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Tax Efficiency

White paper

NATIONWIDE RETIREMENT INSTITUTE®

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 Masters in Management and Leadership and is FINRA 6, 63, and 26 licensed. Carlo's specializations in retirement incoming planning strategies include heath care costs, long-term care costs, and determining optimal Social Security filing strategies.

As more clients choose to delay Social Security filing to maximize their benefit, they're placing a greater burden 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.

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.

In a Nationwide-sponsored survey on retirement income, 85% of advisors surveyed reported that they are either currently offering, or plan to offer, holistic financial planning, largely in response to the Department of Labor Fiduciary Rule.[2] That's a level of 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 do in practice, the traditional file and collect Social Security first spending model, your clients could gain up to six years in portfolio longevity.

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.

The scenarios discussed below are hypothetical, are for illustrative purposes only and results may differ. Neither Nationwide nor its representatives give legal, tax or investment advice. Clients should consult with their attorney or legal advisor for answers to their specific questions. This paper does not constitute legal or investment advice. Please consult with your tax or legal advisor.

[1] Holistic Retirement Income Planning on the Horizon, Insured Retirement Institute, December 20, 2016.

[2] Annual Retirement Income Survey – Nationwide-sponsored Investment News Research, September 2016.

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 — like 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 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.[3] 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.[4] 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 likely 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 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.

Congress has introduced a variety of tax distortions ...

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

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?

[3] "Longevity Risk and Retirement Income Tax Efficiency: A Location Spending Rate Puzzle" Huaxiong and Milevsky, April 20, 2016.

[4] "Social Security and Equivalent Railroad Retirement Benefits" Department of the Treasury Internal Revenue Service, https://www.irs.gov/pub/irs-pdf/p915.pdf, December 2016.

Example 1: Capital gains + IRA

Consider capital gains, which are taxed at 0% when the taxpayer's ordinary income (including the capital gain) is under the 25% income tax bracket, 15% for those in the 25% and 33% brackets, and 20% for those in the highest bracket.

Assuming a standard deduction plus two personal exemptions totaling $20,800, a married couple filing jointly, with

$96,700 of long-term capital gains and no other income in 2017, would pay no federal income tax. If the same taxpayer took $10,000 from an IRA, they would pay no ordinary income tax, because the ordinary income would be eliminated by the standard deduction and personal exemptions, but the $10,000 withdrawal would push $10,000 of capital gains into the taxable range at 15%. The client's tax software or return summary from most major tax preparation firms will show the client in a 0% tax bracket, yet the client will pay a $1,500 federal tax bill.

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.[4]

For this example, we have a married couple, both 65+, who take $16,000 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, plus personal exemptions, total $23,300. With these incomes, the clients will pay no federal income tax.

Social Security benefits aren't taxable Or are they?

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 exemptions), but the act of withdrawing it triggered $1,468 in taxes. The first $1,750 of income was eliminated by the standard deduction and personal exemptions, roughly the next $1,250 was subject to a 15% effective marginal rate, where a dollar of IRA withdrawal caused $0.50 of a Social Security dollar to become taxable, and both were taxed at the 10% bracket. The remainder was subject to an 18.5% effective marginal rate, where each dollar withdrawn from the IRA caused $0.85 of a Social Security dollar to become taxable, still at the 10% rate. When only Social Security and ordinary income are included, the effective marginal rate can reach as high as 46.25% (1.85 x 25%).

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 $2,776 of the $5,000 to federal income

tax, representing a 55.5% effective marginal rate.

Here's what happened:

- The $5,000 IRA withdrawal is taxed at a 15% tax rate
- The withdrawal causes 85% of $5000, or $4,250 in additional Social Security benefits, to become taxable, also at 15%
- $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 15% tax rate on their IRA withdrawal and actually paid an effective marginal rate of 55.5%.

[4] "Social Security and Equivalent Railroad Retirement Benefits" Department of the Treasury Internal Revenue Service, https://www.irs.gov/pub/irs-pdf/p915.pdf, December 2016.

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.

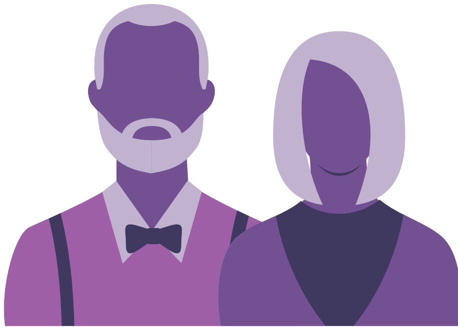
For most clients, this means supporting one of three goals:

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



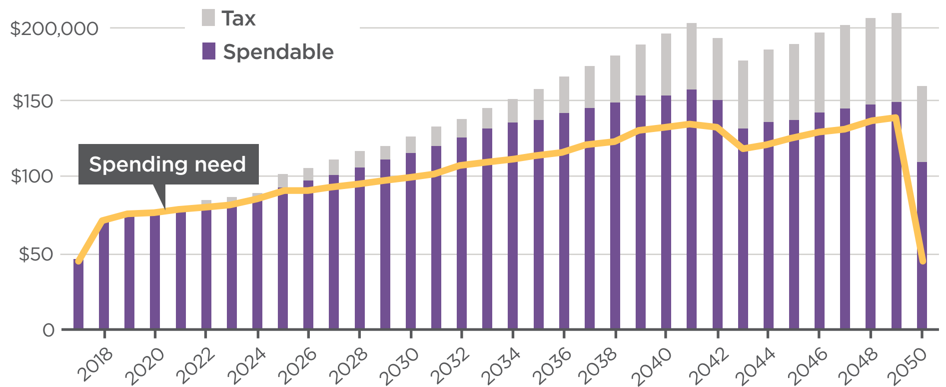
John and Jane are 65 and 62, respectively. John has saved $650,000 in his 401(k) plan. John's Primary Insurance Amount (PIA) — the Social Security benefit he would receive at full retirement age — is $2,600. Jane has a $200,000 IRA and a $1,000 PIA. They have $200,000 in a joint brokerage account with 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 later — they should be wary. Notice how the purple bar extends above the spendable income need line once John reaches age 70½? That often signifies that a different sequence of spending may be beneficial to avoid pushing clients into higher tax brackets in the future.

John and Jane's annual income



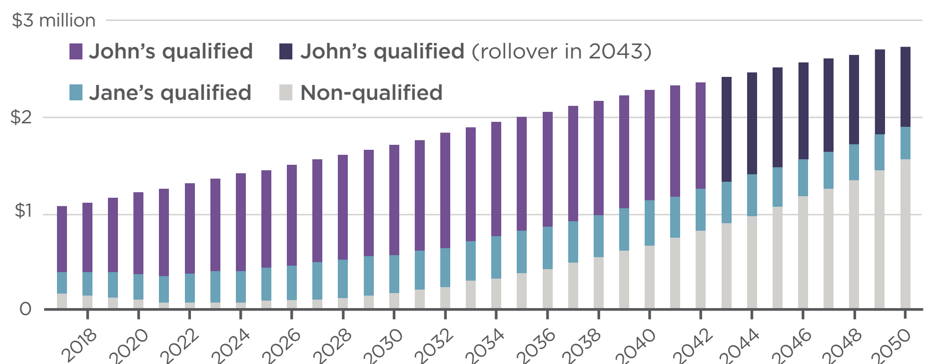
This scenario is hypothetical, is for illustrative purposes only and results may differ.

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 likely 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



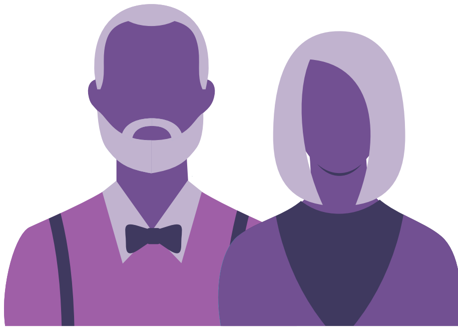
This scenario is hypothetical, is for illustrative purposes only and results may differ.

For John and Jane, the traditional Social Security first sequence of spending generates a net after-tax estate value of roughly $500,000 with approximately $328,000 of lifetime taxes paid.

Social Security-first

IRA-first

Roth conversion

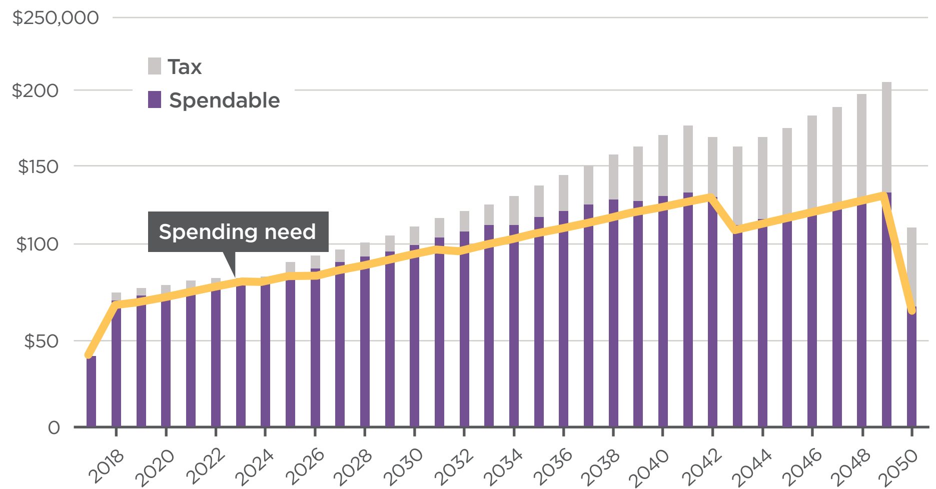


Now let's consider an alternate sequence of spending where John and Jane implement an IRA-first strategy. This scenario assumes that Jane claims her Social Security benefit as soon as John reaches full retirement age and that John files a restricted application for only spousal benefits while delaying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

As a result of applying an IRA-first strategy, we see a $90,000 net increase in the after-tax estate value and a $7,000 increase in the present value of lifetime taxes paid. The net increase in the estate value far exceeds the increase in taxes paid, so this is an improvement over the traditional Social Security-first strategy.

Notice 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.

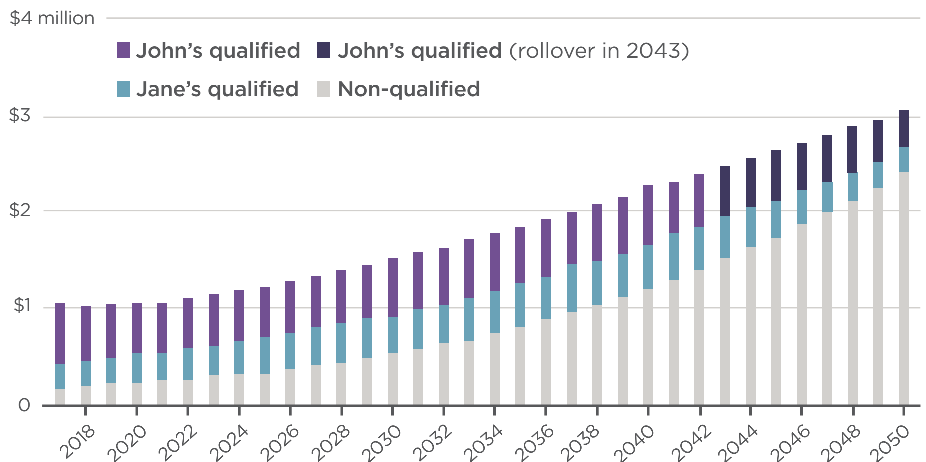
John and Jane's annual income



This scenario is hypothetical, is for illustrative purposes only and 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 tax to the beneficiaries.

John and Jane's annual account balances



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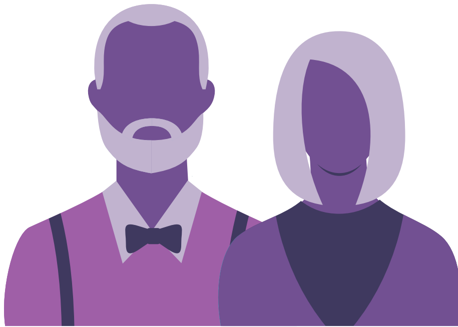
Social Security-first

IRA-first

Roth conversion



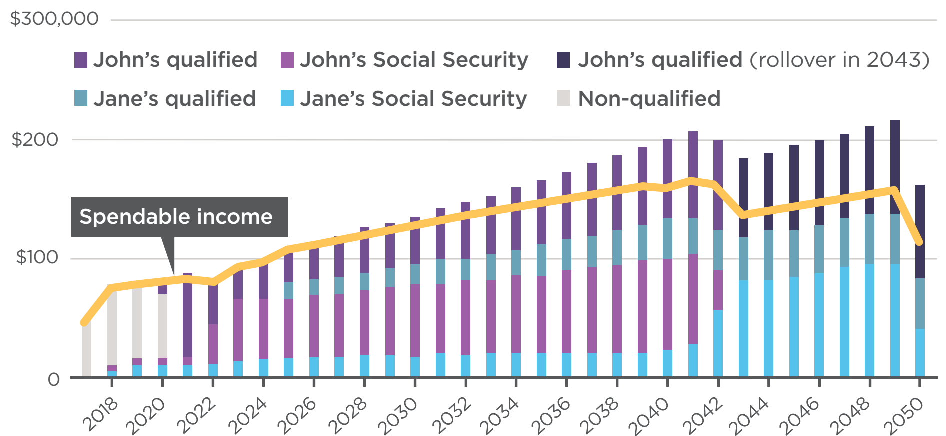
A third potential sequence of spending incorporates the same Social Security strategy, but uses the clients' nonqualified funds to bridge the gap until Social Security benefits begin. We also identify strategic opportunities to convert portions of the clients' IRAs to Roth IRAs. In this strategy, the 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 $97,000 of additional after-tax estate value — nearly a 20% increase over the traditional harvesting pattern — while also reducing the lifetime tax bill by approximately $16,000. Surprisingly, the conversion amounts are relatively small, with the first-year conversion of $38,000 followed by second- and third-year conversions of roughly $21,000.

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 33-year retirement period.

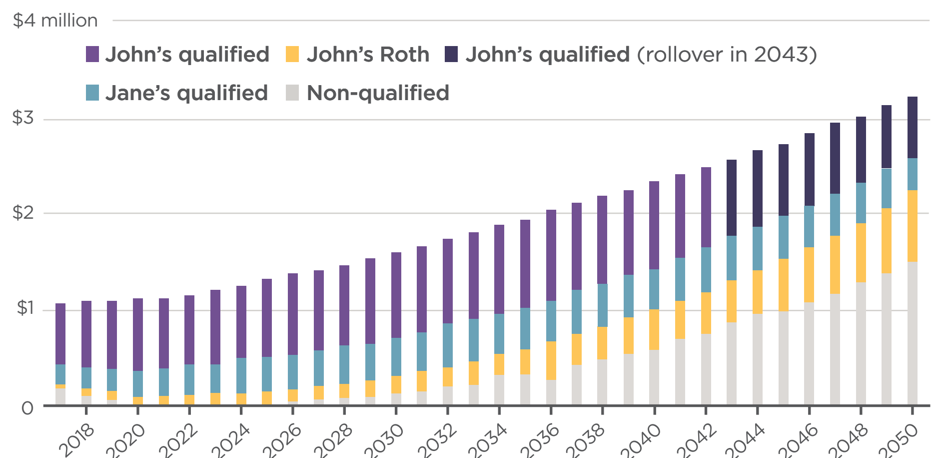
John and Jane's annual income



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

By the end of the 33-year projection period, the Roth assets would have grown to $717,000. Under current tax law, the Roth would transfer to John and Jane's beneficiaries tax-free and be available to be stretched over their life expectancies, providing significant additional tax-free growth potential and tax-free income.

John and Jane's annual account balances



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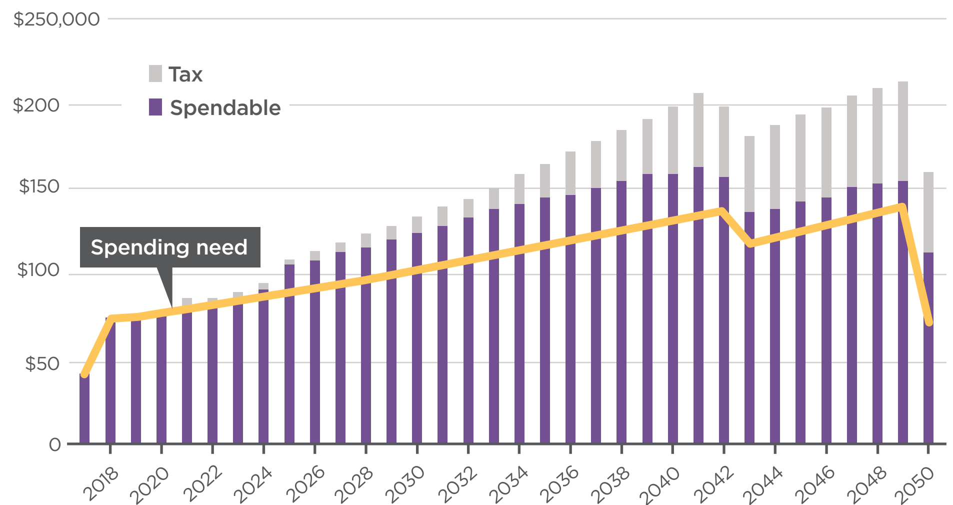
In this example, we maintained equal asset allocations across all accounts. If we locate the highest growth assets in the Roth instead of the equal allocation, the benefits of the conversion strategy would be considerably higher.

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



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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 Retirement Institute Income Planning Team at **1-877-245-0763.**

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NFM-16713AO (09/17)