Yours, Mine and Ours: An Income Planning Case Study

Shirley and Jim (pseudonyms, naturally) were feeling overwhelmed with retirement issues. Shirley was all set to retire when her mother passed away. Stress and anxiety levels were raised considerably while they were hoping to make a smooth transition from working to retirement.

So, Shirley and Jim were at a crossroads. We call it "transitioning."

Transitioning into retirement, given the above, suddenly seemed more confusing than anticipated. Factors to consider were: setting up cash flows; repositioning the portfolio for capital preservation and income; thoughtful consideration of protecting the portfolio from catastrophic health the care risk due to long term illness; life insurance for pension annuity replacement; taking IRA distributions *now for income* and *later when and as required*; weighing a company "rollover" IRA versus either a "joint and survivor" annuity or a "single life" annuity, and so on.

Shirley's Story

"In January, I planned for my July 1 retirement. In April, my mother passed away. Now, I unexpectedly have to deal with a $625,000 inheritance. It's not the managing of the money that's the problem, but the fear that I could mess up what my mother worked so hard to accumulate. I hadn't expected to deal with this just months before I had already planned my retirement!"

Shirley was at the Social Security normal retirement age of 65 years and 6 months; and, her Social Security benefit (known as the "primary insurance amount" or PIA) was at the full amount. She would not reach age 70 ½ until 2011.

Shirley had two adult children from a previous marriage.

Jim's Story

He second husband, Jim, was 55 years old, and worked for a lumber company (since high school), where he had generous benefits. Those benefits included tuition reimbursement, which he eventually used to earn a degree. When the lumber industry shrank (in the 1980s) he was able, at age 35, to work for the state's forestry service. His IRA rollover accumulated for almost 37 years and eventually totaled to almost $575,000. He had some personal (separate) savings, a small Roth IRA and some accumulations in a state-sponsored 457 plan. Fortunately, his 457 plan had a normal retirement age of 55.

As a couple

The overall portfolio seemed in balance until the inheritance came in. With that windfall, they wanted to get "balance" back in the portfolio: 50% bonds and 50% stocks.

As they both had IRAs, and a five-year time frame until age 70 ½, there was an opportunity for conversion of additional funds to Roth IRA funds.

They resided in a Seattle, WA suburb and wanted to move on from all the years of dreary Northwest winters. She wanted to return to the Midwest (her childhood home was Omaha, NE). They considered the highly desirable and under-priced market of Elkhorn, NE. They wanted to downsize and profit from the sale of their "old" home, obtain a new a nice new home (with land and a view) using their tax-free capital gains.

The cost basis in the old home was about $125,000 after improvements. No mortgage balance existed. The home was worth about $640,000. After brokers commission and removal of cost basis they netted about $475,000. They planned to spend $225,000 in cash at closing of the new home purchase. This gave them an additional $250,000.

Shirley stated that she "needed" income from the inheritance and the home sale. This was somewhat confusing as the inheritance was unexpected and the home sale was a long-term windfall. Thus, counseling was required over the "need" for income and the "want" of a certain lifestyle. A "need" lifestyle would certainly be more doable with the inheritance, but clarification was needed for defining "needs versus wants."

In either case, Shirley wanted the inheritance to produce income that was primarily generated from fixed income and bond instruments. It was unclear if the bonds should be taxable or tax-exempt. That would depend on the nature of all other income items.

Jim had considerable flexibility with his 457 plan. He could convert it to an annuity, take income payments at age 55 (provided he separated from service, i.e., retired) or roll it over to an IRA. Since he could roll this money over at any time, did not need a guaranteed income, and did not need the current income, he decided to let it sit (at least temporarily) in the 457 plan.

Mulligan Capital's Assessment

Mulligan Capital spent a goodly amount of time with Shirley and Jim. We discussed the impact of longevity, dissipation risks to a portfolio and the need to hold account withdrawals at no greater than 4.5% of the existing investment pool. After running a number of simulations, and accounting for the ample pension and social security income, we determined that additional income from guaranteed annuities was not required. The portfolio still needed to be reviewed, however, to bring them to a 50/50 bond-to-equity balance, and to avoid investment fund duplication. This was put into writing via an individualized investment policy statement.

At this juncture, we had helped them address a number of key issues:

- Lump sum versus annuity on the 457 plan.
- Cash flow and tax implications (inherited funds impacting Social Security).
- Repositioning and rebalancing of the portfolio.
- Determining an optimum cash flow plan.
- Securing long-tem care insurance.
- Maximizing pension benefits with outside life insurance.
- Shirley's need for a revocable living trust
    - To separate inherited funds.
    - To separate maximized pension via life insurance.
    - Potential life estate to Jim on their "new" home.

This was a lot to consider! So, let's take closer look:

Social Security income

- Shirley has Social Security of $18,000 per year.
- Jim has Social Security of $18,000 per year.

Annuity income

- Shirley's yearly single life annuity pension (no survivor benefits) is $8,000.
- Jim's yearly 75% J&S annuity pension (benefits drop by 25% at death) of $35,000.

Joint assets

- Joint assets are $8,000.

Jim's assets

- Jim's Roth IRA is $55,000.
- Jim's Rollover IRA is $575,000.
- Jim's personal portfolio is $75,000.
- Jim's 457 plan is $125,000.

Shirley's assets

- Shirley's net home proceeds are $250,000.
- Shirley's Roth IRA is $30,000.
- Shirley's inherited IRA (her first spouse) is $425,000.
- Shirley's personal portfolio is also $75,000.
- Shirley's inheritance (her mother) is $625,000.

Outcomes

From the start, Jim and Shirley had $79,000 of guaranteed income benefits. Their combined portfolios (joint and separate, taxable and tax-deferred) amounted to more than $2,200,000. At a conservative 4.5% withdrawal rate, they would have an additional $100,000+ per year income. Shirley's desired an after-tax income of $10,000 per month. Based on the overall income of about $180,000, she was nicely situated.

The underlying portfolios in this case study were already broadly diversified and did not need significant rebalancing and/or repositioning.

Shirley opted for less money in bonds than her initial "need," since the Social Security and pensions already came from a guaranteed pool of funds. This allowed them to move more of the actual tax-deferred accounts into equities and out of bond holdings.

The inheritance was invested 50% in laddered-maturity, tax-exempt bonds and 50% into a period-certain immediate annuity. The period-certain annuity paid income for ten years. And though this draws down principal and income from the annuity, it also created preferentially taxed and guaranteed cash flows.

This served two purposes: 1) it lowered the annual income tax bill, and 2) it leveraged those tax savings (free cash flow) into the needed long-term care insurance coverage. Further leverage was added through the long-term care insurance with its availability of an annual federal tax credit. That "tax credit" cash flow easily covered the cash flow (premiums due) on a 20-year, level-term, policy for Jim's 25% pension reduction.

Finally, Shirley placed an insurance policy in an irrevocable trust to cover her single life annuity. The policy was a Universal Life – Guaranteed Death benefit policy. This policy design allowed her to pay the minimum possible amount that emphasized death benefits; minimized any cash values build-up; and, which in turn kept premiums low and affordable from a quality AAA+ rated company.