Planning With a Large IRA

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As of the end of last year, the typical new retiree had stashed away a bit less than $150,000 in employer-sponsored retirement accounts and IRAs. That's a problem—those dollars won't fund a lot of retirement spending. No wonder only 18 percent of workers are confident they'll be able to retire comfortably. At the high end of the spectrum, some retirees have a different problem, though they may not (yet) view it as such: their retirement accounts may be so large that they'll need to do some serious planning to manage the ordinary income that's about to come their way—and eventually, to their children.

Don't read this as an invitation to stop contributing to your 401k and IRA. Those who achieve multi-million dollar retirement accounts typically do so by contributing the maximum amount for decades, coupled with making savvy investment picks and receiving a generous employer match. If you are one of the lucky ones, congratulate yourself—and start planning.

First things first—do you need to plan? A seventy year old taking his first minimum required distribution from a million dollar IRA would have to withdraw $36,500. A two million dollar IRA requires an initial distribution of $73,000, and so forth. If your retirement accounts will likely require you to withdraw significantly more than you need to support yourself, start planning in your sixties. Before then, you likely can't make accurate projections or take tax-efficient actions.

Most people leave the full-time work force earlier than age 70. Before then, many begin tapping non-retirement investment accounts or claiming Social Security benefits. This may not be the best strategy.

After age 59-1/2, you can begin withdrawing IRA assets penalty free. Typically, every dollar that comes out is fully taxed as ordinary income. This is more onerous than taking assets from a taxable investment account (some tax-free return of capital, some tax-favored dividends and capital gains) or from Social Security (no more than 85 percent taxable). You may be able to mix and match taxable assets and your IRA to provide sufficient cash flow while keeping your tax bracket relatively low. For example, this year the 25% bracket for married couples goes to $151,200. If you project your taxable income at $80,000 without taking non-mandatory IRA withdrawals, you could withdraw up to $70,000 or so while leaving that amount of money (or at least the after-tax amount) in taxable accounts.

This has many potential benefits: you could hold off claiming Social Security benefits, allowing them to grow eight percent annually. You can take less from your taxable investments, leaving you more planning options in later years and perhaps benefitting your children when they inherit. You reduce your future taxable income without jeopardizing your future cash flow.

All this suggests another important point: plan carefully in which account you hold which assets. Because IRAs are tax sheltered and distributions are taxed as ordinary income, it only makes sense for them to hold fixed income, at least to the extent consistent with your overall asset allocation. Conversely and to the extent possible, hold equities in taxable accounts, where you can take advantage

of lower taxes on dividends and capital gains. This pattern has the added benefit of keeping lower-growing assets in your IRA and faster-growing ones in your taxable account, in turn keeping your IRA from becoming an outsized portion of your total assets.

Even better, incorporate your IRA planning into your overall estate planning. When your children inherit taxable investment accounts, the assets in those accounts get a brand new, date of death basis. Retirement accounts are treated differently: your beneficiaries are taxed the same way you are. If every dollar comes out to you as ordinary income, the same will be true for your children. Under the current rules, they'll be able to stretch those distributions out over their individual life spans, but it all has to come out to them. This is not the case with a regular investment account, which affords far more tax planning. Thus, inheriting a $1 million stock portfolio can be far more valuable than inheriting a $1 million IRA. A recurring federal tax proposal would require non-spouses who inherit IRAs to take full distributions within five years. That makes leaving large IRAs to descendants even less attractive.

If feasible, take a gimlet-eyed look at your tax situation and your children's earning potential. If they'll be in a higher tax bracket than the post-retirement you, your family as a whole benefits by your taking IRA assets out during retirement and allowing your taxable assets to accumulate. Not all families are capable of being sufficiently open about relative finances. Even if yours is, your children may be so differently situated that this sort of planning is impossible. Still, it is worth considering.

An additional option is the Roth IRA conversion. If, after taking living expenses from your IRA, you still have room to run in your tax bracket, consider converting some of the IRA to a Roth. You pay ordinary income tax now, but future earnings are totally off the tax grid—for both you and your children. Roth conversions can be done a bit at a time, as it suits your tax situation.

If all of this seems too complicated, consider a different route altogether: to the extent you have charitable intentions, leave some or all of your IRA to charity at your death. The charity can take the entire balance tax free. As of yet, Congress has not re-enacted the ability for those age 70-1/2 or older to make direct, lifetime charitable contributions from their IRAs. That measure had been extremely popular, and the tax community expects it will eventually be made permanent.