

Unlocking Your Retirement Wealth: A Comprehensive Guide to Cash Flow Planning with LTWM

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As the calendar flips to the new year, our focus shifts to cash flow planning. Those of you taking distributions, or starting to in the near future, have probably wrestled with the questions that come up in this process. How much do I need from my portfolio each month? How much can I afford to take? Where should I be taking it from? LTWM advisors strive to make these discussions open and collaborative, tailoring our planning to each individual client's needs, goals, and comfort level. With that being said, our advisors enter these conversations already prepped with data and analysis in tow. For potential clients looking to understand our process, or current clients wanting an in-depth look at our methods, here's a peek behind the LTWM curtain...

The Withdrawal Amount

How much can I afford to take from my portfolio? It's one of the most common, and probably one of the most challenging questions about cash flow planning in retirement. For many of our clients, it's the question that brought them here. Frustratingly, there's no perfect answer, or one-size-fits-all approach to reach it. The right number depends on your retirement income, your goals, your risk tolerance, and a myriad of other factors. Your LTWM advisor is here, armed with quantitative information and years of experience, to help chart the path forward that's best for you.

First, though, a disclaimer: Your money is your money. We're here to steer the conversation in a sustainable direction grounded in numerical evidence, but you are still the driver. You won't hear a LTWM advisor tell you what you can and cannot do; rather, our role is to understand your situation and goals, and use them to create a plan that satisfies your needs while also giving you the peace of mind to know that you can afford your distribution.

As you go through the initial distribution planning process, your advisor will help you gain an understanding of what is affordable and sustainable given your financial situation. But how does your advisor know? One of our most useful tools is Monte Carlo simulations, a modeling method that uses simulations to quantify probabilities in situations far too complicated for simpler arithmetic methods. To be more specific, we pour the details of your financial situation, including goals, asset



allocation, liabilities, and timeframe into our financial planning software; the software then runs thousands of simulations using a set distribution of potential market returns, modeling potential future market outcomes and seeing in how many of them your financial goals are met. If your plan is successful in most of the simulations, that likely means your distribution amount is sustainable.

Tax Efficiency

Ok, so, you and your advisor have landed on a number. Congratulations! Hopefully, you are already feeling the weight lifted off your shoulders. While you can start thinking about the more enjoyable aspects of retirement (piña coladas, anyone?), the work your advisor does for you is just beginning. There are still several ways to optimize your cash flow plan, and chief among them is tax efficiency.

Our goal is to get you your money in the least expensive way possible. That is, we want to get you your money while incurring as little tax as possible. The tricky part is this: the lowest-tax method for your distributions this year might not be the most efficient method in the long run. After all, we're invested in the success of your plan not just today, but for the rest of your life, just like you!

Most retirees have their assets split between multiple types of account, each with their own tax treatment. The three most common types are as follows:

1. Taxable accounts. This is your standard brokerage account. Gains generated from assets sold for profit are taxed at the applicable capital gain tax rate.
2. Pre-tax accounts, also known as tax-deferred accounts. Most common examples are Traditional IRAs and 401(k)s, but this category also includes SEP IRAs, SIMPLE IRAs, 403(b)s, and 457s. Distributions from pre-tax accounts are taxed at the applicable ordinary income tax rate.
3. After-tax accounts. The most common examples are Roth IRAs and Roth 401(k)s. Qualified distributions from Roths are not taxed.

If all of our money was in a Roth, tax planning would be simple! However, that's rarely the case. Usually, Roth IRAs make up only a portion of an overall portfolio, meaning we need to be strategic about when we use them. Between Required Minimum Distributions (RMDs) and the start of Social Security, most retirees see an increase in taxable income the later into retirement they get. For many, this pushes them into higher ordinary income and capital gain brackets. So, while it may be tempting to draw from your Roth this year, that could mean paying more tax in later years unnecessarily. Why use your Roth funds to avoid a lower

marginal tax rate this year, when you could use them to avoid a higher marginal tax rate after your RMDs and Social Security kick in?

The Tax Projection

So, if taking everything from your Roth IRA isn't usually the right move, then what is? The answer to that question depends on many factors and is different for every person. To answer that question for you, we start by projecting your income for the current year in our tax planning software. To do this, we go line by line on your most recent tax return, changing any items for which we expect a different amount this year. Some of these changes are straightforward, like IRA RMDs and Social Security COLAs. For others, we rely on our relationship with you and our previous knowledge of your financial landscape. Events like retirements, job changes, children starting college, business sales, or even electric car purchases can all change your tax situation, and we use our in-depth knowledge of each of our clients to make sure all bases are covered.

Once your tax projection is complete, we'll have a good idea of what your taxable income for the year will be. From there, we can determine your projected marginal ordinary income and capital gain tax rates as well as how much headroom you have in each bracket, which will form the basis of our recommendation. The tax projection lets us know what we're working with, and allows us to directly compare the current-year tax impact of different cash-generating strategies.

What does your future hold?

The tax projection sets our baseline, and clearly defines the variables we're working with, but context is important too. Two people with the same taxable income could have wildly different financial pictures. If we expect income to increase in the future, then "filling out" the current bracket by taking money from a Traditional IRA would make a lot of sense. Conversely, if someone is in an unusually high tax bracket because of a one-time taxable gain, like a home sale for example, "filling out" their current bracket would mean incurring tax at a higher-than-normal tax rate, and a Roth IRA distribution might be more appropriate.

As we plan for your individual cash need, we'll consider your individual context, and what changes we expect in your future. That, in turn, will illuminate which path forward makes the most sense for you.

An Example

Let's illustrate this process with an example. Say we have a client, Collette, who is 64 years old and lives in a state with no income tax. Collette was lucky enough to

retire at 62, and since then has earned about \$40,000 a year from her rental properties and some consulting here and there. After speaking with her financial planner, Collette decided she can afford to spend \$10,000 a month, which means she'll need an additional \$80,000 from her portfolio this year. She has both a Traditional IRA and a Roth IRA, both of which have balances big enough to cover this year's cash need. Additionally, she has \$95,000 in a brokerage account with \$15,000 in unrealized gains.

Collette's advisor would first use the above information to compile a tax projection for the year. The projection would show Collette in the middle of the 12% ordinary income bracket and still in the 0% capital gains bracket, with about \$21,000 of headroom in both. However, the tax projection is just a baseline. Collette's advisor still needs to determine the most appropriate method for generating the \$80,000 she needs, which may create further tax liability.

With the current year tax projection complete, Collette's advisor would turn their attention to future years. Next year, Collette will reach full retirement age for her former employer's pension plan and will start to receive an additional \$60,000 a year. This will be important in evaluating the impact of any distribution strategy on Collette's long-term financial plan. Now, with the tax projection finished and the future changes noted, her advisor can evaluate the impact of each potential funding source.

Collette's advisor, knowing about her impending pension income, would rule out using only Roth IRA distributions right away. Her pension income will push her into the 22% marginal bracket next year, and Social Security will likely take her into the 24% marginal bracket when she turns 67. Why use Roth funds to avoid paying a 12% tax rate this year when she could use it to avoid paying twice that in three years?

With the 100% Roth IRA distribution ruled out, two options remain: the Traditional IRA and the brokerage account. Let's compare the two:

The Traditional IRA

- Considering that Traditional IRA distributions are taxable at the ordinary income rate, Collette would need to distribute around \$100,000 from her Traditional IRA to generate the \$80,000 after taxes. The first \$21,000 of distributions would fall into her 12% ordinary income bracket, which is 10% lower than the expected tax rate on her IRA distributions after her pension kicks in. However, the remaining \$79,000 of distribution would be taxed at either 22 or 24%, right in line with future rates. While being taxed at future rates isn't a bad outcome, there's no benefit to it either; it's essentially a wash. Collette's advisor would likely recommend filling only the 22% bracket



with Traditional IRA distributions and using Roth IRA distributions to cover the remaining cash need. That way, Collette's exposure to her highest expected marginal tax rate is limited. In the end, the benefit of this strategy would be paying 10% less in taxes on \$21,000 worth of distributions.

The Brokerage Account

- To cover her cash need with her brokerage account, Collette's advisor would only need to create \$15,000 in taxable income. This is because her initial contribution, or "basis," isn't taxed on withdrawal; only the gains on her contributions are taxable. So, even though \$80,000 would need to leave the account, only the \$15,000 of gains would be taxed. Another important note is that gains on assets in taxable accounts that are held for more than one year are taxed at the capital gains rate, which is different than ordinary income rates. As stated previously, Collette's current capital gains rate is 0%, meaning she wouldn't have any additional tax from the withdrawal. After her pension starts, Collette would be pushed into the 15% capital gains bracket, meaning she'd save 15% on the \$15,000 by realizing the gain this year.

After the analysis above, Collette's advisor would recommend generating her needed cash entirely from the brokerage account. Since she has more money in the brokerage account than she needs for just this year, not all of the assets would need to be sold. Her advisor would recommend selling the assets with the most gain, as this year is the last year with the advantageous capital gains rate. Additionally, because she had \$21,000 of headroom in her marginal brackets but only generated \$15,000 in new income, Collette could still realize \$6,000 in additional income at the current marginal rates. Her advisor would likely recommend a \$6,000 Roth conversion, which would incur ordinary income tax at the current 12% rate but move the funds to her Roth IRA (more on this later). That way, she can access those funds tax-free when her marginal rate has increased to 24%. Overall, this strategy would save her almost \$3,000!

Other Considerations

Unexpected Changes

- Sometimes, even the best projection can be rendered incorrect by unanticipated events. To account for this, LTWM advisors often do cash flow planning in stages, generating cash for only a few months at a time. This avoids incurring taxes unnecessarily early and allows us to react to unexpected changes with maximum flexibility.



Medicare Costs

- Medicare part B and D premiums can increase when you cross certain income thresholds. LTWM advisors factor in these increases when computing the tax consequences of cash-generating transactions for Medicare-eligible clients.

Charitable Giving

- Charitable gifts can be deducted from taxable income when using an itemized deduction. For clients who give routinely, there may be ways to maximize the tax efficiency of donations. One tool for this is a Donor-Advised Fund, which can be used to donate highly-appreciated capital gain assets without realizing any of the capital gain.

Roth Conversions

- Sometimes, even after all the necessary cash has been raised, a client will have headroom remaining in a marginal tax bracket they won't be able to access in future years due to income increases. When this happens, we often recommend a Roth conversion to "fill" the lower tax bracket. A Roth conversion transfers funds from your Traditional IRA to your Roth IRA. The transferred amount is taxed in the current year, but the funds continue to grow tax-free in the Roth and can be distributed tax-free in future years when marginal rates may be higher. This is especially useful for clients with large Traditional IRAs, whose Required Minimum Distributions often push them into higher brackets.

Conclusion

Planning for retirement distributions without help can be a challenging and overwhelming experience. It's hard to know how much you can afford, optimizing your withdrawals takes a lot of legwork, and flipping from the "saving" to "spending" mindset can be difficult for some. Our advisors are here to help you every step of the way. We consider the full breadth of your financial landscape to make an individually tailored roadmap to success, and use our understanding and experience to help ease the anxiety of transition. Our job is to sweat the small details, so you can enjoy your bigger picture!

**Disclosures**

Traditional IRA account owners have considerations to make before performing a Roth IRA conversion. These primarily include income tax consequences on the converted amount in the year of conversion, withdrawal limitations from a Roth IRA, and income limitations for future contributions to a Roth IRA. In addition, if you are required to take a required minimum distribution (RMD) in the year you convert, you must do so before converting to a Roth IRA. There can be no assurance that any particular investment objective will be realized or any investment strategy seeking to achieve such objective will be successful. Investing involves risk, including the possible loss of principal. Content in this material is for general information only and not intended to provide specific advice or recommendations for any individual.