

# Strategies for Age-Appropriate Retirement Planning

*By Steven Leshner*

Successful retirement planning calls for insight into the attitudes and emotional stability of our clients, as well as the number crunching activity related to measuring progress.

Client attitudes on retirement run the gamut, from concerns there will never be sufficient liquid assets to feel comfortable, to the opposite extreme, unfounded confidence that the amassed assets will somehow suffice, regardless of future events. The extremes notwithstanding, individual retirement plans should be based on realistic attitudes and investment expectations. Complicating that objective are the attitudinal differences evident among various age groups. Let's segregate them as:

- Beginners
- Midstream Savers
- Pre-Retirement Planners
- Active Retirees

Beginners entering today's workplace are conflicted about saving for retirement. They are typically at their lowest earning level, have personal debts that represent a significant percentage of their income, and suffer heavy demands on disposable income for housing, student loans, family needs and the like. Beginners would do well to establish annual saving goals, with attention to balancing qualified and non-qualified savings.

Midstream savers are no less conflicted. The demands of housing, childcare expenses and college savings for their children often compromise their disposable income.

Those approaching retirement are most concerned about asset conservation, extended life expectancy and distribution planning.

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Active retirees are usually concerned about asset protection, inflation, rising medical costs, estate planning and maintaining their independence.

## **Beginners**

Setting goals is the first step on the financial independence ladder. Inevitably, there are multiple goals, some of which may be in conflict, so it is important to allocate the appropriate portion of disposable income to savings. The need to retire credit card balances, student loans or other obligations may conflict with savings objectives. Beginners must learn that debt represents negative savings. Reducing debt is a priority that provides a solid foundation for future saving and helps relieve the emotional stress often associated with outstanding debt. Beginners dealing with college loans or credit card debts are analogous to someone treading water while fighting off sharks. Debt relief is the equivalent of escaping the sharks, getting back to the beach and finding higher ground.

Beginners rarely understand fundamental issues, such as dollar cost averaging, asset allocation, re-balancing and the power of starting savings patterns early; but they need to. Basic savings of 3 percent to 5 percent of gross income may be appropriate as a starting strategy en route to an ideal goal of 15 percent. Conflicting priorities might make this burdensome, but adopting the savings discipline early on helps. The early start provides a longer time horizon and supports a more aggressive equity-based asset allocation. A risk tolerance questionnaire can be an important tool in guiding investment selection for retirement planning. Surprisingly, younger plan participants often specify heavy fixed income concentrations, allocations that seem overly conservative given their time horizon.

## Midstream Savers

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) P.L. 107-16, provides a wonderful opportunity for both the financial services industry and qualified plan participants to embrace portability and transferability for various defined contribution plans, such as IRA's, 403B's and 401K's. The legislation supports the shift to self-funding retirement plans, employment mobility and the opportunity for employees to manage their assets.

Here is an example. A new participant in a qualified plan recently asked me how to deal with his \$25,000 credit card burden. It was impeding his ability to contribute to his 401K plan. Upon further inquiry, I learned he had an account balance of \$40,000 in a prior IRA plan. I suggested by coordinating an institutional rollover from the IRA to the current 401K and taking a loan from the active plan—50 percent of his \$45,000 balance—he could accomplish three financial priorities: Pay lower interest on the debt to his plan, improve his personal credit score and exercise greater control over all his retirement assets.

A couple enrolled in a 401K questioned whether they would be better off with a Roth IRA. Aside from the Roth IRA income limitation for dual-income households earning more than \$160,000, adding a Roth account to their current retirement plan allowed the couple to treat some of their deferral as a tax-free distribution at retirement. This was an important distinction because they had very little non-qualified savings accruing for more favorable income tax distributions during retirement.

Today's internet-based retirement platforms provide easy access to plan balance, year to date performance, and the ability to direct changes for both present positions and future contributions. This supports a wonderful opportunity for self direction. And because clients tend to make changes, the risk assessment questionnaire is useful during every stage of wealth accumulation as a tool for portfolio assessment and review. Retirement portfolio assessment and review should not be a static process. As clients travel along the path towards eventual retirement, they need to periodically check in and be assured they are on track for success.

## Pre-retirement Planners

There are three strategies appropriate for this group.

The first deals with participants eligible for distributions from defined benefit pensions or structured distributions that offer lifetime benefit payments. These typically provide a prescribed distribution option for the retiree and a lower benefit to be paid in the event of a joint and survivor distribution. The survivorship factor can substantially reduce the retiree's distribution. It might make sense to consider the use of a life insurance policy to provide the capital for the survivorship contingency in lieu of a reduced benefit from the pension plan. It's advisable to evaluate this strategy as far in advance of retirement as possible since the insurance cost will be lower and

the likelihood of insurability higher. The pension maximization strategy uses life insurance to provide a spousal benefit in the event of death before life expectancy.

Anticipated longevity and insurability for the annuitant are prerequisites for this strategy. One of our clients worked at a Federal institution and was eligible to retire at age 55. When she was 50, we reviewed her distribution options and realized there was a roughly 25 percent reduction in the initial benefit payment at age 55, plus a further benefit reduction of 38 percent for a surviving spouse in the event the annuitant died prematurely. We considered having the annuitant buy a \$500,000 life insurance policy to provide spousal benefits in lieu of the survivor option. The cost of the insurance was approximately 10 percent of the employer's initial benefit payment so the couple received roughly 15 percent greater income than provided by the spousal benefit. If the spouse does not survive the annuitant, there are additional family benefits provided by the life insurance.

The second strategy involves providing sufficient life insurance coverage to ensure qualified funds continue to be deferred, if desired, until the Required Minimum Distribution (RMD) age.

Many financial planners suggest that the process of wealth accumulation diminishes the need for life insurance as clients approach retirement. I suggest that continuity of life insurance, particularly term insurance into the 70's, provides a survivors' cushion. In the event of death, the decedent's qualified funds

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can continue to be deferred into the 70's until the RMD period begins for the surviving spouse. Recent calculations by our organization suggest a 6.5 percent growth rate and the RMD withdrawal permits a qualified balance to continue to grow in value into the late 70's.

The third strategy deals with looking into the "window of wealth" accumulation. Consider the graphic below, which categorizes the assets of a typical client. The assets in the upper panels represent liquidity for retirement, and may produce three types of income: ordinary, capital gains and tax-free income. A clear indicator of the net income distribution available at an anticipated retirement date can be projected from the target values and related income contributed by each sector.

**Figure 1**

QUALIFIED 401K IRA SEP 403B ROTH IRA / 401K	NON-QUALIFIED CD MONEY MARKET STOCKS BROKERAGE ACCOUNT
REAL ESTATE HOME 2nd PROPERTY BUSINESS PROPERTY	BUSINESS INTEREST SOLE PROPRIETORSHIP PARTNERSHIP CORPORATE OWNERSHIP C – CORP S – CORP

A 60 year-old client of ours had accumulated roughly \$1,500,000 in non-qualified wealth (including a \$200,000 non-qualified annuity), \$500,000 in qualified plan assets and a home valued at \$800,000. Anticipated retirement age was 63; anticipated annual retirement income was \$90,000. We suggested the client continue to defer funds into the 401K plan, and take a ten year distribution from the annuity at age 63 to permit the IRA to grow and also enable the client to take part of the annuity basis as retirement income under the exclusion allowance for tax free income.

## Active Retirees

The active retiree designation may be misleading. People increasingly shift into new careers at earlier ages and the old world vision of retirement may be inappropriate for people in their 50's today.

Many retirees have accumulated non-qualified tax deferred annuities as a piece of their financial profile. These investments were useful tax deferrals in the

highest income earning years, and as a supplement to IRAs, 401k's or defined contribution plans, particularly prior to the EGTRRA enhancements for qualified plans in 2001. However, the incidence of ordinary income taxation upon distribution or in the event of death should signal a reminder that these instruments can provide an optimal role in distribution planning. In cases where there is a long term deferred gain, the best case scenario with many insurers is a five year distribution in the event of death.

In one case, a long term deferred gain amounted to several hundred thousand dollars. We advised the client to convert the deferred annuity to a 10 year certain immediate annuity, allowing the gain to be amortized for ordinary income taxation over a 10 year period. The net distribution was then directed into a brokerage account for future capital gains purposes or for immediate income as needed. This strategy provided important flexibility while supporting estate tax planning and ordinary income tax planning.

Immediate annuities may provide additional estate tax planning opportunities.

A client wanted to provide a series of gifts to her grandchildren. Her desire was to assure a stream of income, insulated from market instability and certain in the event of her death. In this case, a ten year certain annuity was utilized to provide funding for education.

Immediate annuities provide a return of principal and interest payments from the balance of the investment. The return of principal portion is often overlooked as a tax-free distribution that, when coordinated with ordinary income sources, may support the retiree with a higher net income. This concept should be pursued with the assistance of the clients' tax advisor. The goals for distribution planning should seek to maximize both retiree net income, as well as deferral for qualified funds to support tax favored growth and provide unlimited flexibility. A good rule of thumb is that immediate annuities be limited to be no more than 25 percent of an investment portfolio.

Leverage may be a suitable concept for clients with a favorable risk tolerance. A good example is real estate ownership, where a small down payment can provide long-term asset appreciation. Another example is the leverage in a life insurance contract, realized when a small payment establishes a large death benefit.

Many retirees wrestle with the desire to spend down their assets versus the desire to provide an

estate for family members. This is a values-centered question. Retirement planning should be, first and foremost, focused on providing maximum income and flexibility for the retiree. Family needs should be a secondary consideration. However, one strategy to provide for family needs is the creation of irrevocable life insurance trusts to own policies exempt from estate, inheritance and income taxes. The transfer of an annual gift to fund the trust has enabled retirees to feel unencumbered to spend their retirement funds, particularly when the gift is established through an annuity that has been designated for this purpose.

The "window for wealth" accumulation idea suggests that looking at the big picture offers opportunities for flexibility if there is a degree of balance among the four window quadrants previously illustrated. The idea deals with thinking outside the box. Charitable planning and the use of trusts provide strategies for current tax planning, estate planning and the ultimate benefit of living or death bequests for a favored organization or cause. These are personal values, oriented strategies that support the retirement planning process.

We recently reviewed a charitable annuity remainder trust that provided a 10 percent annual distribution for a period of 10 years to the donor. The strategy called for the donor to establish a trust that accepted a \$500,000 gift. The donor received an annual net distribution of \$47,200 for 10 years. The assumption was the charity could earn 6 percent

annually and receive the remainder of the trust corpus at the end of the 10 years, \$227,000. The donor also received a tax deduction limited to 50 percent of adjusted net income, approximately \$120,000. The deduction was determined by the actuarial remainder value to the charity at the end of the period. The donor's tax savings was approximately \$42,000, assuming a 35 percent marginal tax bracket. The key here revolves around charitable intent and confirmation of the client's tax advisor. By planning ahead, clients can utilize their wealth to assist others without compromising their own retirement income needs. This type of values-based planning may provide benefits not otherwise apparent.

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Retirement planning with the big picture in mind requires a full understanding of client values and objectives. Risk tolerance, past experiences, and a realistic understanding of the client expectations are essential for a successful working

relationship. Furthermore, the proliferation of investment programs that have become available through brokers, financial planners, insurance representatives, banks, accounting firms and trust companies require the advisor to coordinate efforts with team members that compliment the client relationship.

Retirement planning issues have changed little over the years. Age-appropriate retirement planning requires that we guide the process with strategies that compliment each other during the transition from beginner to active retiree.