withum WEALTH MANAGEMENT

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Financial Planning Newsletter

FEATURE

What To Do As You Approach Retirement

Inside the Issue

At Withum Wealth, we recognize that planning for retirement involves careful consideration and timely decision - making.

In this Fall edition of our Financial Planning newsletter, we explore key areas that will help you navigate the financial complexities as you approach retirement.

Inside this guide, you'll discover important insights on maximizing Social Security benefits, managing portfolio allocations, making the most of Roth conversions, and understanding Medicare. We also address the potential impacts of the Tax Cuts and Jobs Act's impending sunset and offer personalized strategies for safeguarding your investments as you move into this next chapter of life.

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WEALTH MANAGEMENT

What To Do As You Approach Retirement

For much of the past, retiring at age 65 was the norm. However, retirement looks different for each of us today. Many clients are choosing to retire later for a variety of reasons—whether it's the need to boost savings, a passion for their career, or a desire to stay engaged and avoid boredom. As you approach 60, it's crucial to reassess key areas of your financial plan: How much will you need to retire comfortably? When should you start taking Social Security? Is your investment portfolio aligned with your retirement timeline? Should you consider Roth conversions? And how do you navigate Medicare?

In this newsletter, we'll explore these important questions and offer guidance to help you refine your strategy. This article offers a broad overview to encourage thoughtful planning, but remember, retirement is personal - what works for one person may not work for another. A detailed, tailored wealth analysis is the best way to ensure you're on the right track.

A key starting point in retirement planning is understanding your retirement expenses. We need an accurate estimate of these to determine how much money you will need to retire. First, look at your detailed current expenditures. We can provide a worksheet to assist you with this. Then, consider what will change in retirement. For example, many retirees have increased travel expenses but spend less on work attire and commuting. You might want to help fund 529s for your grandchildren or buy a second home. Your Medicare expenses will vary based on your income level. This is just a small list of things to consider when developing a post-retirement budget.

Another question arises: At what age should we begin taking Social Security? When to take Social Security is both a quantitative and qualitative decision. It is quantitative to the extent that the monthly amount you can receive increases about 8% per year until age 70, and we can calculate when you'll "break even" if you begin taking it later than Full Retirement Age. For healthy clients with a family history of longevity (and no immediate cash need), it often makes sense to wait. Conversely, those with health concerns or fears about the sustainability of the Social Security system may choose to claim earlier (see page 5)

As you near retirement, it might make sense to shift your asset allocation to reduce risk, typically by increasing exposure to less volatile assets like bonds and cash. We use "might" because asset allocation should be tailored to individual circumstances. For those with significantly more than enough money to cover their retirement expenses, the portion intended for beneficiaries can be invested more aggressively. Those who need growth to achieve their retirement goals may need to maintain higher allocations in equities. Assessing your individual needs and objectives with a wealth plan will enable us to determine the appropriate asset allocation for you (see page 7).

Roth conversions can be a powerful tool, especially if your income dips in the years between retirement and the start of Social Security or Required Minimum Distributions (RMDs). Again, everyone's situation is unique. Why convert? If most of the assets you have for retirement are qualified, you may have large Required Minimum Distributions you must take as you age. This could push you into high tax brackets, potentially even higher than during your working years. In this case, you would likely benefit from "smoothing out" your tax brackets, potentially saving significant tax dollars over the rest of your lifetime. This strategy also has the benefit of leaving your beneficiaries with untaxed distributions and is particularly attractive for those whose children are high earners (see page 9).

Even if you do not retire at age 65, you are entitled to Medicare. You are eligible for Medicare Part A (hospital coverage) if you are 65 or older and meet the citizen and residency requirements. You can purchase Part B (doctor visits, outpatient services, and preventive care); the cost depends on your income level. There are several decisions to make regarding the type of coverage and which prescription plan you prefer. For many more details and nuances related to Medicare coverage, please see page 16.

As you approach retirement, the most important thing you can do is create a wealth plan to assess your unique situation. Even if you are nearing the end of your work life, you can still do things to increase your chances of a financially secure retirement. If you are interested in working with a financial planner to create a wealth plan, please contact us. We genuinely enjoy guiding our clients through this period of their lives and believe that with the right plan, your retirement can be a time of financial security and peace of mind.

Maximizing Social Security Benefits:

What You Need to Know for Financial Planning

Are you planning for retirement? While there are many factors to consider, Social Security is a cornerstone of retirement planning, providing a reliable source of income that helps retirees maintain their standard of living. However, the timing of when to claim benefits can significantly impact your retirement strategy. Those approaching retirement should take time to re-evaluate how Social Security fits into your broader financial plan.

One of the most critical decisions in retirement planning is choosing when to claim Social Security benefits. Many people assume they will start taking benefits at retirement. However, that does not have to be the case. You can begin receiving benefits as early as age 62, but doing so reduces your monthly payments. Not only will your benefit be reduced if you start before your full retirement age, you will also be penalized if you are taking your benefit before FRA and still have earned income. If you wait until your full retirement age (FRA), which ranges from 66 to 67 depending on your birth year, you'll receive your full benefit. By delaying benefits beyond your FRA up to age 70, your payout will increase, growing by about 8% annually. This makes waiting an appealing option for those who expect to live longer or who have other sources of income in the meantime. When deciding on timing, it's important to factor in your life expectancy, immediate financial needs, and spousal benefits. A longer life expectancy may justify delaying benefits to maximize lifetime income, while immediate financial needs might necessitate claiming early. If you're married, coordinating your benefits with your spouse's can also enhance overall retirement income.

When considering when to apply for Social Security, it's essential to approach it as part of a broader retirement strategy. Social Security will likely make up only a portion of your retirement income, so it's important to assess how it fits with other sources like pensions, IRAs, or investment accounts. Many people choose to do Roth conversions during early retirement years. Deferring Social Security benefits might make room for more conversions. Conversely, starting Social Security benefits earlier can provide cash needed to cover living expenses and taxes. This highlights the fact that each person's situation is unique. Be mindful of how Social Security benefits are taxed, as depending on your total income, a portion of your benefits may be subject to federal taxes. This tax impact can influence the timing of your claims, especially if you have substantial income from other retirement sources. Your longevity and health should also factor into your decision. If you're in good health and have a family history of longevity, delaying Social Security may lead to higher lifetime income. On the other hand, if health concerns are present, it may be more practical to claim earlier. Social Security benefits are adjusted annually for inflation through Cost-of-Living Adjustments (COLA), but you'll need to ensure that your other income sources are also protected against inflation to maintain your purchasing power.

It's also worth considering estate planning when deciding when to claim Social Security. A higher-earning spouse delaying their benefits can lead to increased survivor benefits for the lower-earning spouse, which may provide additional income security later in life. Working closely with your financial advisor can help you model different scenarios for the optimal Social Security claiming strategy. We can analyze how starting benefits at different ages will affect your overall financial situation, considering factors like taxation and the potential impact of other retirement accounts.

Ultimately, Social Security is just one piece of the retirement puzzle. With thoughtful planning and consideration of your unique financial situation, you can maximize your benefits and ensure a more secure retirement. Integrating Social Security into your overall financial plan will help you make more informed, strategic decisions as you approach your golden years.

Portfolio Allocation Considerations When Approaching Retirement

As you near retirement, how you position your portfolio becomes increasingly important. Proper asset allocation can help ensure that your retirement savings will sustain you throughout your retirement years, providing both growth and income.

Asset allocation involves dividing your investment portfolio among different asset classes, specifically stocks (equities), bonds (fixed income), and cash. The goal is to balance risk and potential reward. The first step is determining your risk tolerance, portfolio distribution needs, and time horizon for needing the funds (see our companion piece on retirement withdrawal strategies). Another consideration is the growth rate required to ensure the funds meet your needs over time. Don't let risk tolerance alone dictate your allocation, as you might end up with a portfolio that misses the mark in meeting your future living expenses.

Historically, stocks have outperformed bonds, and bonds have outperformed cash over the long-term. However, market behavior is more uncertain in the short-term, and stocks have tended to be more volatile than fixed income and cash. This volatility can be frightening, especially when you must use your portfolio to meet month-to-month living expenses in retirement.

The average market downturn and subsequent recovery (to the previous high watermark) has been roughly three years. Of course, this is an average, and there have been longer (and shorter) recovery times. But using this as a rule of thumb and keeping enough years of living expenses in liquid, safe, shorter-term investments can help prevent the forced selling of equities or other longer-duration investments in a down market to meet spending needs. In a volatile market, having one year of living expenses in cash and 2-3 years in short-term investments can help you sleep at night, confident that your upcoming living expenses will be met and that your next meal isn't reliant on the market's direction.

Now that you are almost retired, it's time to go all-in on bonds, right? Not so fast! Remember that inflation can erode your purchasing power and that stocks can continue to act as the growth engine to help combat the pernicious impact of inflation. In retirement, your investment time horizon is your life expectancy. Hopefully, even at retirement, we have many years ahead of us—maybe thirty or more. So, while some of the nest egg is needed to fund near-term living expenses each year and you want to be mindful of you risk tolerance, you should consider devoting a portion of the portfolio to growth to help meet some of those longer-term funding needs as well. Stock investing has a place in most portfolios, even in retirement.

It's important to recognize that even within each asset class, there are also varying degrees of risk and reward. For instance:

- **Equities:** This asset class might include small-cap, mid-cap, and large-cap companies, as well as international stocks. Each segment carries its own risk profile and potential for returns.
- **Fixed Income:** This category can encompass bonds with different maturities, different issuers, and varying credit qualities. Each type of bond will have different risks, potential income/return profiles, and might react differently to changes in interest rates and economic conditions.
- **Cash & Cash Equivalents:** Cash equivalents are short term investments such as: money market funds, CDs, or T-bills (Treasury issues with a maturity of a year or less). While cash investments tend to be lower in volatility, there can still be risks present within cash investments.

Therefore, it's crucial to not only monitor your overall asset allocation but also to pay close attention to the specific positions and potential risks within each asset class.

Making sure you have put aside your near-term living expenses in liquid, safe, shorter-term investments, and establishing an asset allocation that is comfortable, meets your investing needs, and considers your upcoming needs is of great importance. Reviewing your portfolio at least annually is critical to ensure it remains aligned with your overall plan. Market gyrations can cause your asset allocation to drift, so periodic rebalancing can help to maintain your desired positioning. Of course, be sure to consider any potential tax implications with your tax advisor before making any adjustments to your allocation either before or during retirement.

Approaching retirement is a significant milestone that requires careful planning and adjustment of your asset allocation. By tempering risk yet maintaining some growth potential and regularly reviewing your portfolio, you can help ensure a stable and secure retirement. Remember, the right asset allocation strategy is one that aligns with your unique financial goals, risk tolerance, and overall financial plan. Creating a plan and regularly revisiting it can be your anchor during turbulent market times, helping you to reach your long-term goals and enjoy retirement.

Timing Is Everything:
Making the Most of Roth Conversions

Planning for retirement can feel like navigating a maze of tax strategies, with each turn potentially saving—or costing—thousands of dollars. One major change at retirement is the absence of a paycheck. The resulting drop in taxes is often seen as a very welcome change. Alternatively, it can be taken as an opportunity. A well-planned Roth conversion strategy can take advantage of these low tax brackets while also reducing future tax bills. But like any good play, it's all about timing and strategy. Let's dive into how Roth conversions work and why, when done right, they can be a key part of your financial plan.

A Roth conversion involves transferring funds from a traditional retirement account, such as a Traditional IRA or a 401(k), into a Roth IRA. Unlike contributions to a Traditional IRA or 401(k), which are mostly made with pre-tax dollars and taxed upon withdrawal, Roth IRA contributions are made with "after-tax" dollars, allowing withdrawals in retirement to be tax-free, provided certain conditions are met. To put it more simply, pre-tax investments are being converted into post-tax investments, with taxes paid on the funds converted in the year of conversion. Let's take a closer look at how it works and the potential benefits:

MECHANICS OF A ROTH CONVERSION

1. **Conversion Process:** To convert, you simply take money from your Traditional IRA or 401(k) and move it to a Roth IRA. The amount converted is treated as taxable income for the year in which the conversion occurs. This means that if you convert $50,000, that $50,000 will be added to your taxable income for that year.

2. **Tax Implications:** When you convert, you'll owe income tax on the converted amount at your current tax rate. This is because the funds in a Traditional IRA or 401(k) have not yet been taxed. The key is to plan for the tax hit carefully. Ideally, convert in a year when you expect to be in a lower tax bracket or can cover the taxes without dipping into the converted funds.

3. **Timing:** Timing is crucial in a Roth conversion. Many people choose to convert during years when their income is lower, reducing the overall tax impact. For example, many clients have a "window" of several years to do Roth conversions after they retire but before they begin drawing Social Security or are required to take RMDs from pre-tax accounts. Additionally, converting when the market is down can be advantageous since the amount converted would be lower, thus potentially reducing the tax bill.

WHY ROTH IRA CONVERSIONS ARE EFFECTIVE

Roth IRA conversions offer several compelling advantages, making them an attractive option for many savers:

1. **Tax-Free Withdrawals:** The primary benefit of a Roth IRA is that qualified withdrawals are tax-free. This means that once you reach age 59½ and have held the Roth IRA for at least five years, you can withdraw both your contributions and earnings without incurring any taxes. For retirees who anticipate being in a higher tax bracket in the future, paying taxes now at a potentially lower rate can result in significant savings.

2. **No Required Minimum Distributions (RMDs):** Traditional IRAs and 401(k)s are subject to Required Minimum Distributions (RMDs) starting at age 73 (as of 2024). These mandatory withdrawals can push retirees into higher tax brackets. Roth IRAs, on the other hand, do not require RMDs during the account owner's lifetime, allowing the funds to grow tax-free for a longer period and providing greater flexibility in managing retirement income.

3. **Estate Planning Benefits:** Roth IRAs can also be advantageous from an estate planning perspective. Since Roth IRAs do not have RMDs, account owners can leave their investments to heirs who can then benefit from tax-free withdrawals. This can be particularly beneficial if heirs are in a higher tax bracket or if the account is expected to grow significantly. Due to recent SECURE Act changes, non-spouse heirs must empty inherited IRAs within 10 years, which increases the estate planning benefits of a Roth IRA, especially for heirs in high tax brackets.

4. **Tax Diversification:** Having a mix of taxable, tax-deferred, and tax-free accounts (such as a Roth IRA) can provide greater flexibility in managing your tax liability in retirement. This diversification allows you to strategically withdraw from different accounts based on your tax situation, potentially reducing your overall tax burden.

5. **Opportunity for Growth:** Funds in a Roth IRA can grow tax-free, which can be particularly advantageous during periods of significant market growth. By converting funds, you might position yourself to benefit from this growth without having to worry about future tax implications on the gains.

CONSIDERATIONS AND POTENTIAL DRAWBACKS

While Roth conversions can be highly effective, they do have potential drawbacks that should always be considered.

1. **Upfront Tax Cost:** The immediate tax cost of converting can be significant. It's crucial to have a

strategy to cover this cost without impacting your retirement savings. Paying the tax from sources outside the retirement account, such as from personal savings, is generally advised.

2. **Impact on Financial Aid:** For individuals with college-bound children, the increase in taxable income from a conversion could impact financial aid eligibility, as many financial aid formulas consider income from the previous year.

3. **Conversion Limits:** There are no income limits for Roth conversions, but high-income individuals should be mindful of how conversions impact their overall tax situation, especially if it pushes them into a higher tax bracket.

4. **Charitable Intentions:** If charitable gifts are intended, it is better to make them from a pre-tax retirement account than from a Roth account.

In summary, a well-timed Roth conversion can be a powerful tool in your financial planning toolkit, offering tax-free growth, flexibility in retirement, and potential estate planning benefits. However, every situation is unique, and the upfront tax cost requires careful consideration. Working closely with your financial advisor and CPA can help you determine the best approach, ensuring that a Roth conversion aligns with your long-term goals and maximizes the potential for tax savings.

Should You Pay Off Your Mortgage?

Many people wonder whether they should pay off their mortgage as they approach retirement. The decision to pay off your mortgage involves many key considerations that should be evaluated in order to make an informed decision.

While the appeal of being debt-free is evident, it is critical to weigh the pros and cons. This decision is highly dependent on an individual's specific situation and should include factors outside of pure mathematical calculations, such as the psychology of holding debt. Here are some key factors to consider when weighing the decision:

1. **The Mortgage Interest Rate & Opportunity Cost**

If your mortgage has a low interest rate (say 3 or 4%), holding the mortgage may be beneficial. Historically, the stock market or other investments have provided higher average returns than the cost of carrying that debt. If you can invest your money at a higher rate of return than your mortgage rate, you could grow your wealth faster by investing instead of paying off the mortgage.

Conversely, if your mortgage carries a higher interest rate (say 6% or more), then paying it off early could offer significant interest savings, which might outweigh the returns you'd get from other investments.

Remember: investments typically involve taking on investment risk as well. Not all investments are equal. Consider your investment options, expected investment returns, and risk tolerance.

2. Tax Considerations

Mortgage deduction: For homeowners in the U.S., one of the main financial incentives to keep a mortgage is the mortgage interest tax deduction. However, the 2017 Tax Cuts and Jobs Act (TCJA) significantly raised the standard deduction, meaning fewer taxpayers itemize their deductions. As a result, the tax benefits of mortgage interest may not be as significant as they once were, especially for those who no longer itemize.

If you do itemize your deductions, this can reduce your effective mortgage rate (or after-tax mortgage rate). In this case, it makes sense to compare your effective mortgage rate to the after-tax expected return on your potential investment(s).

Capital gains tax: If paying off the mortgage would involve selling investments, consider potential capital gains taxes that could impact the overall benefit of paying off the mortgage. This is especially important for folks with low-basis investments.

3. Liquidity

One of the biggest risks of paying off your mortgage early is losing liquidity. Once you pay off the mortgage, your money is locked into your home's equity, and accessing it can be difficult or costly. You'll need to take out a home equity loan or line of credit (HELOC) if you ever need to tap into that cash. This comes with additional fees, interest, and paperwork.

Sacrificing your emergency fund or tying up all your liquid assets in your home could be costly. It's crucial to maintain enough cash reserves to cover at least 3-6 months' worth of living expenses or for unforeseen financial emergencies.

4. Your Retirement Plans

Your stage in life plays a significant role in this decision. If you're nearing retirement, eliminating the mortgage may seem appealing to reduce your monthly expenses and provide financial stability. Many retirees strive to become debt-free before leaving the workforce.

However, if you have a long time until retirement, it might be more beneficial to continue with your regular payments and focus on building your retirement savings. The longer your money is invested in tax-advantaged accounts like IRAs or 401(k)s, the more time it has to grow and benefit from compound interest.

5. Other Debts: Prioritizing High-Interest Liabilities

Before paying off your mortgage, make sure you've addressed any high-interest debts such as credit card balances, personal loans, or even car loans. These types of debts often carry much higher interest rates than a typical mortgage.

6. Emotional and Psychological Considerations

While the decision to pay off a mortgage is often viewed as a mathematical decision, emotions can't be discounted. For many, the idea of living without a mortgage provides a sense of security and peace of mind. If paying off your mortgage gives you a strong sense of financial freedom and reduces stress, that psychological relief can be just as valuable as any financial return you might get from investing the money elsewhere.

7. The Inflation Factor

Mortgage payments are fixed, meaning that over time, inflation erodes the real value of your monthly payments. In essence, your mortgage becomes "cheaper" as your income rises with inflation while the mortgage remains constant. This phenomenon makes holding onto a low-interest mortgage more attractive in an inflationary environment, as your dollars are worth less each year, but your payment stays the same.

8. Prepayment Penalties

Some mortgages come with prepayment penalties that can be triggered if you pay off your loan early, including through refinancing. These penalties can be costly and negate the benefits of refinancing. Review your current loan documents to determine if a prepayment penalty applies and how much it will cost.

9. **Convenience of Property Tax and Insurance Payments**

Often, property tax and property insurance payments are bundled into one monthly payment with your mortgage. Paying off your mortgage could mean having to facilitate these payments on your own.

10. **Home Ownership**

Consider whether outright ownership of your home matters to you.

ABCs of Medicare

As you approach retirement, there are many factors to consider and decisions to make. Some might be fun, such as where you will travel or what hobbies you will pursue, but others might not be as exciting, like planning for Medicare. Understanding your different Medicare options and choosing the right approach for you is very important as you prepare for retirement.

Medicare, a federal health insurance for those aged 65 and older (Or those with a disability), is a crucial aspect of retirement planning. The process of enrolling in Medicare can seem daunting, but by starting at least six months before your 65th birthday, you can familiarize yourself with the program and the options available, putting you in control of your healthcare needs.

You must sign up for Medicare coverage during your initial enrollment period unless you have coverage from an employer. Your initial enrollment period starts three months before you turn 65 and ends three months after you turn 65. If you do not enroll during this period, you may have to wait to sign up and pay a late enrollment penalty. This penalty could be for a lifetime, and the longer you wait, the higher the penalty. You will be automatically enrolled if you are collecting Social Security before 65. If you are turning 65 and not yet collecting Social Security, you must go to:

https://www.ssa.gov/medicare/sign-up

If you're considering working past age 65 and your employer has more than 20 employees, you have the flexibility to delay enrolling in Medicare. This allows you to continue contributing to a Health Savings Account (HSA) if you have one. To avoid tax penalties, it's important to stop contributing to an HSA at least six months before applying for Medicare. After leaving your employer, you have an eight-month Special Enrollment Period (SEP) to sign up for Medicare Part B without facing a late enrollment penalty.

Medicare is divided into four parts:

- **Part A** – Helps cover hospital inpatient care, skilled nursing facility care, hospice care, and some home health care services. Most people do not pay a premium for this part as long as they paid Medicare taxes for at least ten years. There are deductibles and coinsurance amounts.
- **Part B** – Outpatient services, including doctor's visits, labs, medical equipment, and preventive services. Most people will pay a premium for Part B, which is determined based on your income. Part B also includes an annual deductible and coinsurance, typically 20%.
- **Part D** – Drug plan, which helps cover the cost of prescription drugs, including vaccines and shots.

You can get Medicare coverage in two different ways:

1. **Original Medicare** – Includes Part A and Part B. You can join a separate Medicare drug plan for drug coverage (Part D). You could also buy a supplemental policy (Medigap) to help cover out-of-pocket expenses and coinsurance. You can go to any doctor or hospital that accepts Medicare anywhere in the U.S. There is no annual limit on what you pay out of pocket unless you have a Medigap policy.
2. **Medicare Advantage** (also known as Part C) – This is a Medicare-approved plan from private insurers. It's a network plan, so you can only go to specific doctors within the network. It's important to check whether your doctors are in the plan before signing up. Sometimes, there might be additional benefits that Original Medicare does not cover, such as certain vision, dental, hear-

ing services, or even gym reimbursement. You pay the monthly Part B premium plus a possible premium for the specific plan. Some plans may have a $0 premium and may help pay a portion of your Part B premium. Plans have a yearly limit on what you pay for covered Part A and Part B services (with different limits for in-network and out-of-network services). Once you reach your plan's limit, you'll pay nothing for covered services for the rest of the year.

As you consider the different options available, think about your current medical needs, and evaluate potential future medical needs and scenarios to determine your best approach.

Tax Cuts and Jobs Act of 2017 Impending Sunset:
Estate Planning Considerations

The Tax Cuts and Jobs Act of 2017 (TCJA) made sweeping changes to tax laws. Most notably, it effectively doubled the federal estate and gift tax exemption from $5.49M to $11.18M as indexed for inflation (currently $13.61M per person). Due to the nature of the legislation, it is scheduled to sunset or expire on December 31, 2025, barring any changes from Congress. The time is now to optimize estate planning strategies before the law reverts to pre-TCJA levels.

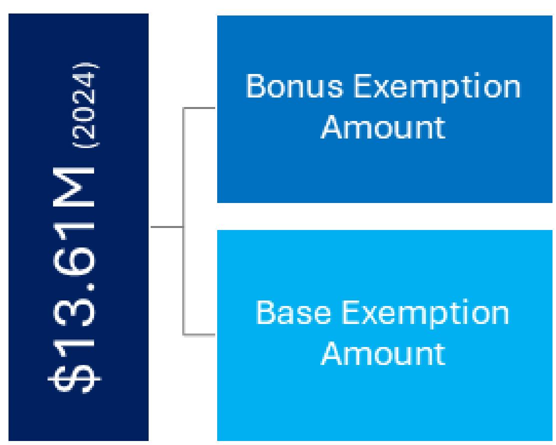
BACKGROUND

To be clear, what's at stake here is the opportunity for wealthy families to make permanent estate tax planning decisions, if appropriate, based on a temporary piece of legislation. To explain, some further background is required. Prior to TCJA, a married couple could shield as much as $10.98M from federal estate tax ($5.49 per individual), known as the base exclusion amount. The exemption amount was doubled in 2018 under TCJA, and, indexed for inflation, an individual can enjoy a $13.61M federal estate and gift tax exemption in 2024, or $27.22M for married couples. Assuming TCJA sunsets at the end of 2025, the federal estate and gift tax exemption is set to revert to $5M per person indexed for inflation, or approximately $7M in 2026. Due to the temporary nature of the law, the added exemption amount is commonly referred to as the bonus exemption amount.

After TCJA was signed into law there was some concern that individuals who decided to make large taxable gifts after 2017 and before 2026 could see those gifts clawed back and taxed under the lower estate exemption amount if death occurred after 2025. Thankfully, the IRS passed final regulations on this topic in 2019 which has come to be known as the "anti-clawback rule". The regulations prevent estates from being taxed on gifts that were within the exemption amount at the time of gifting.

Taking advantage of the bonus exemption amount is a fairly straightforward strategy. Since the bonus exemption amount is considered a "use it or lose it" tax provision, taxpayers truly benefit when making significant gifts in excess of the future exclusion amount. For example, consider an individual who makes an irrevocable gift of $7M today then dies in 2026 when the exemption amount has dropped to $7M. In this case, the bonus exemption expired before the date of death and there is no remaining exemption amount to be used by the estate. However, if this same individual were to gift $13.61M today, then the situation changes. There is still no remaining exemption amount for the estate, but this person already removed the bonus exemption from his estate in addition to the $7M base exemption. The anti-clawback rule prevents the bonus amount from being taxed. Taking advantage of the bonus exemption amount requires making an irrevocable gift between $7M and $13.61M by the end of 2025. In other words, think of fully maximizing gifting from the ground up. To get to the top floor the journey begins in the lobby.

Furthermore, married couples are encouraged to gift plan together, yet individually. Consider a couple who plans to gift away $14M before the end of 2025. If they each gift $7M they would defeat the purpose of taking advantage of the bonus exemption amount. A better solution would use one spouse's full $13.61M exemption now while the other spouse would gift the difference. Or, in anticipation of the 2025 inflation adjustment to the lifetime gift and estate tax exemption amount, one spouse gifts the full 2024 amount now, and then tops it off in January 2025, thus preserving the other spouse's full exemption for further consideration.



SAMPLE SCENARIOS

To help illustrate how the increased federal estate and gift tax exemption for individuals can work, consider the following examples:

Example	Death Occurs	Value of Estate	Lifetime Exemption	Taxable Gifts Made 2018-2025	Available Lifetime Exemption At Death	Taxable Estate
A	2024	$20M	$13.61M	$0	$13.61M	$6.39M
B	2024	$20M	$13.61M	$5M	$8.61M	$6.39M
C	2026	$20M	$7M*	$13.61M	$0	$6.39M
D	2026	$20M	$7M*	$5M	$2M	$13M
E	2026	$20M	$7M*	$10M	$0	$10M

*estimated federal estate and gift tax exemption after 2025, indexed for inflation

Example A – The taxpayer simply made no taxable gifts, but death occurs during the TCJA while the bonus exemption still applies, leaving a taxable estate of $6.39M.

Example B – The taxpayer made a $5M taxable gift and death occurs during the TCJA. The gift was less than the bonus exemption available, resulting in the same taxable estate of $6.39M as shown in Example A ($15M estate - $8.61M remaining lifetime exemption).

Example C – The taxpayer gifts the full $13.61M exemption amount before 2026, and death occurs after the TCJA sunset (after 2025) when the federal estate exemption would be cut roughly in half to about $7M indexed for inflation. Since the taxpayer fully utilized the base plus the bonus exemption before death, there is no further exemption available, leaving a $6.39M taxable estate.

Example D – This is similar to Example B except death occurs after the TCJA sunset (2026) when the exemption amount is estimated to be $7M. This results in a taxable estate of $13M ($15M estate - $2M remaining lifetime exemption), representing the "use it or lose it" nature of the bonus exemption and the concept of gifting "from the ground up".

Example E – This is similar to Example C, but the taxpayer gifts only $10M (perhaps representing the maximum that could be afforded), which uses up all of the base exemption and a portion of the bonus exemption, resulting in a $10M taxable estate.

PLANNING OPPORTUNITIES UNDER TCJA

We recommend that taxpayers begin by building a personal balance sheet with updated values of all the property owned and included in their estate. This provides an opportunity to evaluate the taxable gifts that have been previously made and filed on a federal gift tax return to determine how much remaining lifetime exemption is available. Taxpayers interested in making large lifetime taxable gifts should quantify how much they can afford to give away while maintaining their lifestyle. There's little sense in over-gifting if assets will be needed over the course of remaining life expectancies.

ANNUAL GIFT EXCLUSION

The current annual gift exclusion amount is $18,000 per person ($36,000 for married couples). This represents the maximum gift a person can gift without tapping into his/her lifetime gift and estate tax exemption. Gifting in this capacity can be a powerful strategy if it aligns with a taxpayer's estate planning goals. Consider a married couple with three children. They could gift $36,000 per child annually ($108,000 in total) without using up any of their lifetime exemption. If done over a ten-year period, these gifts would total over $1M (with no adjustment for inflation). Also, note that tuition and medical payments made directly to an educational institution or medical provider on someone's behalf do not count toward the annual gift exclusion limit.

PLANNING FOR SPOUSES

Gifting to trusts for estate planning purposes is a common method to accomplish multiple goals. Trusts can be created with a certain set of guidelines along with the appropriate legal terms to meet objectives. One strategy that has been gaining in popularity is the Spousal Lifetime Access Trust, or SLAT. Spouses may not want to gift away assets to other recipients, and a SLAT can provide benefits for the non-donor spouse. Essentially, one spouse gifts assets to the SLAT for the benefit of the other spouse. This can be an effective way to use up at least one spouse's bonus exemption amount prior to the sunset of TCJA. The trust provides certain benefits for the non-donor spouse during life before eventually distributing assets to the next generation. Although both spouses can create and fund SLATs for each other, it is highly recommended that the trusts be created differently so as not to be scrutinized by the IRS under the reciprocal trust doctrine.

PORTABILITY

To reiterate, for married couples, the combined federal gift and estate tax exemption is currently $27.22M. it is not uncommon that, upon the death of the first spouse, there may be some unused exemption amount left over. The unused exemption can be preserved by the surviving spouse by electing portability of the deceased spouse's unused exemption (DSUE). The executor of the deceased spouse's estate must file a federal estate tax return (Form 706) in a timely manner on which a portability election can be made. This unused exemption amount is then added to the surviving spouse's remaining exemption.

GIFTING TO THE NEXT GENERATION

Continuing with the trust theme, taxpayers can gift assets to an irrevocable trust for the benefit of their children. The irrevocable nature of the trust ensures that the gifted property is moved outside the grantor's estate. Individuals are encouraged to identify assets that have the most growth potential so that not only the initial value of the gifted assets is removed from the grantor's estate, but also the future appreciation.

Dynasty trusts, as the name suggests, focus on trust planning for families interested in creating a legacy for multiple generations. Beneficiaries of dynasty trusts often include grandchildren and generations beyond. This type of long-term estate planning introduces the concept of another category of taxation called the Generation Skipping Transfer Tax, which is beyond the scope of this article. Suffice it to say, planning for multiple generations requires quite the attention to the legal details.

PLANNING FOR LIQUIDITY

Families whose wealth will be subject to estate tax should plan for creating liquidity to pay the tax obligation. Life insurance can be a great solution for estate liquidity. Generally, taxpayers are advised to use a trust to own the life insurance policy rather than owning it outright. This technique helps ensure the death benefit is removed from the taxable estate. An Irrevocable Life Insurance Trust (ILIT), when properly structured and funded, can help accomplish tax-efficient estate liquidity. In addition, certain language in the trust can qualify premium payments gifted to the trust for the annual exclusion amount.

It's important to coordinate annual exclusion gifts, as ILIT beneficiaries are often the same individuals who may be receiving outright gifts from the same grantor.

GIFTING FOR INDIVIDUALS WHO HAVE EXHAUSTED THEIR FEDERAL EXEMPTION

For those who have already used up all their available lifetime federal gift and estate exemption, there are still ways to transfer wealth to the next generation without incurring more taxable gifts. A Grantor Retained Annuity Trust (GRAT) allows an individual to gift property to a trust in exchange for a fixed annuity payment for a set term or period of years. The gift tax calculation is determined by subtracting the present value of the annuity payments over the term of the trust from the initial value of the gift made to the GRAT. Any remaining assets left in the GRAT (the appreciation) after the last of the annuity payments is complete passes free of estate and gift tax to the beneficiaries.

SELLING RATHER THAN GIFTING

Another technique that may be appropriate in situations where lifetime gifting has been exhausted involves the sale of an asset to a grantor trust. This type of trust is referred to as an Intentionally Defective Grantor Trust (IDGT). It is purposely "defective" for income tax purposes with the simultaneous goal of removing the property from the grantor's estate should certain requirements be met. The grantor would identify an asset with potential for future growth to sell to the grantor trust. Since the trust and the grantor are treated as a single tax unit, there is no recognition of gain on the sale. In exchange, the grantor will take back a promissory note with annual payments over the course of the trust term. Again, there is no income tax applied to the promissory note payments to the grantor. Income tax payments made by the grantor for activity within the trust allow the trust to grow tax-free for the benefit of chosen beneficiaries. The income tax payments can be viewed as another method to further reduce the grantor's estate over time.

The potential sunset of the Tax Cuts and Jobs Act presents many potential complexities while opening the door for planning opportunities. We encourage clients to revisit their priorities as they relate to this legislation, their goals, and objectives.

For more information on the potential sunset of the Tax Cuts and Jobs Act, be sure to tune into our recent podcast, "What the Expiration of the 2017 Tax Cuts & Jobs Act Means For You" - and please do not hesitate to reach out to your wealth advisor to further explore this topic and actionable solutions.

Nest Egg Navigation
Estate Planning Considerations

This article is a companion to a recent episode of our Amplified Wealth – According to Plan podcast

In retirement planning, one of the key decisions is determining how to sustainably withdraw from your portfolio to maintain your lifestyle without depleting your nest egg. Financial advisors and academics have articulated dozens of retirement withdrawal strategies in recent decades, with none as widely-cited and enduring as "the 4% rule."

While the 4% rule is a valuable rule of thumb, it has its limitations. In this article, we'll explore the origins and value of the 4% rule, examine its limitations, and discuss how technology now allows financial planners to create personalized retirement withdrawal strategies that are flexible and can adapt over time.

ORIGINS AND LIMITATIONS OF THE 4% RULE

The 4% rule has its origins in a 1994 paper by financial planner Bill Bengen titled "Determining Withdrawal Rates Using Historical Data." Bengen's goal was to help retirees maximize their withdrawals while reducing the risk of running out of money. Using historical investment data, he examined withdrawal rates, portfolio allocations, and retirement outcomes. He concluded that retirees could safely withdraw 4% of their portfolio in the first year of retirement, adjusting for inflation each year thereafter, and expect their portfolio to last 30 years. This "rule" was based on a portfolio consisting of 50% stocks (the S&P 500) and 50% fixed income (intermediate-term U.S. Treasuries), and assuming annual rebalancing.

Bengen's 1994 paper did not explicitly refer to a "4% rule" — that monicker only became popular as financial advisors and the media digested and simplified his findings, which, to his credit, were much more flexible and nuanced. The simplified 4% rule, as it is commonly understood, suffers from several limitations. First, it's important to remember that it was created in a specific historical context and calculated based on market conditions and inflation rates from previous decades. In today's dynamic market environment, inflation rates and interest yields may deviate from historical norms.

Another major limitation is that it assumes fixed levels of both income and spending throughout retirement. Retirees' spending often varies significantly depending on life stage and health. For example, many retirees spend more in the early years of retirement during their "Go-Go years," followed by a decline in the "Slow-Go" years, and potentially a rise in healthcare costs during the "No-Go" years. The 4% rule doesn't account for these changing spending needs, nor does it account for unexpected one-time expenses. Inflation-adjusted income in retirement can also be similarly variable depending on factors such as when a retiree begins drawing on Social Security, size and timing of pension and annuity payouts, RMDs, and more.

Another significant limitation of the 4% rule is that it doesn't fully account for taxes. For simplicity and ease of calculation, Bengen assumed that the retirement portfolio was a traditional (non-Roth) retirement account and that taxes would be paid from the withdrawals. In the real world, clients may withdraw from an array of accounts with different tax treatments (IRA, Roth IRA, taxable brokerage, etc.) The bottom line is that any effective withdrawal strategy has to account for both pre-withdrawal income tax due and tax due on the withdrawal itself, when applicable.

Portfolio allocation (see page 7) also plays a crucial role in the success of the 4% rule. Bengen understood that retirees' risk tolerances and portfolio compositions can vary widely. While he found that a 50/50 portfolio was the safest risk-adjusted allocation to ensure not running out of money over a 30-year retirement period, this need not imply that it is the best allocation for everybody. More aggressive portfolios might offer higher returns and expected final portfolio value, but come with greater volatility. On the other hand, less aggressive portfolios may not generate the growth necessary to cover expenditures in the later years of retirement.

ALTERNATIVE WITHDRAWAL STRATEGIES

Recognizing the limitations of the 4% rule, financial planners and academics expanded on Bengen's findings and developed alternative withdrawal strategies that allow for greater flexibility. One such strategy is the guardrails approach developed by Jonathan Guyton and William Klinger, which starts with a higher withdrawal rate but adjusts the amount annually based on portfolio performance and previous withdrawals. This allows for higher spending when markets perform well and lower spending when markets underperform, ensuring that retirees don't outlive their assets.

Similarly, for retirees who are concerned about inflation, one option is to adopt a reduced inflation adjustment strategy, skipping inflation adjustments in years following market declines. This approach can help preserve the portfolio during challenging economic conditions, but it also requires the retiree to adapt to changing living standards.

Another strategy involves using Required Minimum Distributions (RMDs) as a withdrawal framework, where the withdrawal percentage increases as life expectancy decreases. While this method mirrors the structure required for retirement accounts like IRAs, it can also be applied more broadly. However, this approach may lead to greater volatility and less predictability in annual withdrawals.

While all of these "rule of thumb" strategies are useful, financial advisors nowadays have many technological tools at their fingertips that enable them to create personalized withdrawal plans for clients. Utilizing sophisticated planning software, advisors can easily account for factors like variable income sources (e.g., delayed Social Security, pensions without cost-of-living adjustments), variable spending needs (e.g., home repairs, weddings, or vacations), individual goals (such as leaving a legacy for heirs), and tax considerations. Planning platforms also enable ongoing monitoring and adjustments, ensuring that retirees stay on track even as their circumstances change and the market fluctuates. The ability to model different scenarios in real-time offers peace of mind and ensures that retirees can confidently manage their finances over the long term.

FLEXIBILITY IS KEY

The key to successful retirement planning is flexibility. Retirees must be prepared to adapt their withdrawal strategies based on their individual circumstances and changing market conditions. No two retirements are alike, and while a "one-size-fits-all" approach may succeed, it is unlikely to maximize value for a given retiree. By personalizing your withdrawal strategy and leveraging financial planning tools to monitor and adjust your over time, we can help you develop a retirement that is not only sustainable but also tailored to your needs and goals. Staying flexible and regularly reviewing your strategy with a financial advisor will help you navigate the uncertainties of retirement and maximize the enjoyment of your golden years. ▪

We hope you've found this newsletter insightful as you consider your financial future - particularly as you approach or navigate retirement. Preparing for retirement and understanding key topics such as Social Security benefits, Medicare, portfolio allocation, and tax planning are crucial steps to ensuring financial confidence in the years ahead.

For more information, be sure to check out our monthly podcast, **'Amplified Wealth: According to Plan'** where we hold insightful conversations on timely financial planning topics with various members of our Financial Planning Committee.

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WEALTH MANAGEMENT

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