Optimal Tax-efficient Retirement Income and Lifestyle Planning: Making the Most of One’s Nest Egg (Part II)

INFORMS New York Metro
Wednesday, December 18, 2013

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Outline

- Motivation for Service Development \(\ldots\) Slides 3-5
- Original Process For Planning Retirement Withdrawals \(\ldots\) Slides 6-8
- Enhancements \(\ldots\) Slides 9-11
- Benefits \(\ldots\) Slides 12-13
- Typical Scenario Results \(\ldots\) Slides 14-30
- Future Development \(\ldots\) Slide 31
Questionable Advice

Prior to retirement, I did NOT get the best planning advice

Wealth Manager, CPA cited Common Rules:
- Initially withdraw “safe” amount, increase annually by inflation
- Draw your taxable savings before tax-deferred
Motivation For Service Development

- Complicated Tax Issues
  - Tax deductions and exemptions offset taxes on tax-deferred withdrawals
  - Higher tax brackets for delayed tax-deferred withdrawals due to federal required minimum distributions (RMDs) starting at age $70^{1/2}$
  - Taxable savings leverage:
    - Capital gains strategies
    - Managing capital losses
  - Impact of Roth conversions

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Motivation For Service Development

- More problems
  - Lifestyle issues: withdrawing a “safe %” implies adjusting lifestyle to what’s left after taxes
    - More sensible to figure what is needed to live a desirable lifestyle; then plan withdrawals for high savings growth; then assess risk “safety”
  - Investment strategies: portfolio distributions vary depending on tax treatment, resulting in different ROIs and volatility risk for different account types
  - Accounting for and evaluating impact of other income sources
provide decision support for retirees and their wealth managers in planning retirement withdrawals.

- Use mathematical optimization to:
  - Determine amount to withdraw from each wealth source
  - Assure satisfaction of:
    - Before-tax expense specifications
    - Federal RMD constraints
  - Approximate federal income taxes as an integral part of the process to maximize final accumulated wealth (Final Total Account Balance – FTAB)
Withdrawal Plan Determination

FIXED DATA
Age, Account Values, Tax info, etc.

DISCRETIONARY DATA
Before-tax Expenses, Average Account RORs

DATA

OPTIMIZATION MODEL
(e.g., linear programming)

FEASIBLE SOLUTION?

YES

OPTIONAL:
Risk Analyses
(e.g., Monte Carlo Simulation)

ACCOUNT WITHDRAWALS

SELECTED PLAN
Selected From OPTIMAL PLANS

RE-EVALUATE
Before-tax Expenses? RORs?

NO

IMPLEMENT PLAN

*patent pending
Income Sources

- Both spouses’ Social Security start years, initial amounts
- Initial savings: taxable, tax-deferred savings (e.g., IRAs), tax-deferred fixed annuities

Anticipated annual RORs for each account
Annual expenses, with itemized deductions sub-totaled
Fixed: birth dates for spouses, planning horizon of 25 years, federal tax constants, inflation rate
Data

- Income sources added
  - Earned and other taxable
  - Tax-free
- Taxable income deductions, capital losses
- Account sources and characteristics
  - Addition of tax-free: Roths, munies
  - Specification of long term capital gains sources for taxable savings
  - Proportions in cash, stocks, bonds for use in MC
Process

- Married or single use
- Choice of planning horizon: 15 – 30 years
- Long term capital gains included in tax computation
- Roth conversions/withdrawals:
  - Prohibit all, or
  - Specify annually-- either limit or unlimited

Monte Carlo risk assessment

- Income, initial account levels, living expense data fixed for each simulated scenario; only annual RORs vary randomly
- MC statistical results compared to plan based on anticipated RORs to confirm if plan within anticipated risk
Enhancements: Results

- Added annual results
  - Taxed and tax-free income sources
  - Annuity use details
    - Amount converted to 10 year fixed or lifetime
    - Amount of payments from all annuities
    - Future annuity payments
  - Contributions to tax-deferred
  - Roth conversion amounts
  - Tax-free withdrawals

- Monte Carlo
  - Sustainability percent
  - Selected statistical account balance trends
Benefits

- Tax-efficient vs. Other methods
  - To *retirees*:
    - Greater retirement wealth
    - Focus on meeting *desired* lifestyle income needs
    - Fast, flexible evaluation of impact of alternative lifestyle and/or investment scenarios
    - Results feedback supports wide range of financial and lifestyle decisions, including
      - Optimal management of retirement assets and expenses
      - Property sales
      - When to start Social Security
Benefits

- Tax-efficient vs. Other Methods
  - To financial planners:
    - Greater assets under management
    - More assets under management for longer time period
    - Client loyalty and asset retention
    - Higher new client potential
Typical Scenario

- **Fixed Data**
  - A couple: Max – age 61, Melanie – age 59
  - Planning horizon- 30 years
    - First 4 years part time work
      - Combined annual earnings: $100,000
      - Includes annual payroll taxes: $6,000
  - **Initial Social Security**
    - Max: $24,000 starting 2018
    - Melanie: $14,400 starting 2020
    - Melanie’s pension: $15,000 starting 2016
  - Assumed inflation rate: 2.3%
Savings Data

- Initial savings: $1,342,000 split
  - Taxable savings/investments: $102,000
    - Anticipated ROR: 3.1%, Interest: 23%; LTCG: 41%; Growth: 36%
    - 42% Stocks, 11% Bonds, 47% Cash
  - Tax-deferred savings: $1,140,000
    - Anticipated ROR: 5.1%
    - 36% Stocks, 64% Bonds
  - Tax-free Roths: $100,000
    - Anticipated ROR: 6.1%
    - 25% Stocks, 75% Bonds
Typical Scenario

Living Expenses + Payroll Taxes
(Excluding Federal Income Taxes)

Anticipated total over 30 years 7% less than CR

Reduce travel, entertainment, car expense after 2031

Mortgage Ended 2023
Scenarios Evaluated
1. Common Rule (CR)
   ▶ Taxable first, then tax-deferred, then tax-free
2. Baseline Tax Efficient (TE)
   ▶ CR expenses, itemized deductions replace standard
   ▶ Optimization model determines withdrawal sequence
3. Scenario 2 with detailed expenses
4. Scenario 3 with Roth Conversions
5. Scenario 4 with some tax-deferred annuities
Scenario 1: Common Rule

Total Account Balances

- **FTAB**: $492,853
- **% Sustainable**: 73%
- **Total taxes**: $567,741
Scenario 2: Baseline Tax Efficient (TE)

Total Account Balances

FTAB: $713,734
% Sustainable: 76%
Total taxes: $417,224

Roth and other Tax-Free Savings
Tax-Deferred Savings
Taxable Savings
Scenario 2: Baseline Tax Efficient (TE)

Revenue Sources
Scenario 3: TE + Detailed Expenses

Revenue Sources

- Total Income
- Roth and other Tax-Free Savings Withdrawal
- Taxable Savings Withdrawal
- Tax-Deferred (non-Roth) Savings Withdrawal
- Anticipated Detailed
- Total Expenses
Scenario 4: Scenario 3 + Roth Conversions

Comparison of Account Balances and Roth Conversions
Roths vs No Roths

- Limited Roth Conversion
- Unlimited Roth Conversion
- Account Balances Unlimited Roths
- Account Balances Roths Limit $50K

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Scenario 4: Scenario 3 + Roth Conversions

Total Account Balances

FTAB: $1,251,429
% Sustainable: 85%
Total taxes: $404,631
Scenario 4: Scenario 3 + Roth Conversions

Revenue Sources

- Total Income
- Roth and other Tax-Free Savings Withdrawal
- Taxable Savings Withdrawal
- Tax-Deferred (non-Roth) Savings Withdrawal
- Living Expenses
- Total Expenses

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Scenario 5: Limited Roths + $600K To TDAs

Total Account Balances

- FTAB: $979,595
- % Sustainable: 93%
- Total taxes: $390,287
Scenario 5: Limited Roths + $600K To TDAs

Revenue Sources

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Scenario 5: Limited Roths + $600K To TDAs

Key Monte Carlo Account Balances Results

<table>
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Anticipated RORs | Average MC | Min MC | 25th %ile MC | Median MC | 75th %ile MC | Max MC

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Future Development

- Add assessment of account values prior to age 59\(\frac{1}{2}\) resulting in “lifetime” income planning
- Enhanced Monte Carlo methods
- Greater tax computation accuracy
- Scenario suite, including guidance in evaluating:
  - Age to start Social Security
  - Immediate annuity
  - Selling property
THANK YOU