Designing Income

CASE STUDY

ALLODIUM
INVESTMENT CONSULTANTS

Challenge

Edward was a 62-year-old widower and had just retired when he first came to Allodium a year ago. He was transitioning from earning a healthy income to having no income. He had decided to defer receiving Social Security benefits until he turns 70. For the eight years between ages 62 to 70, he needed to develop a plan to create income from his retirement accounts. He had built up a healthy amount of savings and had enough money in his after-tax accounts to live on until age 70. He had also saved nearly $2 million in tax-deferred retirement accounts. He wanted to access his accounts strategically so that he could leave as much money as possible for his son and daughter. They both had successful careers, but they lived in high-cost areas and couldn't afford to save much for retirement. Edward planned to live on the after-tax savings, but he wondered if that was the right decision. He came to Allodium for a second opinion in designing his retirement income plan.

Recommendation

Allodium assessed the situation and made some retirement income planning recommendations. If Edward were to live solely on the funds from the after-tax accounts between ages 62 to 70, his $2 million in tax-deferred retirement accounts would continue to grow tax-deferred. However, at age 72, Edward will be obligated to take very large Required Minimum Distributions (RMDs) from his tax-deferred accounts. These distributions will be three times the amount that he needs for living expenses and will result in higher income taxes for Edward. During the first eight years of retirement, his income taxes would be relatively low, but then increase dramatically when the RMDs begin.

Allodium suggested a plan to strategically spend from his after-tax accounts while systematically performing a series of Roth conversions before he turns 72, while his income taxes are low. Roth conversions essentially shift dollars from a traditional IRA to a Roth IRA. This leads to only a small amount of tax each year, while making it possible to build up Roth IRAs that are entirely tax-free. In effect, Edward would pay some taxes on the IRA distributions early and at a lower rate than he would pay if he were to allow the IRA to grow and distribute the RMDs when he turns 72. The funds in the Roth IRA can continue tax-free growth, allowing for tax-free withdrawals of earnings in contrast to taxable withdrawals from the IRA.

Result

Edward agreed to execute the eight-year financial plan that Allodium recommended. He is meeting his own income needs while implementing a plan that will maintain a steady income tax bracket through the years. By age 72, his mandatory RMD will be reduced because the balance in his IRA will be lower, and he will have created a tax-free source of funds in the Roth IRA that he can use or pass on tax-free to his children. Edward appreciated the thoughtful and forward-thinking approach to designing his income plan.