

PLANNING PAYS

Make Your Money Last Through Retirement

Avoid this very common mistake

James Lange, CPA, JD

Once you retire, if you start drawing from your investment and savings accounts in the wrong order, you greatly increase the odds that your money will run out—or that your heirs will be left with less than they could have inherited.

Common mistake: Many retirees assume that they should start withdrawing money from their IRAs, 401(k)s and other retirement accounts as soon as they retire—retirement is, after all, what this money is intended for.

Reality: Your financial future could be a lot brighter if you leave retirement accounts untouched for as long as government rules and your financial situation allow. That way, you sharply reduce your annual tax payments.

Example: Two people retire at age 65. Each has a total of \$1.4 million—\$1.1 million in retirement accounts, such as IRAs and 401(k)s, and \$300,000 in taxable nonretirement accounts. Each earns an 8% annual return on his/her overall investments and—drawing on both principal and investment returns—spends \$8,000 per month on expenses. *How they diverge:* Mr. A starts living off his retirement accounts as soon as he retires—and sees his savings run out at age 98. Ms. B lives off her taxable investments for as long as possible before tapping tax-protected retirement accounts—and still has \$1.2 million remaining at age 98 (see chart).

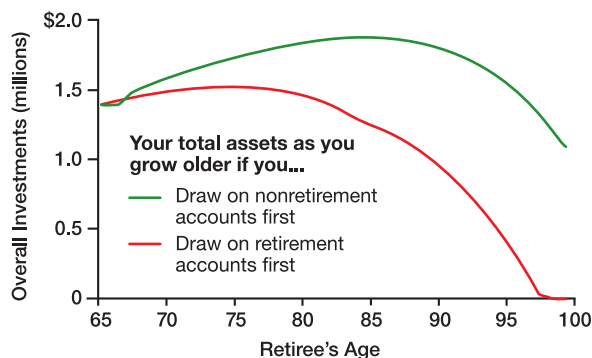
THE BEST ORDER

Once a retiree passes age 70½, government rules require specific minimum annual withdrawals from most tax-deferred retirement accounts, including traditional IRAs and 401(k)s. A retiree's tax bracket, health and personal priorities can alter the order in which assets should be withdrawn. These caveats aside, most retirees should tap accounts in roughly the following order...

1. Taxable income. Pension distributions, earned income from retirement jobs and income from dividends and interest in accounts other than IRAs and 401(k)s should be spent first. If you already have begun to receive Social Security payments, that money should be used as well. (If you have not yet started receiving your Social Security benefits, see item 4.)

BENEFITS OF USING NONRETIREMENT ACCOUNTS FIRST

Based on retiring at age 65 with \$1.4 million



Source: Lange Financial Group, LLC

2. Traditional IRA and/or traditional 401(k) distributions if your tax bracket is low. This is an exception to the general rule that you should leave tax-deferred retirement accounts untouched for as long as possible. If your retirement income is low enough to keep you in the 10% or 15% tax bracket, withdraw money from your tax-deferred retirement savings just until you reach the taxable income limit of the 15% tax bracket. In 2007, the limit is \$63,700 for a married couple filing jointly and \$31,850 for an individual. *Example:* After deductions, a retired married couple's taxable investment income, pension benefits and other retirement income total \$50,000 for 2007. They withdraw \$13,700 from their traditional IRA and remain in the 15% tax bracket.

Better: If you can live without this income for now, instead of taking a distribution, convert a portion of your traditional IRA to a Roth IRA (whose assets will never be taxed in the future), but not so much that the converted assets push you out of the 15% tax bracket. (The converted assets count toward your income for tax purposes.) ▶

3. Taxable investments and savings. Among these assets—including stocks, bonds and mutual funds outside of retirement accounts—there are three basic steps to consider...

First, sell those that have dropped in value and are no longer attractive so that you can use the capital losses to offset capital gains.

Second, draw on any assets that are in cash (including money market funds) and fixed-income investments, such as matured bonds and matured certificates of deposit (CDs). By reducing these assets, you lower the amount of taxes you pay on future interest and dividends. If this action shrinks your overall allocation for fixed-income investments, you can raise the amount of fixed-income investments you have in IRAs and 401(k)s.

Third, sell taxable investments that have appreciated in value but are no longer attractive, especially those that have appreciated the least. Any long-term capital gains—on assets held for more than one year—are taxed at no more than 15%.

4. Social Security benefits. Retirees who have not yet begun to receive Social Security benefits might consider delaying the start of their benefits until as late as their 70th birthdays if they can afford to do so.

Retirees can receive Social Security checks at age 62. However, the size of the checks will increase by 7%, 7.5% or 8%—depending on the year the retirees were born—for each year they delay from age 62 until 70. There is no advantage to delaying the start of benefits past age 70. Retirees who will benefit from waiting...

Have enough other retirement assets and income to cover their expenses and don't have to dip into their tax-deferred retirement accounts (except as mentioned in item 2) and...

Are healthy and come from families in which members tend to live a long time. The longer you expect to live, the more sense it makes to delay the start of Social Security benefits. If your health or family history suggests that you might not live much past age 84, start benefits by age 66.

5. Traditional IRAs, 401(k)s and other tax-deferred retirement accounts. Withdrawals from these accounts generally should be delayed as long as possible to take maximum advantage of tax-deferred investment growth. Eventually, however, either your financial situation or tax rules may force you to start withdrawing money.

Strategy 1: Married couples who must tap into tax-deferred accounts before tax laws require should draw on the older spouse's accounts first. That way, the older spouse will have already met part of the minimum required distribution.

Strategy 2: Tax laws typically require that annual withdrawals from tax-deferred retirement accounts begin by April 1 of the calendar year following the year in which the retiree turns 70½. Most retirees, however, should begin taking withdrawals in the same calendar year that they turn 70½, not the one after. That way, you don't end up

MORE from James Lange

Types of Accounts

Tax-deferred retirement accounts. These include traditional IRAs and 401(k)s for which taxes have not yet been paid. No taxes are paid as long as the money remains in the account, but taxes must be paid at regular income tax rates on any withdrawals, including interest, dividends and even capital gains.

Roth IRAs and Roth 401(k)s. Taxes were paid before the initial contributions were made, and no further taxes will ever have to be paid on the initial contributions or the interest, dividends and gains (as long as certain conditions are met).

taking two required distributions—the initial one and the second one—in a single year, which could push you into a higher tax bracket. (See IRS Publication 590, *Individual Retirement Arrangements*, or www.paytaxeslater.com/calculator to calculate required withdrawals.)

Exceptions: Minimum required distributions from a traditional 401(k) often can be delayed as long as you are still working for the company that sponsors the 401(k). You also might be able to delay minimum distributions until age 75 on contributions made before 1987 to a 403(b), a type of retirement account offered by nonprofit organizations. (For more details, contact your retirement plan administrator or employee benefits supervisor.)

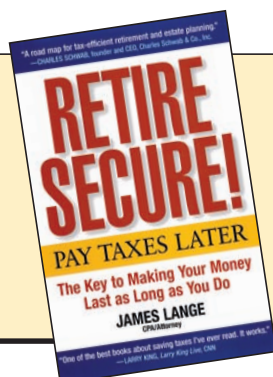
6. Home Equity. Many retirees don't want to tap into home equity once their mortgages have been paid off, preferring not to take on new debts. For those who can get past this psychological barrier, the home can provide a useful source of income. Use a home-equity line of credit (HELOC) to tap this resource, not a reverse mortgage. Reverse mortgages tend not to offer very attractive terms to homeowners, but HELOC interest rates often are below the prime rate, which is currently 8.25%.

7. Roth IRAs. Assets held in Roth IRAs and Roth 401(k)s generally shouldn't be spent until all other assets have been exhausted, because there are no future taxes on Roths—including on investment gains—even for heirs. And there are no minimum required distributions for you and your surviving spouse from your Roth IRA. To avoid minimum required distributions on your Roth 401(k)s, roll them into your Roth IRA. ■■

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Bottom Line/Personal interviewed James Lange, CPA, JD, principal of Lange Financial Group, LLC, a retirement and estate-planning company in Pittsburgh.

He is author of *Retire Secure! Pay Taxes Later: The Key to Making Your Money Last as Long as You Do* (Wiley). www.paytaxeslater.com

