Kiplinger's
RETIREMENT PLANNING 2018
YOUR GUIDE TO A SECURE RETIREMENT

Stretch Your *Retirement Income*

USE THESE SIX STRATEGIES TO MAKE YOUR SAVINGS LAST A LIFETIME.

BY EILEEN AMBROSE & SANDRA BLOCK

When it comes to saving for retirement, maybe you've done everything right. You started early, maxed out your 401(k) plan, invested in a diversified portfolio and avoided costly mistakes, such as cashing out your retirement plan. Fantastic. But now comes the hard part: making sure you don't outlive your money.

That's a tall order for today's retirees. Taxes, unpredictable investment returns, rising health care costs and inflation down the road can significantly erode the value of your nest egg. And perhaps the biggest challenge is that you'll probably need the money for a long time. A 65-year-old man has a life expectancy of 19.3 years; it's 21.6 years for a 65-year-old woman.

Fortunately, there are steps you can take to generate extra income and extend the life of your portfolio.

PUT YOUR MONEY IN BUCKETS

A bear market just as you enter retirement couldn't come at a worse time if you're forced to sell securities after prices have plunged. Certainly, many investors today worry about how long the bull market can keep running. That's where the "bucket system" can help. Basically, you divide your money among different kinds of investments based on when you'll need it. Jason L. Smith, a financial adviser in West Lake, Ohio, and author of *The Bucket Plan* (Greenleaf Book Group Press), uses the system with clients, splitting their assets among three buckets: "Now," "Soon" and "Later."

The Now bucket holds what you'll need in the short term. Smith recommends setting aside enough so that, when added to Social Security or a pension, it will cover your basic expenses for up to a year. It should also have enough for major expenses that are likely to crop up over the next couple of years, such as paying for a new roof or that once-in-a-lifetime trip around the world, plus cash for unexpected emergencies.

Money in the Soon bucket will be your source

of income for the next 10 years. Smith recommends investing in a fixed annuity (not an immediate annuity, which locks you into receiving monthly payments) or high-quality short-term bonds or bond funds. As the Now bucket is depleted, you withdraw money from the annuity or sell some of the fixed-income investments in the Soon bucket to replenish it.

The assets in the Later bucket aren't meant to be tapped for more than a decade into your retirement, so they may be invested more aggressively in stock funds, which provide greater growth potential, and alternative investments such as real estate investment trusts, or REITs. This bucket can also include life insurance or a deferred-income annuity, which pays income later in life. Consider selling securities in the Later bucket to replenish the Soon bucket starting about five years before it runs out of money. If the market is in a downward spiral, you can wait, knowing you still have a few years before the Soon bucket will be empty.

KIP TIP: Money you'll need in the near term should be parked in a savings account. Yields on deposit accounts have been abysmal, and even though the Fed has been nudging rates higher, most banks haven't passed on all of the increases to savers. Still, many are boosting rates. Yields on saving accounts requiring little or no minimum balance were recently 1.8% at Dollar Savings Direct, 1.6% at Live Oak Bank, 1.55% at CIT Bank and 1.3% at BankPurley.

MANAGE YOUR SPENDING

To avoid running out of money during retirement, the standard rule has been to withdraw 4% from your nest egg in the first year of retirement and use the inflation rate as a guide to adjust withdrawals in subsequent years. For example, if you have $1 million, you can withdraw $40,000 in year one. If the inflation rate clocks in at 2% in year two, your withdrawal grows by 2%, to $40,800.

The 4% rule is based on historical market returns for a portfolio evenly split between stocks and bonds. But as the saying goes, past performance is no guarantee of future returns. Plus, the rule assumes you will live 30 years in retirement, so you might want to adjust the withdrawal rate up or down based on your life expectancy, says Judith Ward, a senior financial planner at T. Rowe Price.

Still, you should do just fine if you use the rule as a starting point for withdrawals. In fact, T. Rowe Price tested the 4% rule for a worker who retired in 2000 with a $500,000 portfolio (60% stocks, 40% bonds) and experienced two bear markets—the 47% drop in Standard & Poor's 500-stock index in 2000–02 and the 55% drop in 2007–09. Though the retiree's balance shrunk to about $300,000 by 2009—a 40% decline—the subsequent bull market helped restore the balance to $414,000 by the end of 2016.

KIP TIP: Like any rule of thumb, the 4% rule won't work for everyone or in every situation. You might need to reduce the withdrawal rate if you retire early or have a major expense, or if a market downdraft wipes out a chunk of your nest egg. Or you might increase it if your investments have appreciated more than expected, or you've spent less than you anticipated and have built up a sizable balance.

EARN EXTRA INCOME

When Steve Cornelius retired in 2011 from his job as an executive for an industrial supply company in Atlanta, he moved to Minneapolis—no doubt passing other retirees who were headed in the opposite direction. "I can't stand hot weather," he says. Cornelius loves spending time outdoors and playing golf, but after a couple of years he realized he needed something else to do during Minnesota's long, cold winters. His solution: a part-time job with tax-preparation giant H&R Block.

Cornelius, 67, started working for Block in 2013 and has a growing roster of return clients. His hours are flexible, but he usually works 32 hours a week from January through April. During the rest of the year, he works about 10 hours a week providing clients with general tax-planning advice.

Cornelius says the income from his job will allow him to postpone claiming Social Security benefits until he's 70. He'll get a bump up of 8% for every year he delays taking benefits after his full retirement age of 66. "That's going to give me security against inflation, which will rear its ugly head at some point," Cornelius says.

The income has also enabled Cornelius to take trips he might not otherwise be able to afford. Last fall, he and his partner, Robin, took a cruise through Southeast Asia, with stops in Hanoi, Ho Chi Minh City, Bangkok and Singapore. "I've got a great retirement plan, but unless you're Warren Buffett, you're on a budget," he says.

In addition to allowing you to delay taking

KIP TIP

Downsizing and moving to a tax-friendly location for retirees could save you money (see Kiplinger's State-by-State Guide to Taxes on Retirees at kiplinger.com/links/retireetax map). But before you move to a new zip code, take an extended vacation to the new neighborhood you're considering. And be sure to visit during the off-season to see if the weather agrees with you.

KIP TIP

Even modest inflation can erode your purchasing power over time. Treasury inflation-protected securities, or TIPS, are bonds issued by Uncle Sam that can be a good hedge against rising consumer prices. Buy them online at TreasuryDirect (www.treasurydirect.gov).

Social Security, income from a part-time job can help cover your expenses during a market downturn, which means you won't have to sell investments at a loss to pay the bills. Part-time and seasonal job opportunities run the gamut, from working as a park ranger to teaching English as a foreign language in another country. Freelancing is another way to earn extra cash (see www.freelancersunion.org for advice on everything from contracts to taxes). Freelance gigs range from online tutoring to consulting in your former profession. If you have a garage apartment or second home, you can earn income through home-sharing services, such as Airbnb.

KIP TIP: If you're receiving Social Security benefits and haven't reached full retirement age—66 for most retirees—be mindful of the earnings test. In 2018, if you make more than $17,040, you'll lose $1 in benefits for every $2 you earn over that amount. If you reach full retirement age in 2018, you'll give up $1 for every $3 you earn over $45,360 before your birthday. Starting in the month you reach full retirement age, you can earn as much as you want without worrying about the earnings test. (For more on Social Security and the earnings test, see "Social Security: Get It Right.")

BUY AN ANNUITY

Unless you're a retired public service employee or you worked for one of the handful of companies that still offer a traditional pension, you're not going to receive a monthly paycheck from your employer for the rest of your life. But that doesn't mean that a guaranteed source of lifetime income is an impossible dream. You can create your own pension by buying an immediate fixed annuity.

When you buy an immediate annuity, you give an insurance company a lump sum in exchange for a monthly check, usually for life. You can buy an annuity that has survivor benefits so that it will continue to pay your spouse after you die. But you pay for that protection by accepting smaller monthly payouts. Another option is a deferred-income annuity; you purchase the annuity when you're in your fifties or sixties, but the payments don't start for at least 10 years. The longer you wait, the bigger the payouts. Of course, if you die before payments start, you get nothing—unless you opt for return of premium or survivor benefits. (These products are often referred to as longevity insurance, because they protect you from the risk of outliving your savings.)

A relatively new type of deferred-income annuity, a qualified longevity annuity contract (QLAC), offers a tax benefit for retirees who have a lot of money in tax-deferred retirement accounts. You can invest up to 25% of your traditional IRA or 401(k) plan (or $125,000, whichever is less) in a QLAC without taking required minimum distributions on that money when you turn 70½. To qualify for this special tax treatment, your payments must begin no later than age 85.

An analysis by New York Life illustrates how this strategy could lower your tax bill. A 70-year-old retiree in the 24% tax bracket with $500,000 in an IRA would pay about $100,000 in taxes on RMDs between age 70 and 85, assuming 5% annual net returns. If the retiree opted instead to put 26% of the IRA balance into a QLAC at age 70, he would pay roughly $74,000 in taxes over the same period—a $26,000 reduction. Taxes would increase, however, once the annuity payments began at 85. You can shop for QLACs at www.go2income.com.

KIP TIP: Don't stash all of your nest egg in an annuity. Most experts recommend investing no more than 25% to 40% of your savings in an annuity. Alternatively, calculate your basic expenses, such as your mortgage, property taxes and utilities, and buy an annuity that, when added to Social Security benefits, will cover those costs.

MINIMIZE TAXES

To get the most out of your retirement savings, you need to shield as much as possible from Uncle Sam. Fortunately, there are plenty of legal ways to lower your tax bill, but you need to understand how your different retirement accounts are taxed.

Let's start with your taxable brokerage accounts—money you haven't invested in an IRA or other tax-deferred account. Because you've already paid taxes on that money, you'll be taxed only on interest and dividends as they're earned and capital gains when you sell an asset. The top long-term capital gains rate—which applies to assets held for more than a year—is 23.8%, but most taxpayers pay 15%. In 2018, if you file an individual return and have taxable income of under about $38,600, or if you file jointly and have less than roughly $77,200 in taxable income, you qualify for the 0% rate on long-term gains.

Next up: your tax-deferred retirement accounts, such as your IRAs and 401(k) plans. Withdrawals from these accounts are taxed at ordinary income rates, which range from 10% to 37%. The accounts grow tax-deferred until you take withdrawals, but you can't wait forever. Once you turn 70½, you'll have to take required minimum distributions (RMDs) every year, based on the year-end balance of all of your tax-deferred accounts, divided by a life-expectancy factor provided by the IRS that's based on your age. The only exception to this rule applies if you are still working at 70½ and have a 401(k) plan with your current employer; in that case, you don't have to take RMDs from that account. You'll still have to take withdrawals from your other 401(k) plans and traditional IRAs, unless your employer allows you to roll them into your 401(k).

Finally, there are Roth IRAs, and the rules for them are refreshingly straightforward: All withdrawals are tax-free, as long as you've owned the account for at least five years (you can withdraw contributions tax-free at any time). There are no required distributions, so you may leave money in the account to grow for your heirs. This flexibility makes the Roth an invaluable apparatus in your retirement toolkit. If you need money for a major expense, you can take a large withdrawal without triggering a tax bill. And if you don't need the money, the account will continue to grow, unencumbered by taxes.

Conventional wisdom holds that you should tap your taxable accounts first, particularly if your income is low enough to qualify for tax-free capital gains. Next, take withdrawals from your tax-deferred accounts, followed by your tax-free Roth accounts so you can take advantage of tax-deferred and tax-free growth.

There are some exceptions to this hierarchy. If you have a large amount of money in traditional IRAs and 401(k) plans, your RMDs could push you into a higher tax bracket. To avoid that scenario, consider taking withdrawals from your tax-deferred accounts before you turn 70½. Work with a financial planner or tax professional to ensure that the amount you withdraw won't propel you into a higher tax bracket or trigger other taxes tied to your adjusted gross income, such as taxes on your Social Security benefits. The withdrawals will shrink the size of your tax-deferred accounts, thus reducing the amount you'll be required to take out when you turn 70½.

KIP TIP: Another strategy to reduce taxes on your IRAs and 401(k) plans is to convert some of that money to a Roth. Note that the conversion will be taxed as ordinary income and could bump you into a higher tax bracket. To avoid bracket creep, roll a portion of your IRA into a Roth every year, with an eye toward how the transaction will affect your taxable income. K

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