer: Client's cash needs & also wanting Income to top of 24% bracket

RESULT: Avoids having Income taxed at relatively high rate ≥ age 70!

Case C's RESULTS

Case C:	% difference in portfolio life
Comparisons: Tax Efficient versus Schwab and versus Conventional Wisdom	Tax Efficient Strategy beats Schwab and C.W. by:
Nest-egg ($3 M: 45% taxable (tax basis is 1/2); 45% IRA; 10% Roth IRA). Annual After-Tax Cash Flow = $167,000	5%, 2%, respectively

Further Discussion of Case C's Results

The tax-efficient strategy in the last two slides focused on the following:

- Avoiding being taxed at too high of a rate over the remaining years

There was a second tax-efficient strategy also used in Case C (i.e., $3M nest-egg). It focused on the following:

- Avoiding or Reducing "IRMAA Tax" (i.e., additional Medicare premiums)

- Coincidentally, just because of the facts, the latter strategy also beat Schwab and Conventional Wisdom by 5% and 2%, respectively.

More on Avoiding or Reducing “IRMAA Tax”

- 2023 Medicare Parts B & D Additional Premiums (i.e., IRMAA “Tax”) are based on 2021’s *total Income* (i.e., typically, Form 1040’s Gross Income + Muni bond interest)…
- So, 2025’s IRMAA “Tax” is based on 2023’s *total Income*

How can a CFP assist clients in avoiding IRMAA “Tax”?

- Annual Income Planning
- Doesn’t the client’s tax return preparer do this?
- Typically, No.

How much is IRMAA “tax” per person on Medicare?

2023 Medicare Parts B & D Additional Premiums (i.e., IRMAA Tax”) are based on 2021’s *total Income*

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Single Tax Return	Married filing Joint Tax Return	MONTHLY Additional Premiums	ANNUAL Additional Premiums
Less than or equal to $97,000	Less than or equal to $194,000	$0	$0
Greater than $97,000 and less than or equal to $123,000	Greater than $194,000 and less than or equal to $246,000	$78	$937
Greater than $123,000 and less than or equal to $153,000	Greater than $246,000 and less than or equal to $306,000	$196	$2,356
Greater than $153,000 and less than or equal to $183,000	Greater than $306,000 and less than or equal to $366,000	$314	$3,773
Greater than $183,000 and less than $500,000	Greater than $366,000 and less than $750,000	$433	$5,191
Greater than or equal to $500,000	Greater than or = to $750,000	$472	$5,664

How do you do "Income Planning"?

Manage "*total Income*" (per tax return) each year to avoid IRMAA "tax" two years later

Determine Decumulations (i.e., distributions/withdrawals/sales) strategy that increases *total Income* early in year. Savings per year: often $1,460/person & /jump

In early years, if additional spending needs best choice is to pull from:

- Savings or Money market accounts or CDs;
- Stocks (stock funds) or Bonds (bond funds) that net to $0 Income

In later years, if additional spending needs pull from Roth accounts

NOTE: Good reason to avoid actively managed mutual funds invested in stocks

- Their uncertain capital gain distributions can ruin Income planning!

So, 2 ways CFPs can Add "Tax Alpha" (i.e., value)

<u>Income planning</u>: Manage "*total Income*" (per tax return) each year to avoid IRMAA "tax" two years later

Income Planning is tied into <u>Tax Efficient Decumulation planning</u> each year to reduce income taxes paid over the years

Thanks!

If you want to talk, I'll be around now but have to leave after I talk to people who want to talk now.

I have a wedding rehearsal dinner I need to get to in Pittsburgh.

After this morning, just email me at:

geisler@iu.edu

Or call me at 812-855-3834