Cracking The Nest Egg – Decumulation Strategies in Retirement

[This is one of my monthly columns I wrote for MDMag.com (formerly Physician Money Digest) about decumulation strategies. It originally ran here.]

Physicians and other high-income professionals may spend 20 to 40 years accumulating money inside tax-free (Roth), tax-deferred, fully taxable accounts, and even cash value life insurance.

By the eve of retirement, many of them are quite well-versed in the advantages and disadvantages of the various types of savings, investing, and retirement accounts with regards to the accumulation of money. However, very few have given a great deal of thought to the process of actually spending the money.

It is not that they cannot think of vacations to go on, toys to buy, and grandkids to spoil. It is simply that they have not determined the best way to take their accumulated nest egg and, in a tax-efficient manner, ensure it lasts longer than

they do while maximizing their ability to spend and the money they can leave behind to heirs and their favorite charities.

This article will discuss some of the main themes of the decumulation phase (as opposed to the much more straightforward accumulation phase) and give the individual investor some guidelines to determining how best to withdraw and spend his or her money.

Strategies For Decumulation in Retirement

Guarantee Your Needs With Annuities

An immediate annuity—particularly an *inflation-adjusted immediate annuity*—should play a role in the decumulation stage of most investors. Immediate annuities are similar to the increasingly rare employer-provided pension, whereby the employer pays you a certain amount every month in retirement until the day you die. Social Security is a similar form of annuity.

Many investors are not aware they can purchase their own annuity from dozens of insurance companies. Basically, you take a lump sum of money and give it to an insurance company in exchange for a guaranteed payment every month for the rest of your life.

Since pensions, Social Security, and annuities are guaranteed, they allow you to spend more of your money each year. A good general guideline for how much of a balanced portfolio you can spend each year in retirement, while having a reasonable expectation that the money will last, is 4%. So a $1 million portfolio can be expected to provide an inflation-indexed income of about $40,000 per year. However, if you annuitize a lump sum at age 70, you can enjoy an income of over 8% on a nominal basis, or over 6% on an inflation-indexed basis. In

short, by annuitizing, you can safely spend 50% to 100% more in retirement!

The basic concept here is that you guarantee your income needs using guaranteed sources of income like Social Security, a pension, or an immediate annuity. Then, you use your remaining portfolio of stocks, bonds, and real estate to provide for your wants, vacations, new automobiles, college money for the grandkids, charitable giving, and inheritances. Along these same lines, one of the best deals in annuities out there, at least for single people and the higher-earner in a couple, is to delay Social Security to age 70, at least if you enjoy good health.

Determining how much of your portfolio to annuitize can be difficult, but an honest assessment of your true spending needs should get you most of the way there. Also, be sure to consider the maximum annuity size your state insurance guaranty corporation will back in the event of insurance company bankruptcy. The guaranteed amount is state-specific, but typically in the $100,000 to $300,000 range. If you desire to annuitize more than this, you may wish to purchase annuities from more than one company.

How to Approach Required Minimum Distributions

A typical investor will arrive at retirement with a tax-deferred account, a smaller tax-free or Roth account, and a taxable investment account of some size. Prior to age 70, the investor can withdraw from each of these accounts in any manner he or she should so choose.

Beyond age 70, the investor is required to at least withdraw the required minimum distribution (RMD) from the tax-deferred account. This amount is as small as 3.6% of the portfolio at

age 70 but rises to 5.3% at age 80, 8.8% at age 90, and 15.9% if you are lucky (or unlucky) enough to live to 100 years.

Just because you withdraw that money from the tax-deferred account doesn't mean you have to spend it; you can always reinvest it in a taxable account.

Who Do You Want to Pay the Taxes?

If your desire is to minimize the amount of taxes you pay during your lifetime, the best way to do that is to take only the minimum out of the tax-deferred account, and then spend from the tax-free account by borrowing from life insurance and selling taxable investments with a high basis (meaning they're not worth much more than you paid for them) at the long-term capital gains rate.

However, your heirs would prefer that you choose to spend a little bit differently. The best asset to inherit is a tax-free account. Not only are there no income taxes due upon inheritance, but that account can be "stretched" providing decades of additional tax-free growth for the heir(s). Taxable assets are also a fantastic inheritance. Since the basis on the investment is "stepped-up" as of the date of your death, there are no income taxes due to the heirs on that inheritance.

Life insurance proceeds also make for excellent inheritances, although, given the low returns of cash value life insurance, the amount you leave behind is likely to be less than if you had simply used a taxable account in the first place. On the other hand, if they inherit a traditional IRA, all of that money is "pre-tax" and so every withdrawal from the account is associated with a tax bill.

If your goal is to minimize the overall tax bill due, a careful balancing act must be maintained.

Charitable Giving

If charitable giving is a big part of your estate plan, you should also consider where that contribution should come from.

Charitable giving is a fantastic use of a tax-deferred account. When the charity inherits the IRA (or receives a distribution from it) neither you nor the charity will owe income taxes on that money. So if you have a $1 million IRA, you can either give your children $600,000, or you can give the charity $1 million.

Taxable assets are also a great charitable gift, especially for low-basis assets given during your lifetime, since you get the full deduction for the gift and the charity won't owe any capital gains taxes on it.

Compared to a tax-deferred account, leaving a Roth to charity seems a waste.

State Taxes

Another benefit of decreasing the relative size of the tax-deferred account, either by spending or charitable giving during your lifetime, is that this account partially belongs to the government. But if the size of the estate is greater than the estate tax exemption amounts, the estate will owe estate taxes on both your portion and the government's portion

of the accounts.

Cash Value Life Insurance

In general, I recommend against using cash value life insurance (such as whole life) as an investing and retirement account. Although it has certain asset protection, tax, and insurance benefits, these benefits cannot usually overcome the typical low returns and high fees associated with these policies.

However, if you own cash value life insurance, that money can be used for retirement spending, charitable giving, and perhaps most beneficially, as an inheritance for heirs. The key concept to remember is that during your life the cash value is borrowed from the policy in a tax-free, but not interest-free, manner.

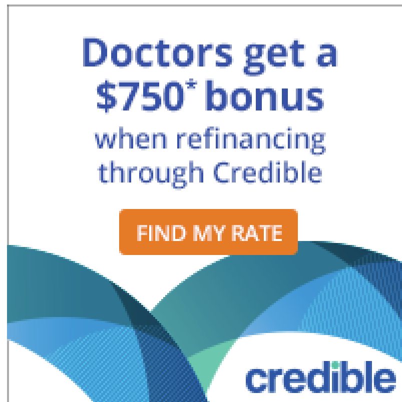
Best Account		
To Minimize Your Income Tax	**To Leave to Heirs**	**To Give to Charity**
1. Tax-Free	1. Tax-Free	1. Tax-Deferred
2. Life Insurance	2. Life Insurance	2. Taxable
3. Taxable	3. Taxable	3. Life Insurance
4. Tax-Deferred	4. Tax-Deferred	4. Tax-Free

Finding the Balance

Most investors are trying to find the right balance between maximizing retirement spending and the size of their bequests, while minimizing taxes now and taxes paid by their family. A balanced strategy is likely to work best.

Delaying Social Security until age 70 and maximizing any employer-related pensions is a good first start. The next step is annuitizing sufficient tax-deferred assets (or exchanging life insurance cash value into an immediate annuity) to

provide for basic needs not covered by Social Security and pensions.



Dividends, interest, and rents from the taxable accounts are added at this point. Then, take out the RMDs from the tax-deferred account. Beyond this, withdrawing from tax-deferred accounts up to the top of the lower tax brackets (10%, 15%, and perhaps even 25%) is a smart move. Then, sell taxable assets with a high-cost basis. If cash value life insurance was purchased, it can be borrowed tax-free (but not interest-free) at this point.

If additional income is needed, tax-free assets can be tapped or low-basis taxable investments can be sold. In general, the goal is for inheritances to be composed of as much tax-free money, taxable money and life insurance as possible, with the remainder of the tax-deferred account being left to charity.

For most investors, the decumulation strategy is going to be more complicated than the accumulation strategy, especially when it is combined with estate planning. However, like with anything in personal finance and investing, failing to plan is planning to fail.

What do you think? Did I miss something? How do you plan to decumulate your assets? Comment below!