

### Three Fundamental Questions

*Do I have enough money to retire?*

*How do I access my retirement account in a tax efficient manner?*

*How do I organize my investments to last?*

#### ***Do I have enough money to retire?***

To get a handle on this question, you must have a clear understanding of your sources of cash flow coming in and going out. Like any plan, if your cash coming in is greater than the cash flow going out, you can afford to retire. If the cash going out is greater, you will spend principal and you may run out of money depending on how long you live.

What makes the equation a little more complicated is the effect of inflation over time and increases in your variable cost like health cost as you age. Inflation is relatively predictable. Therefore, you can build into the equation a reasonable inflation factor. Variable costs are not so easy. If you go to a nursing home at \$9,000 per month, it will affect the viability of the plan.

While you were employed, most of your income was fixed in nature. Your paycheck was the same each month. Therefore, you set your budget at or below that income level. In retirement, your sources of income are fixed and variable. Setting your budget needs to take this difference into consideration.

#### **Sources of Cash Flow**

Cash flow comes from four sources. They are:

- Wages from full or part time employment
- Return on your investments
- Pensions and social security
- Stock options

Cash flow from these sources may be fixed or variable. The fixed sources you cannot control. The variable sources you can control. Examples of fixed cash flow would be dividends, social security, and pensions. You get what the government gives you. You are not able to increase or decrease your social security by your action or inaction. This is good from the stand point that the cash flow is predictable. The more predictable your sources of cash flow, the better. Variable cash flow comes from your work efforts and investment skills in the market. You may chose to work full time or part time after taking a retirement package. If your

employment income covers all or some part of your budget, you can reinvest the cash flow from your investments for a longer period of time.

Investments may have both a fixed and variable component. P&G stock has a fixed and predictable dividend. It is paid quarterly. It has never been suspended or decreased. Periodically, the dividend rate increases. The appreciation in the price of the stock or lack thereof is the variable source. If the stock goes from \$60 per share to \$75 per share, the increase is a variable source of cash flow.

A goal in retirement planning is to create as many predictable forms of cash flow as possible. I have several clients who live solely on the dividend income from their portfolio and social security. All appreciation in the value of the portfolio is reinvested. To them, fluxuations in the price of the stock does not matter because the dividends keep coming.

Some people need to rely on both the fixed cash flow and the variable cash flow to pay for their retirement budget. A person may need a 4% draw on their investments to meet their budget. The 3% dividend is available with a high degree of certainty, but in addition, they need to use 1% of the principal to add to the cash flow. This is fine as long as the value of the stock has gone up by 1% or more. All you are doing is skimming off profits to add to your budget. However, when the stock does not appreciate, you are dipping into principal to meet your budget.

## **Budget**

Your budget, cash flow going out, is also both fixed and variable. The fixed portion may be your health insurance premium, food, your mortgage, and car payment. Household expenses like utilities and real estate taxes are somewhat fixed. They may be adjusted up or down by buying a bigger or smaller house, but short of a structural change, the cost continues and cannot be turned off. Variable costs are the ones you can turn off, turn on, or delay. These may include vacation cost, gifts to children, clothing purchases, and the purchase of a new car.

## **Plan**

A perfect cash flow plan would match fixed income to fixed cost and variable income to variable cost. If your social security and dividends equaled \$40,000, and the fixed cost in your budget was the same, you have a high degree of security. You would never have to rely on capital appreciation to meet your fixed budget. You would rely on capital appreciation for the extra stuff like a new car, vacation or gifts. When the market is up, realize some of the profit for current and future variable spending needs. When it is not, don't sell stocks. I have clients that evaluate their finances in November of each year. Out of profits, they set aside the next year's budget money, funds needed for a new car, and some is reinvested for inflation. If, after the set aside amount, there is a surplus, they make gifts to children. Some years the children get a big gift; others years the children get no gift. Under this formula, you do not spend principal to make gifts, buy cars or other items that may be deferred. Rather, you are spending profits.

Restated in a different manner is to set your “needs” at about 3% of your investment assets. Set your “wants and wishes” at 1% to 2% of your investment assets. The “wants and wishes” portion of your budget can be adjusted as the market goes up or down.

### **Rule of Thumb**

The financial planning rule of thumb is you may use 3% to 4% of your investments toward your budget. If you use 5% to 6%, there is some risk that the plan may fall apart depending on the market. This is particularly true if the market is down in the first five years of retirement. Thus, your sources of cash flow may look like this.

Before tax budget	\$ 95,000
Expected part time employment	<u>(\$24,000)</u>
Cash flow needed from investments	\$ 71,000

You need to have \$1,775,000 in investment assets at 4% to produce \$71,000 in cash flow. The theory behind the 4% draw rate is, in the long run, you have a rate of return of 7%. You spend 4% and 3% is reinvested for inflation. In the long run, this approach will have a high degree of sustainability. Rates of return, however, are not linear. Some years are over the target of 7% and some years are below. In the short run, your bond ladder covers the short term risk of not earning 7% in a given period. Below, there is a more detailed description on how a bond ladder works.

### ***How do I access my retirement account in a tax efficient manner?***

How you take your retirement plan away from P&G can make or break your retirement plan, income tax plan, estate plan, and charitable giving plan. It is critically important to work with someone who understands these rules, and the short and long term ramifications of the decision.

### **Don't Try This Yourself**

P&G employees have a number of choices when they retire to access their retirement accounts. There are significant long and short term income tax differences between the choices. There are also significant financial planning ramifications. **This is one of the most important decisions you need to make at retirement.** For the most part, you only have one opportunity to make this decision on how to take your retirement account away from the profit sharing plan.

You need professional guidance to navigate these rules. The rules are complicated and filled with pitfalls. It is important to seek a tax expert or a financial advisor who fully understands the ins and outs. There are 10% penalties, 50% penalties, ways out of the penalties, age 55 rules, age 59½ rules, age 70½ rules, re-qualifying events, and 60 day deadlines. Below is a general review of your distribution choices.

## The Concept of NUA

Before we start, there is a concept that you need to understand called Net Unrealized Appreciation.

NUA stands for Net Unrealized Appreciation. P&G has kept track of the cost of the shares in your PSP. The basis in the preferred stock is as low as \$6.84. The basis in the common stock is as low as \$10. Your actual basis may be higher. Under the NUA method, you have the opportunity to take P&G stock from the PSP and pay tax on the \$6.82 or \$10.00 rather than the fair market value. The NUA method is only available on P&G stock. Most retirees take advantage of this method at some level because of the extremely low income tax cost.

The NUA method can be used at three qualifying events:

- Separation from service
- After age 59½
- At death

In order to take advantage of the NUA method, the distribution must qualify as a Lump Sum Distribution. In order to qualify, you must take 100% of your plan assets away from P&G in one calendar year. If you take a distribution in 2012 and then try to use the NUA method in 2013, you may have blown the opportunity. There are two exceptions to the all in one year rule. First, if you take distributions from the PSP prior to age 59½, once you turn 59½, it is a new qualifying event. You can use the NUA method again. Your family can also use the NUA method at your death. Again, this is an area where professional guidance is extremely important. Mistakes can cost hundreds of thousands of dollars.

There are several advantages of taking some P&G stock out of the plan under this method. The income tax cost to get the stock out of the plan is the lowest. The NUA is taxed at the capital gain rate of 15% (20% in 2013) rather than ordinary income rates as high as 35% (43.4% in 2013). Further, because your IRA is smaller, the required minimum distributions starting at age 70½ are smaller.

## Age at Separation from Service

Your separation from service age is important. If you separate from service before turning age 55, there is a 10% penalty if you need to access your funds. There are ways to avoid or minimize the 10% penalty. The 10% penalty applies to profit sharing distributions taken out if you separate from service prior to age 55. The same penalty concept applies to distributions from an IRA. However, the IRA age is 59½. There are also ways to avoid the penalty for distributions from an IRA prior to age 59½.

If you separate from service after turning age 55, the 10% penalty is no longer a factor for distributions from the PSP. Once you turn 59½, the 10% penalty is no longer a factor for distributions from an IRA. Because the PSP and IRAs operate under two different age

requirements, you need to determine where your cash flow will come from between ages 55 and 59½.

## **The Four Distribution Plans**

You have four fundamental choices as follows. See Exhibit "A".

- Leave your PSP at J.P. Morgan in P&G Plus (This is essentially the same as rolling it all into an IRA except your family can use the NUA at your death).
- Roll all of your profit sharing plan and savings plan (both referred to as PSP) into an IRA.
- Take a full Lump Sum Distribution of your PSP.
- Take a full lump sum distribution from the PSP and do a partial IRA rollover.

### ***P&G Plus***

You may leave your retirement account at P&G in the P&G Plus Plan. This option is, for the most part, the same as a full IRA rollover. Essentially, J.P. Morgan becomes your money manager. They have created several mixed funds similar to mutual funds. You self manage the account by diversifying P&G stock and investing the proceeds in available funds. Between ages 55 and 70½, there are no rules. You can take out any amount as needed. Any distribution is subject to ordinary income tax rates. At age 70½, you must start required minimum distributions. One advantage of the P&G Plus is that death is a re-qualifying event. If there is low basis P&G stock still in the plan, your beneficiary could still use the NUA method.

### ***IRA Rollover***

In an IRA rollover, the PSP is transferred Trustee to Trustee from J.P. Morgan to the custodian of your IRA. No income tax is paid on an IRA rollover. The income taxes are deferred until you withdraw the money from the IRA. Between ages 59½ and 70½ there are no rules. You can take out any amount as needed. Any distribution is subject to ordinary income tax rates. At age 70½, you must start required minimum distributions.

### ***Lump Sum Distribution***

Under a Lump Sum Distribution, all of your PSP is taken out of the plan. You do not put any of it into an IRA. In a Lump Sum Distribution, you take your entire account away from P&G in one calendar year. There are specific rules you must follow to qualify the distribution as a Lump Sum Distribution. The benefit of a Lump Sum Distribution is the ability to pay income tax on the employer's cost basis and defer tax using the NUA method.

Lump Sum Distribution is a distribution of a participants entire plan balance in a single tax year. The distribution must be made after one of these events.

- Because of the participant's death
- Due to separation from service of the employer
- After the participant has attained the age of 59½

The advantage is that your retirement assets are outside of retirement accounts at a very low income tax cost. The dividends, currently, enjoy a lower tax rate. Any NUA is taxed as a capital gain at lower rates. Further, there are no required minimum distribution rules. The disadvantage is that all of your retirement assets are in one stock, P&G.

### ***Partial Rollover***

A partial rollover mixes both a Lump Sum Distribution and an IRA rollover. First, you must take the entire account away from P&G in one taxable year followed by a rollover of some amount into an IRA. If, for example, you have 30,000 shares in your PSP, you would direct J.P. Morgan to send 23,000 shares to your IRA and send 7,000 shares to you. The IRA portion follows the IRA rules. The 7,000 shares get the NUA treatment. This is a balanced approach that allows you to adjust the size of your IRA to a smaller amount and to take some shares out of the plan under the NUA method. This is an extremely valuable opportunity that should not be overlooked.

### ***How do I organize my investments to last?***

A preliminary decision is whether you will manage your own money or whether you will retain professional help to manage your money. If you hire a financial advisor, this will be his or her job to develop a plan, execute the plan, and adjust the plan from time to time. The cost of a money manager can range from .75% to 1.5%, depending on the investments in your portfolio. You should gain a clear understanding of all of the fees being charged by the advisor, the custodian, transaction fees, hidden cost, and expense ratios. If you do not hire a financial advisor, this section provides you with an understanding of how a financial plan is constructed. This is just one approach. The benefit of hiring a financial advisor is you get a financial plan tailored to your specific goals.

### **Short Term Emergency Fund**

**Layer One.** Establish a rainy day fund. This fund should be six or more months of living expenses held in a savings account. This fund is for family emergencies and extra expenses that were not contemplated. Your child is laid off from a job and you want to loan him some money. You need to pay for funeral cost. You can make a great buy on a condo in Florida, but you need the down payment money in two days. This fund should be invested in short term money market accounts, so that it is readily available. In lieu of this account, you can have a home equity line of credit to tap into in the case of an emergency.

## Intermediate Term Investments

**Layer Two.** Establish a cash flow plan for the next five years. You should set up and know where your living expenses will come from during this time period. The goal is to set up the cash flow plan, so you do not have to sell any investment when the market is down.

### Creation of a Cash Flow Plan

Once you have an accurate list of your sources of cash flow and budget, establish a cash flow plan for the next five years. First, use your predictable sources of cash flow to determine what deficiency exist. Then, determine how to fill the deficiency. Will you sell P&G stock, draw from your IRA, use your bond ladder or seek part time employment? See Exhibit "B" as an example.

### Bond Ladder

Once the five year cash flow plan is created, determine if there is any shortfall. Any shortfall should be made up by a bond ladder. In any year with a shortfall, purchase a bond that will come due at the beginning of that year in the amount of the shortfall. See Exhibit "B". The bond can be a certificate of deposit or government bond.

In the example, the first year's budget will come from the severance pay. Thus, you do not need a bond to cover the first year. In the second year, there is a shortfall of \$63,900. Purchase a bond that comes due in that amount. Therefore, in year two of retirement, you may use the bond money, sell P&G stock or tap into your IRA to fill the shortfall between the fixed income sources and your budget needs. As in the example, because the market was down, you would not want to sell P&G or tap into the IRA. You would use the bond proceeds.

Set it up for the first five years to have the choice each year to sell stocks when they are up or to use the bond if stocks are down. Under this approach, you do not have to sell stock in a down market for your budget needs. In a year where the market is up, sell stocks or use the IRA and purchase a new bond to replace a bond that was used or to create an additional rung of the ladder.

## Long Term Investment Plan

**Layer Three.** Establish a long term strategic plan to create and maintain a diversified portfolio. This process is called asset allocation. Purchase multiple segments of the market to reduce the risk in your portfolio. You want to own big companies, small companies, international investments, long term and short term bonds, growth companies, and value companies. By owning some of each segment at any given time, something will be up which can be sold to harvest profits to add to your account to cover your budget.

An asset allocation plan is based on risk and return. You need to determine how much return you need from your portfolio to sustain your budget. You also need to determine how much risk you are willing to take for that given return. The goal can be stated as seeking the

largest return for the minimum risk. A diversified portfolio will generally have lower risk than a non-diversified risk at the same level of return.

Once the plan is in place, on a periodic basis, every six to eighteen months, the portfolio is rebalanced. If your target is 25% in large company stocks and the current percentage is 20%, you sell investments or segments that are over weighted and buy more large company stocks to bring you back into balance. Under this method, over time, you sell segments that are up and buy segments that are down. In the strategic component of the planning, you have to decide on the overall assets allocation. Additionally, the assets allocation percentages may change from time to time. Thus, if your plan is 60% stocks and 40% bonds, this is a strategic decision. The tactical part of the plan is what to buy, when to buy, and when to sell for each segment part. If you change to 55% stocks and 45% bonds, this can be a short term tactical decision or a long term strategic decision.

This is the area where a good money manager will be of extreme value. It takes time and effort to manage this part of your investment plan.

### ***Other Information***

### **My Services**

As an Attorney, CPA (in active), and a CFP, I assist clients with the following:

- Estate Planning
- Retirement Planning
- Income Tax Planning
- Wealth Transfer
- Estate and Trust Administration
- Probate Avoidance

My office has four attorneys who devote most of their practice to estate planning and elder law. I would be happy to help you and your family find the correct solution for your legal, tax, and financial needs.

### **Link to Retirement Guide**

If you are interested in a more detailed explanation of these issues, you can download my P&G Retirement Guide at <http://www.cmrklaw.com/pg-retirement.php>.

### **Disclaimer**

***Do not make financial decisions before consulting a tax advisor. This guide does not constitute legal or tax advice. As you can see, the available options and what is right for you depends on your unique situation. There are sub variations not included here. Therefore, it is critical to consult an advisor concerning your unique situation. No attorney client relationship has been created by your receipt of this guide.***

I hope this helps you plan your retirement. Let me know if I can be of assistance.

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