

Strategies for uncovering hidden value in retirement income planning



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As a Vice President for the Nationwide Retirement Institute, Carlo has more than 25 years of experience implementing comprehensive retirement income solutions. He is dedicated to educating advisors, agents, clients, plan sponsors and plan participants on the latest in retirement income planning strategies. In addition to his MSM, RICP, CRPS and CLTC designations, Carlo earned a master's in Management and Leadership and is FINRA Series 6, 63 and 26 licensed. Carlo's specializations in retirement income planning strategies include health care costs, long-term care costs and determining optimal Social Security filing strategies.

Americans are retiring at a faster rate than ever before. With an average of 10,000 baby boomers retiring every day, over 57 million will reach retirement age by 2030.¹ Today's retirees are expected to live longer, and they're making plans to live those years to the fullest. It's easy to understand why sustainable income is their top concern.

The more clients choose to delay Social Security filing to maximize their benefit, the greater the burden they're placing on their retirement savings earlier in retirement. This white paper explores how an understanding of tax efficiency in retirement can help you bring a new perspective to your conversations with clients about retirement income planning.

In a Nationwide-sponsored survey on retirement income, 85% of advisors reported that they are either currently offering or plan to offer holistic financial planning.² That promotes confidence for clients who look to you to help them bring their retirement vision to life — whether they want to make their money last longer, fund a full and active lifestyle or simply leave more behind for those they love.

A tax-efficient spending plan — the order in which clients choose to tap into their savings to fund their income needs — can give clients the assurance that their money can last through their retirement years. And with alternatives to what clients typically practice (the traditional "file and collect Social Security benefits first" spending model), your clients could gain up to six years of portfolio longevity.³

The Nationwide Retirement Institute is pleased to be your partner. Look to us for resources, tools and fresh takes on retirement planning so your clients can continue to look to you for solutions.

Joe Elsasser, President, Covisum, contributed technical content and scenarios to illustrate the tax-efficiency strategies discussed herein.

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¹ "Holistic Retirement Planning on the Horizon," Insured Retirement Institute (Dec. 20, 2016).

² "Annual Retirement Income Survey," Nationwide-sponsored InvestmentNews research (September 2016).

³ "Tax-Efficient Withdrawal Strategies," K. Cook, W. Meyer and W. Reichenstein, Financial Analysts Journal, Vol. 71, No. 2 (2015).

Shift your clients' perspective on retirement income planning

Your clients look to you for expertise and advice as they transition to their retirement years. Guiding them to a sound retirement income strategy is one of many opportunities you have to help them live the life they've imagined.

Retirement income planning often takes a predictable approach: Claim Social Security benefits as early as possible, and when additional income is needed, liquidate investments with the lowest tax impact first. Generally, this means using any nonqualified funds first and reserving qualified funds — such as money in IRAs and 401(k)s — for later in retirement or taking only required minimum distributions (RMDs) from those accounts.

As a growing body of research illustrates the importance of Social Security benefits to a retirement income plan, more clients are opting to access those benefits after full retirement age. This can be a burden on other income sources (such as Roth IRAs and taxable accounts such as stocks and bonds) early in retirement, and it leaves clients the task of determining which assets to use — the best sequence of spending to follow — to meet income needs during the Social Security delay.

Economists John Shoven and Sita Slavov suggested that retirees are often considerably better off using qualified assets, such as IRA or 401(k) funds, to bridge

the gap during a period of Social Security delay.⁴ Another pair of economists, Huaxiong Huang and Moshe Milevsky, argue that in the presence of differential tax rates, people should intentionally deplete certain assets sooner in retirement while saving other assets for later in retirement.⁵ Both papers suggest few clients are evaluating sequencing options as they make retirement income decisions.

Advisors who can offer a practical process for evaluating spending decisions from a holistic perspective can deepen relationships by providing clients with the assurance that their assets are working together to help them achieve their retirement goals.

Tax brackets are only part of the story — and here's why

The tax differential among alternate sequences of spending can be significant, and the potential lies in looking beyond account- and product-level taxation.

Many advisors acquire a knowledge base on taxation through the course of their practice — whether formal or practical — yet their understanding tends to be in the context of a specific account or product. They know a CD pays interest that is treated as ordinary income, and when they sell a stock or a mutual fund, they will probably incur a short- or long-term capital gain or loss. Advisors also learn about account-level taxation. Assuming certain holding periods and age limits, withdrawals from a Roth IRA are tax free, and withdrawals from a fully deductible traditional IRA will be treated as taxable ordinary income. If they sell a stock inside the account and withdraw the funds, the withdrawal gets account-level (rather than product-level) tax treatment.

What practical experience typically fails to deliver is an understanding of the implications of *interactions* among



Congress has introduced a variety of tax distortions ...

The result is a complex system that may offer opportunities for those who pay attention and pitfalls for those who don't.

income sources. What does an IRA withdrawal do to the taxability of a capital gain? What does the presence of capital gains do to the taxation of Social Security benefits? And how is the client's marginal tax rate impacted

when he or she has all of the above? The first two questions are examples of product- and account-level tax considerations; the third points to the importance of a deeper awareness of interactions.

An IRA withdrawal alone rarely creates a tax surprise for a client. Instead, it is the IRA withdrawal (or the phaseout of a medical expense deduction or the introduction of a net investment income tax) and its interaction with capital gains and Social Security. To avoid wholesale revisions to our tax code over the years, Congress has introduced a variety of tax distortions, such as the net investment income tax, that are targeted at smaller segments of the population. The result is a complex system that may offer opportunities for those who pay attention and pitfalls for those who don't.

The question to ask is not what tax bracket the client's income falls into, but rather what is the actual tax rate — the effective marginal tax rate — that will be triggered by an additional withdrawal?

⁴ "Longevity Risk and Retirement Income Tax Efficiency: A Location Spending Rate Puzzle," H. Huaxiong and M. Milevsky, *Insurance: Mathematics & Economics* (April 20, 2016).

⁵ "Social Security and Equivalent Railroad Retirement Benefits," www.irs.gov/pub/irs-pdf/p915.pdf (December 2018).



Example 1:

Capital gains + IRA

Consider capital gains, which are taxed at 0% when the taxpayer's ordinary income plus capital gain falls under certain thresholds: 15% for most taxpayers and 20% for the highest-income taxpayers.



Assuming the new standard deduction of \$24,000, a married couple filing jointly with \$101,200 of long-term capital gains and no other income in 2018 would pay no federal income tax.



Example 2:

Social Security + IRA

Let's consider a second example, in which we combine a Social Security benefit with IRA withdrawals. In the absence of any other income, Social Security benefits at current levels will not trigger federal income tax; however, the presence of other income causes the Social Security benefit to become taxable income.⁵

For this example, we have a married couple, both age 65+, who take \$19,000 from an IRA to supplement their combined \$50,000 Social Security benefit. Because they are both over 65, their standard deduction plus additional deduction for being over 65 or blind totals \$26,600.



Social Security benefits aren't taxable. Or are they?

With these incomes, the clients will pay no federal income tax. This year, they have decided to withdraw an extra \$10,000 from their IRA to fund a dream vacation — expecting, at worst, to lose 10% on part of their withdrawal to federal income tax.

In this case, the \$10,000 withdrawal itself was not taxed (the 10% tax rate is offset by the standard deduction and personal exemption), but the act of withdrawing it triggered \$1,693 in taxes. The first \$860 of income was eliminated by their deductions. The balance of the withdrawal was subject to an 18.5% effective tax rate. Each dollar withdrawn from the IRA caused \$0.85 of a Social Security dollar to become taxable, also at the 10% rate. When only Social Security and ordinary income are included, the effective tax rate can reach as high as 40.7% (1.85 x 22%).



Example 3:

Social Security + IRA + capital gains

Now let's consider a scenario with income from three sources: Social Security, IRA withdrawals and capital gains. A couple, both age 65+, have \$60,000 in combined Social Security benefits, \$40,000 in annual IRA withdrawals and \$20,000 in long-term capital gains. If they decide to take an extra \$5,000



IRA withdrawal, they lose \$2,498 of the \$5,000 to federal income tax, representing a 49.95% effective marginal rate.

Here's what happened:

- The \$5,000 IRA withdrawal is taxed at a 12% tax rate
- The withdrawal causes 85% of \$5,000, or \$4,250 in additional Social Security benefits, to become taxable, also at 12%
- \$9,250 of capital gains that would otherwise have fallen into the 0% capital gains bracket is now taxed at 15%

The clients expected a 12% tax rate on their IRA withdrawal and actually paid an effective marginal rate of 49.95%.

Common sequences of spending every advisor should know

Product interactions with tax implications are relatively common and often highly impactful. It's easy to see how careful consideration of the sequence of spending can

add substantial value to the client's spendable income. Few clients will be willing to plan on a year-to-year basis — they'll want the assurance of knowing that their money will last, and they'll

want to feel prepared — so it may be useful to establish a spending plan that is thoughtfully constructed and retains the flexibility for occasional modifications.

Three basic sequences of spending to consider



Social Security first

The most common sequence, in which Social Security is claimed as early as possible, either due to retirement or attainment of age 62. Nonqualified assets are used to supplement the Social Security benefit for as long as possible, and qualified assets are accessed as required to meet RMDs at age 70½ or for required income.



IRA first

A sequence that's gaining popularity, in which Social Security benefits are delayed, and qualified funds are used to provide income during the delay. Any nonqualified funds are reserved for future needs.



Roth conversion

A less common sequence, in which Social Security benefits are delayed and annual Roth conversions are considered to the extent they can be completed without increasing the client's effective marginal tax rate under the Social-Security-first model. Spending during the delay and any additional taxes resulting from the conversions are paid from nonqualified assets for as long as possible. Qualified funds are likely to be needed at age 70½ to meet RMDs.

The right strategy is personal and based on the client's goal

So how can you determine which strategy is best for your client? You can certainly assess the impact on your client's total tax bill. You should also consider how each scenario contributes to your client's financial well-being.

For most clients, this means supporting one of three goals:

- 1 Extending the life of their retirement portfolio (portfolio longevity)
- 2 Maintaining their standard of living in retirement (sustainable income)
- 3 Preserving savings to pass on to heirs (after-tax estate value)

We'll use these common goals to compare the Social-Security-first sequence against the other sequences of spending to see what could deliver a higher value. To illustrate, let's apply our three sequences of spending to a hypothetical client.

Putting the three spending sequences to the test



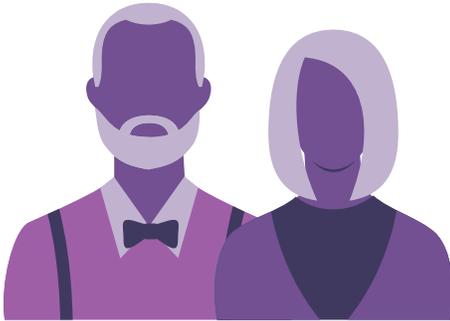
Social Security first



IRA first



Roth conversion



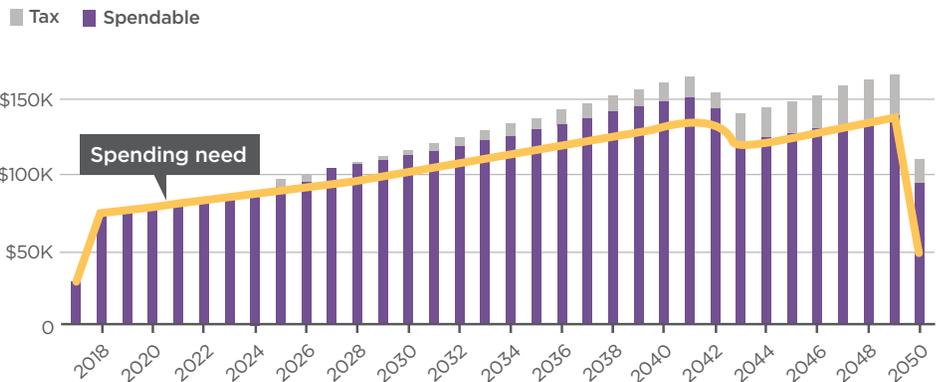
John and Jane are 65 and 62, respectively. John has saved \$650,000 in his 401(k) plan. John's primary insurance amount (PIA) — the Social Security benefit he would receive at full retirement age — is \$2,600 per month.⁶ Jane has a \$200,000 IRA and a \$1,000 PIA.⁶ They have \$200,000 in a joint brokerage account with a basis of \$150,000, and they are planning for life expectancies of 90 for John and 95 for Jane. They need an after-tax income of \$6,000 per month in retirement and \$5,000 for the survivor.

If they follow the traditional Social-Security-first sequence of spending, John and Jane can expect to be able to meet all of their spending goals with a significant surplus at Jane's death.

Explanation: The purple bars are the net spendable income after federal income tax. The gray is the amount paid in federal income tax and the yellow line is the after-tax spending need. Ideally, the purple bar will extend to the yellow need line for all years of retirement (and even in alternate scenarios in which the plan is stressed by changes in the investment markets, an untimely death or a long-term care event).

For the first several years of retirement, John and Jane would pay no federal income tax. In all likelihood, they are thrilled, but when advisors see this — particularly when there are large IRAs that will force RMDs

John and Jane's annual income



This scenario is hypothetical and for illustrative purposes only; results may differ.

later — they should be wary. Note how the purple bar extends above the spending need line once John reaches age 70½.

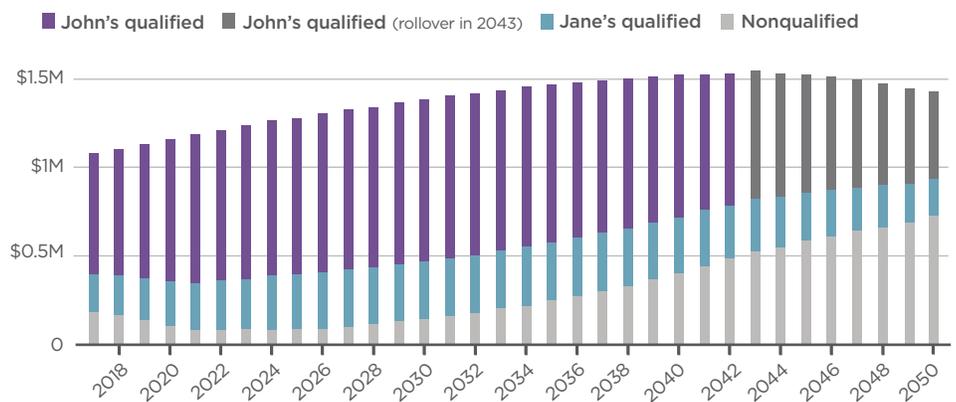
This could signify that a different sequence of spending may be beneficial to avoid pushing clients into higher tax brackets in the future.

Here's what John and Jane's account balances look like over time after accounting for their income withdrawals. You can see their balances growing throughout their lifetimes.

John and Jane are probably ideal clients for many advisors. If they follow the traditional Social-Security-first sequence of spending, they will be fine.

Many would say they don't need an advisor; however, a well-trained advisor could use this analysis to identify significant value for this client.

John and Jane's annual account balances



This scenario is hypothetical and for illustrative purposes only; results may differ.

For John and Jane, the traditional Social-Security-first sequence of spending generates a net after-tax

estate value of roughly \$550,000 with approximately \$307,000 in lifetime taxes paid.

⁶ The cost-of-living adjustment (COLA) is assumed to be 2.6% annually.



Social Security first



IRA first



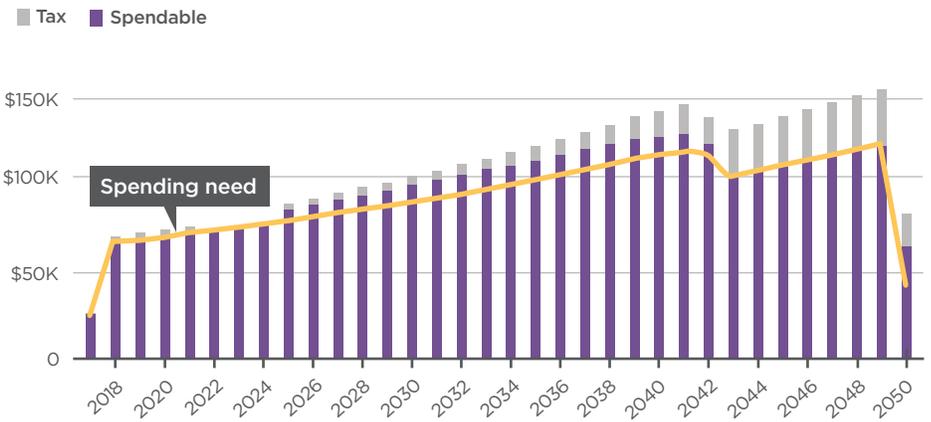
Roth conversion



Now let's consider an alternate sequence of spending in which John and Jane implement an IRA-first strategy. This scenario assumes that Jane claims her Social Security benefit as soon as John reaches full retirement age and that John files a restricted application for only spousal benefits while delaying his own benefit to age 70.

As a result of applying an IRA-first strategy, we see a \$130,000 net increase in the after-tax estate value and a \$25,000 decrease in the present value of lifetime taxes paid. The net increase in the estate value is partially due to the tax reduction and partially due to the more effective use of Social Security as part of the plan.

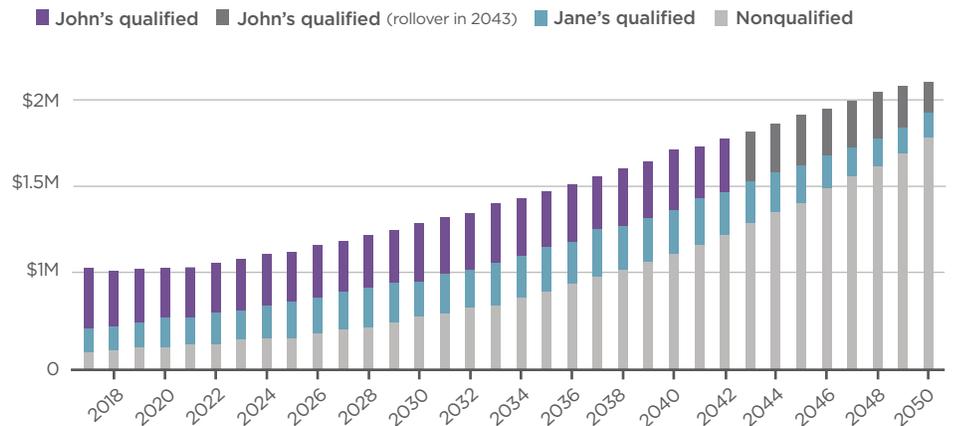
John and Jane's annual income



This scenario is hypothetical and for illustrative purposes only; results may differ.

Notice that taxes are more evenly disbursed throughout retirement. In the early years, John and Jane are paying some federal income tax, but also note that the RMDs forced from the IRAs at age 70½ are considerably smaller.

John and Jane's annual account balances



This scenario is hypothetical and for illustrative purposes only; results may differ.

Here's what their account balances look like over time after accounting for their income withdrawals. In this case, the nonqualified account has been allowed to grow throughout the clients' lifetime, leaving primarily assets to beneficiaries that will receive a step up in basis, resulting in very little net income tax to the beneficiaries.



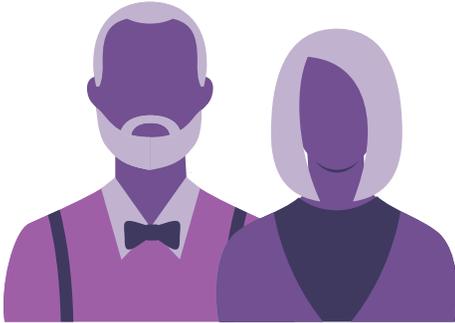
Social Security first



IRA first



Roth conversion



A third potential sequence of spending incorporates the same Social Security strategy, but uses the clients' nonqualified funds to bridge the gap until Social Security benefits begin. We also identify strategic opportunities to convert portions of the clients' IRAs to

Roth IRAs. In this strategy, the older client's IRAs are converted first to provide the maximum reduction in the couple's eventual RMDs.

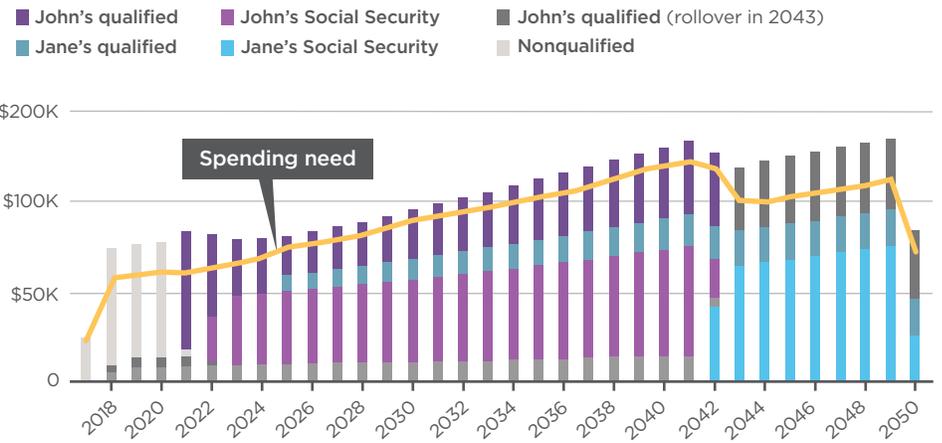
To do this, we annually determine how much could be converted to Roth to the extent the rate we would pay to do a Roth conversion is lower than the clients' lifetime average tax rate if they followed the traditional harvesting pattern. If it is lower, we convert only enough IRA to reach that tax rate. You could consider this the "first do no harm" method for identifying Roth conversions. Although more aggressive Roth conversion strategies may yield higher lifetime benefits, this strategy

considers the possibility that tax rates or structures may change in the future, making Roth IRAs less attractive than they are in the current tax environment.

Incorporating Roth conversions into this sequence of spending produces approximately \$134,000 of additional after-tax estate value⁷ — nearly a 25% increase over the traditional harvesting pattern — while reducing taxes by approximately \$31,000. Surprisingly, the conversion amounts are relatively small, with conversions of approximately \$24,000 per year for the first four years (\$22,780; \$23,897; \$24,502; and \$27,027, respectively).

You can see John and Jane are drawing heavily from the nonqualified account early in order to delay John's larger Social Security benefit. Then you see the IRA withdrawals kick in. Notice there are no Roth withdrawals, effectively allowing the Roth assets to compound tax-free over the entire retirement period.

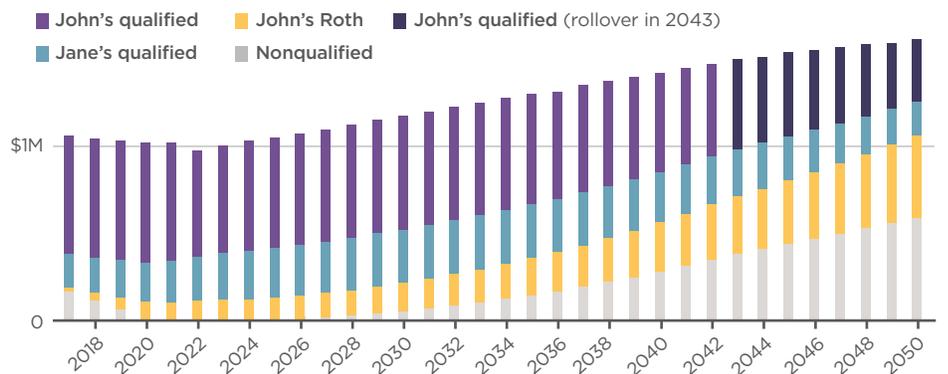
John and Jane's annual income



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By the end of the projection period, the Roth assets would have grown to \$515,000. When the survivor of John and Jane dies, current tax law allows the Roth to transfer to his or her beneficiaries tax-free and to be stretched over the beneficiaries' life expectancies. This may provide significant additional tax-free growth potential and tax-free income. For those with large estates, the transfer may be subject to estate taxes.

John and Jane's annual account balances



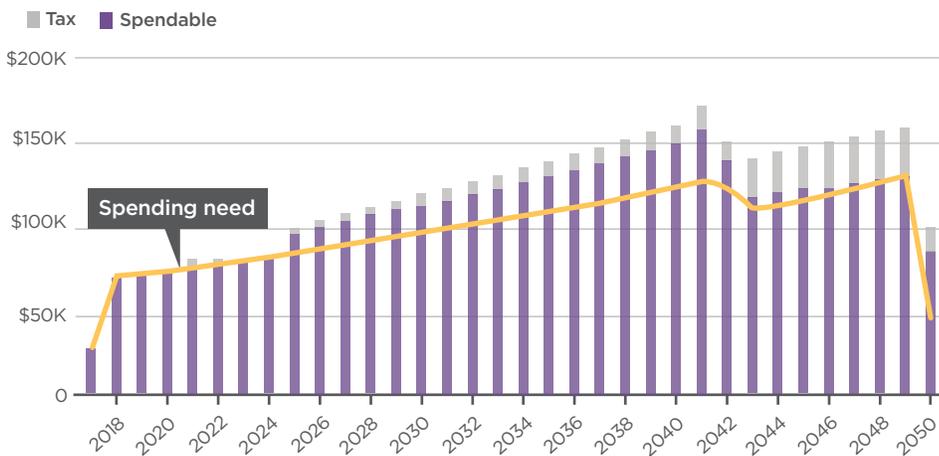
This scenario is hypothetical and for illustrative purposes only; results may differ.

⁷ Calculations reflect conversion costs based on tax rates at the time of the conversion. Projected tax brackets assume a 2.6% annual increase.

John and Jane's annual income

In this example, we maintained equal asset allocations across all accounts. If we locate the highest growth assets in the Roth instead of the equal allocation, the benefits of the conversion strategy would be considerably higher.

From a tax perspective, you notice there is still very little tax bill in early retirement.



This scenario is hypothetical and for illustrative purposes only; results may differ.

The power of an objective framework

Working through the details of John and Jane's situation should not suggest that all clients follow a Roth-conversion strategy.

Instead, it is intended to highlight a process that may be used to evaluate multiple sequences of spending for any client. For many, the IRA-first strategy will be more impactful.

For some, the traditional Social-Security-first sequence will offer the greatest benefit. Ultimately, advisors should evaluate the options through a consistent and objective framework.

A strategic spending plan can have a significant impact on clients' ability to achieve their desired

lifestyle in retirement and to leave a financial legacy to the people or causes they care about.

Advisors who incorporate tools to identify and implement sequence of spending options for their clients stand to grow their business and differentiate themselves as retirement income specialists.



For more information and support, call the Nationwide Retirement Institute Planning Team at **1-877-245-0763**.



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