



The Pothole in Income Distribution Planning (2009)

by

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This report reflects the expected modification in which the estate tax free amount that can pass to heirs will likely remain at the 2009 level of \$3.5 million (\$7 million per couple) with a top tax rate of 45%.

The entire financial services industry is concentrating on retirement income distribution planning -- and rightfully so since accumulation planning is only half the story. And by the time an individual or couple is ready for retirement, the accumulation game is over -- all that is left is income distribution planning.

So what's the pothole? Let's take the example of Matthew and Catherine Fox, age 65 and 60, in an assumed income tax bracket of 35.00%. In addition to their social security benefits, they have liquid assets available for retirement income consisting of the following:

- \$ 600,000 Certificate of Deposit -- assumed yield: 4.00%
- \$ 833,333 Municipal Bond Fund -- assumed yield: 3.50% (mgt fee of 0.35%)
- \$ 2,250,000 Mutual Funds -- assumed yield: 6.00% growth; 1% dividend (mgt fee of 0.80%)
- \$ 750,000 Matthew's 401(k) -- assumed yield: 8.00% (mgt fee of 0.80%)
- \$ 900,000 Catherine's IRA -- assumed yield: 8.00% (mgt fee of 0.80%)
- \$5,333,333 Total

Assume their financial adviser has determined that with this range of assets, \$200,000 is a supportable level of *after tax* retirement cash flow compounding by a 3.00% factor for inflation.

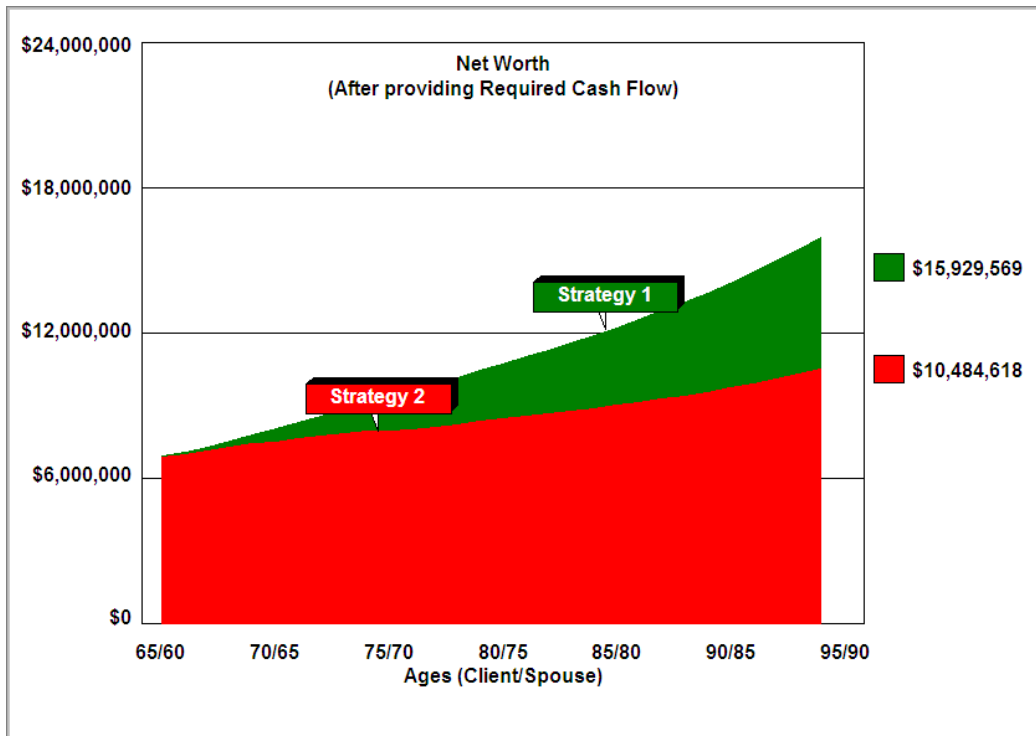
But first, the pothole. Once the adviser departs after having made this cash flow recommendation, the Foxes are really on their own to decide how to implement it. Imagine that it is the first day of the first month of their retirement. They need to withdraw \$16,667 (200,000/12). From which account do they take the \$16,667 -- and does it make any difference?

Let's have them access their liquid assets for the cash flow in the order listed on Page 1. We'll call this **Strategy 1** or "Good Logic".

We will next compare a plan that reverses the order of the liquid assets, as follows:

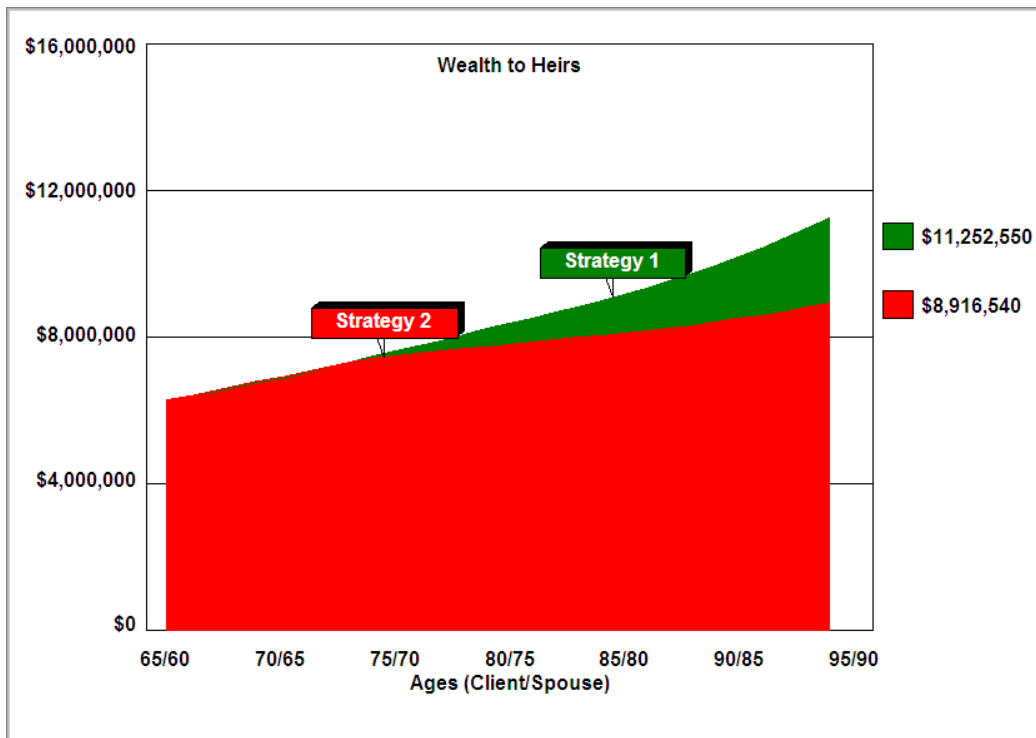
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We'll call this **Strategy 2** or "Bad Logic", and the graphic that follows illustrates the difference in the Foxes' projected Net Worth based on the two methods of accessing their liquid assets.



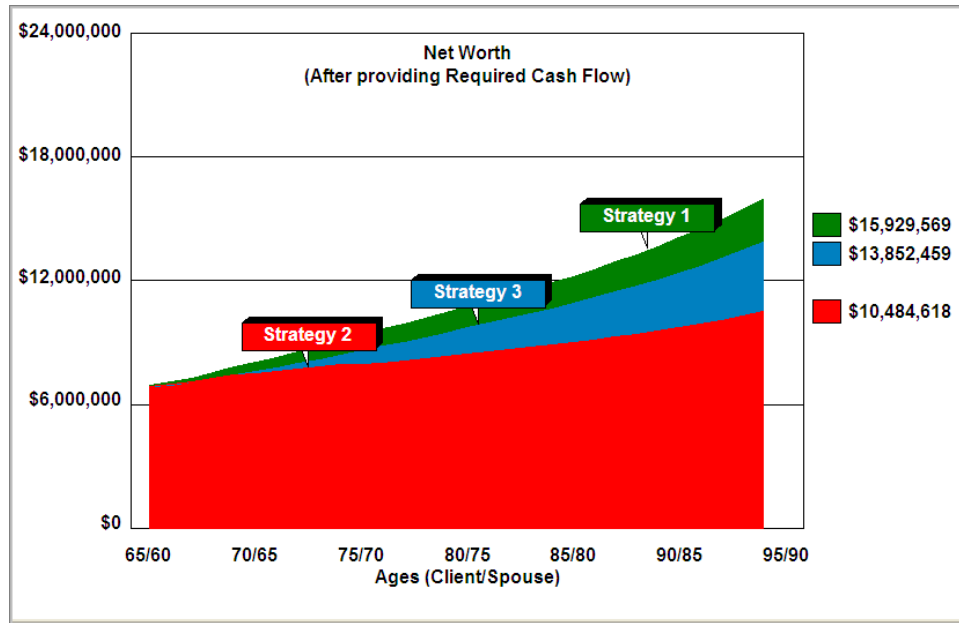
■ Strategy 1 - Good Logic
■ Strategy 2 - Bad Logic

Both withdrawal patterns meet the Foxes' cash flow needs, but **Strategy 1** produces long-range Net Worth 52% higher than **Strategy 2**. The graphic that follows compares the results of the two strategies for the Foxes' three children.



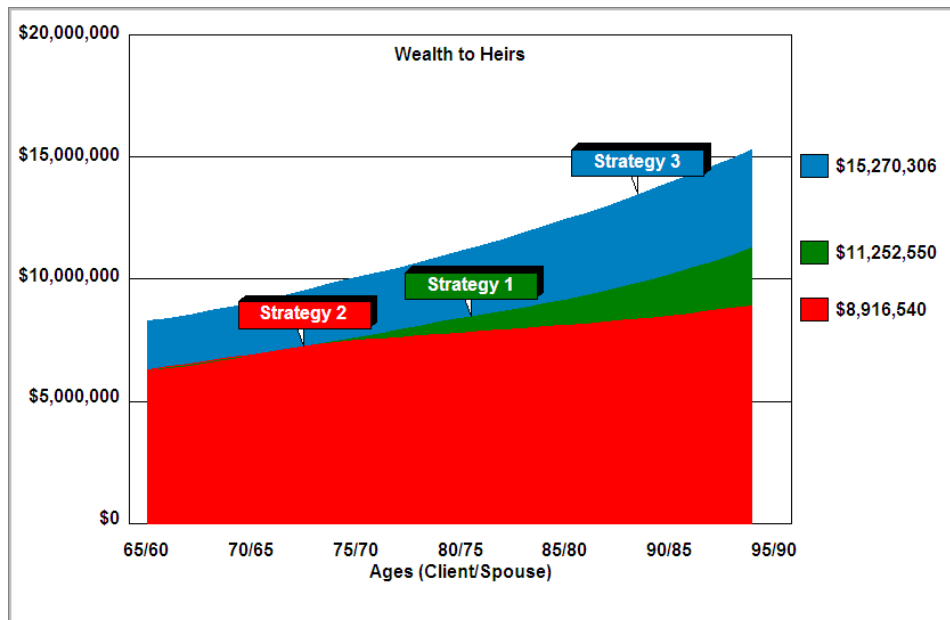
From a long-range perspective, is there *any* justifiable reason to short-change the Foxes' children by over \$2,300,000? Looked at from virtually every angle, there is not!

Variation #1: Good Logic provides financial room to include a gifting program for heirs. The following graphics add **Strategy 3** or “Good Logic + Gifts”, a design in which the Foxes make annual gifts to fund a \$2,000, life insurance policy owned by an irrevocable trust established on behalf of their children.



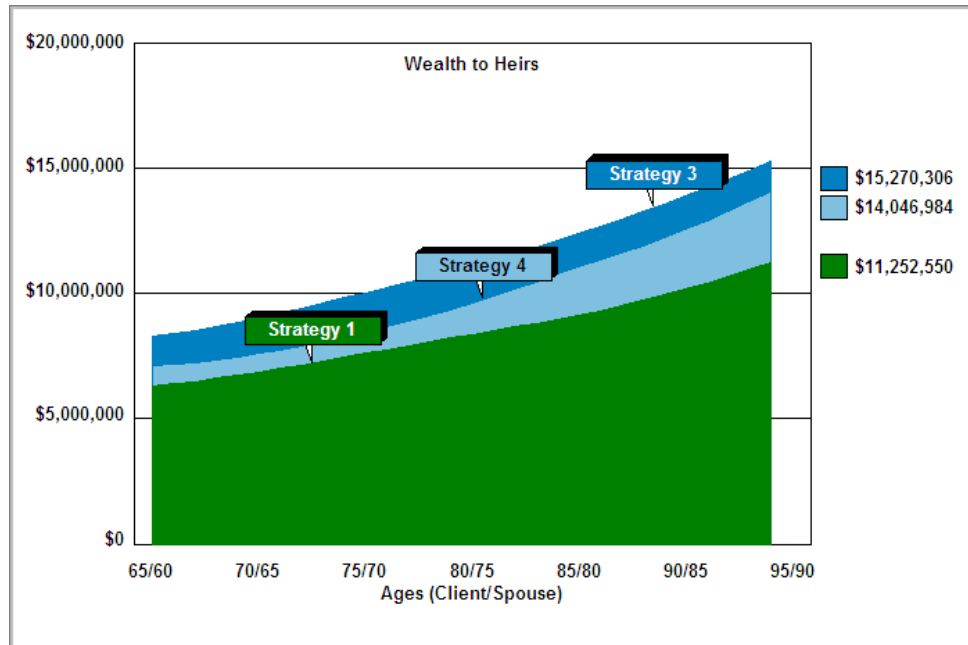
- Strategy 1 - Good Logic
- Strategy 2 - Bad Logic
- Strategy 3 - Good Logic + Gifts

The cash flow for the gifts associated with **Strategy 3** reduces their long-range Net Worth by \$2.1 million compared to **Strategy 1**-- significantly more favorable than the Bad Logic of **Strategy 2**; however, the graphic below shows how effective the gifts are for heirs.



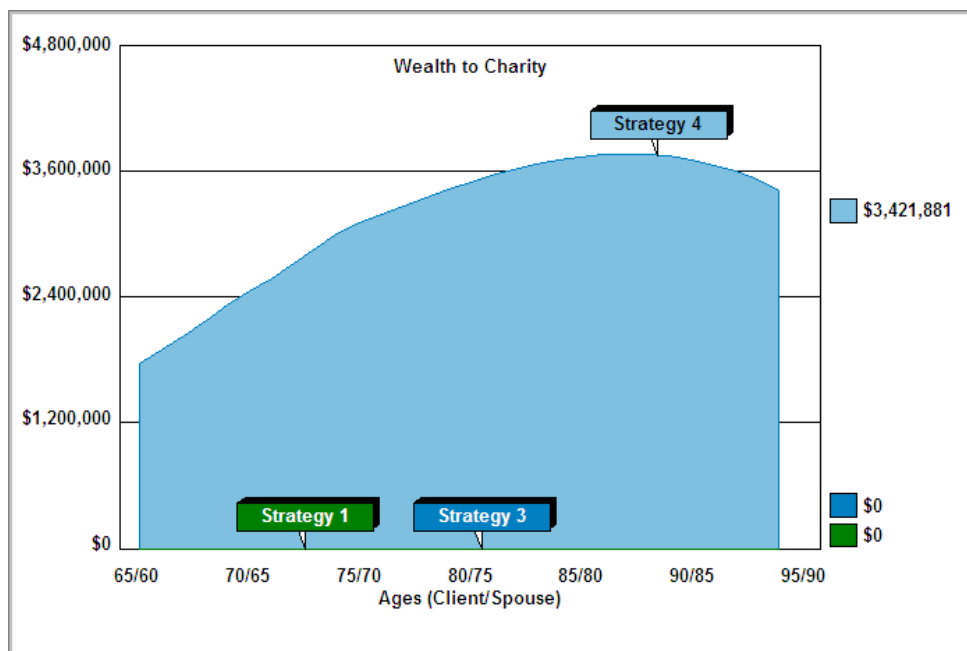
Results: **Strategy 3**, Good Logic + Gifts, increases long-range Wealth to Heirs by almost \$6.4 million (71%) over the Bad Logic of **Strategy 2**, and \$4 million (36%) over the Good Logic of **Strategy 1**. This is very effective wealth planning.

Variation #2: Between a combination of income and estate taxes, the Foxes' retirement plans are severely impacted at death. Let's have them designate their favorite charities as the ultimate beneficiary of their retirement plans at death. We'll call this **Strategy 4**, and since it does not involve their giving up access to their retirement plans during their lifetimes, their pre-death Net Worth is unaffected. See below for the impact on the heirs and charity.

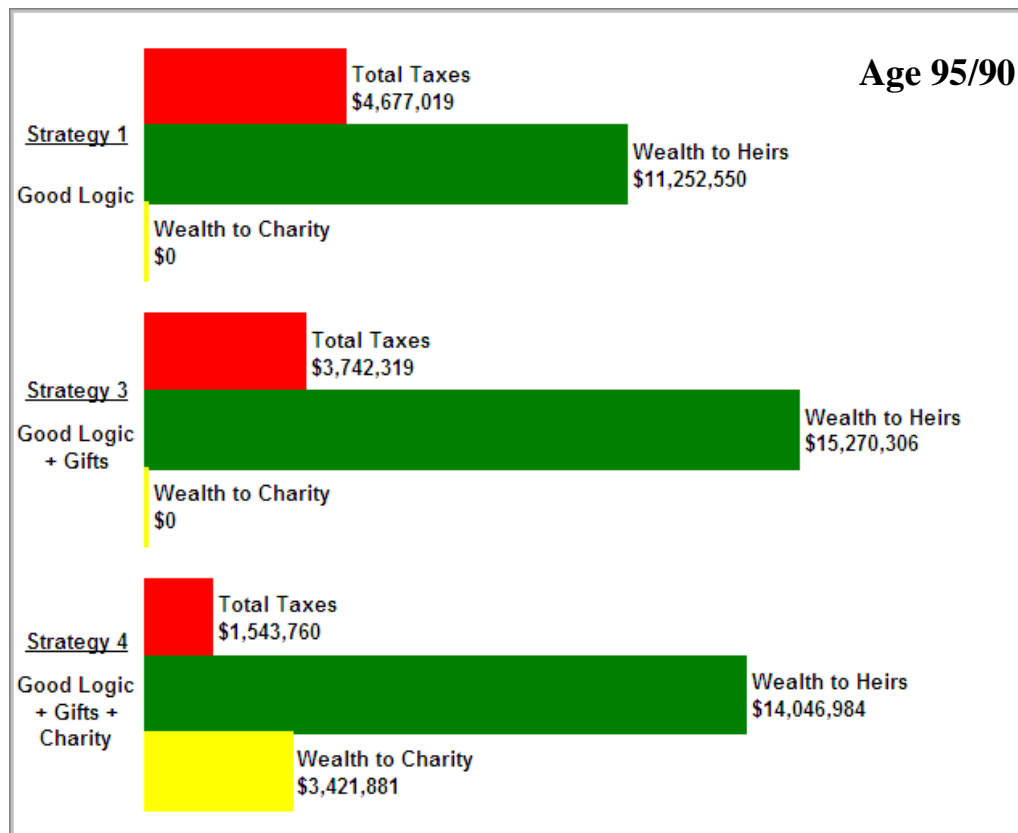


- Strategy 1 - Good Logic
- Strategy 3 - Good Logic + Gifts
- Strategy 4 - Good Logic + Gifts + Charity

Reducing their heirs' long range inheritance by \$1.2 million provides long-range wealth to charity of almost \$3.5 million -- a superb trade considering the Foxes' significant charitable motivation.



Below is another long-range way to look at this last scenario. It presents a compelling picture.



In all the strategies illustrated above, the Foxes' *after tax* retirement cash flow has been scheduled at the same level: \$200,000 a year compounded by a 3.00% factor for inflation.

The discussion in this article features only one of the several functions available within a Wealthy and Wise analysis. Whether the need is comprehensive wealth preservation, retirement, or charitable planning (or a combination), Wealthy and Wise is unique wealth planning software due to its comparative logic (“here’s what happens if you do this” versus “here’s what happens if you do that”). Most significantly, each planning technique involves confirmation that the client has an acceptable level of after tax retirement cash flow and residual Net Worth *because most people are more concerned with running out of money than any other financial issue.*

For Wealthy and Wise licensees who would like to review the data behind the several strategies in this report, an electronic System Workbook named “Pothole in Planning (2009).!WW” can be downloaded from our website at www.insmark.com. Click on Producers Center, then on the Workbook Download icon at the top of the next page. Then click on the Concept Library icon and look for the Wealthy and Wise file listed under “The Pothole in Income Distribution Planning” (2009).” You can load this Workbook into your System by double clicking on the file name.

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