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Trust UPDATE

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Retirement income assessment

How can you provide for a 30-year retirement?

Conventional wisdom in structuring a portfolio for retirement sustainability calls for heavy equity exposure during the early years of saving. That gives the portfolio the most growth potential, and the risks inherent in the stock market can be leveled out over time. As retirement approaches, the equity allocation is reduced, and the less volatile fixed-income component of the portfolio is increased. That reduces the chance of a major portfolio loss just before retirement drawdowns begin.

When retirement begins, how much can be withdrawn each year without running the risk that the portfolio will be exhausted? That depends upon the behavior of the financial markets and the portfolio's asset allocation. If a bear market takes hold just as the retirement is starting, the risk of running out of money can be high. On the other hand, in a steady or rising market, the portfolio may generate enough income to build a buffer in the early years of retirement, protecting it from down markets later on. See page two for an example of this phenomenon.

Unconventional thinking

If the primary risk for any withdrawal strategy is the chance of an early bear market, perhaps the conventional thinking should be turned on its head for retirees. That was the hypothesis tested by Michael Kitces and Wade Pfau in a January 2014 article in the *Journal of Financial Planning,* "Reducing Retirement Risk with a Rising Equity Glide Path." Rather than reducing equity exposure during retirement, they tested the strategy of increasing it by one percentage point each year.

Financial models are used to test whether a portfolio with a

given strategy will last for 30 years. Tests are run of a series of "Monte Carlo simulations" to determine sustainability. In this case, the authors tested withdrawal rates of 4% and 5%, which are somewhat high for today's low interest-rate environment. They ran the simulations using historical return data, then with a more conservative data set and, finally, with a still more pessimistic assumption that bonds offered zero real return.

What they discovered from their simulations was interesting and surprising.

- At the lowest levels of equity exposure, in the range of an average of 25% throughout retirement, there was no advantage offered by the rising glide path in owning stocks, for either the 4% or 5% withdrawal rate. This was true for all three of the market data sets.
- For a portfolio with 45% average equity exposure, the authors tested a constant 45% stocks-55% bonds portfolio against one with equities rising from 30% to 60% through retirement. They also included the opposite, in which equities are at 60% as retirement begins, and then fall to 30% by the end of the period. The rising glide path produced the best result for the 4% withdrawal rate, and the effect was similar, but not as pronounced, for the 5% rate.
- With the most pessimistic market assumptions, the more traditional approach of reducing equities during retirement did best.
- For equity allocations of 45%, 55% and 75%, there was surprisingly little variation in the success rates. For example, the 45% stock portfolio had a success rate of 93%. Boosting the stock exposure 30 points, to 75%, reduced the success rate by just three points, to 90%.

Investing can be complicated

There are many caveats for investment studies such as this. Whatever investment return assumptions are used, we know that future market realities will be different. Investment decisions will have to respond to those developments; they won't be made mechanically. In the case of poor returns, it's possible to reduce the withdrawal to lessen pressure on the portfolio, increasing its longevity. Still, the examples are worth pondering as strategies are developed.

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Timing is critical

Retirees are concerned about outliving their financial resources, and with good reason. There are not many options for a retired person to boost his or her income other than selling assets. What is a sustainable withdrawal rate for a retiree? At what withdrawal rate can a retiree be reasonably confident that he or she won't exhaust the available retirement capital? Timing is everything in trying to answer this question. If retirement commences during good economic times, the nest egg has a good chance of lasting decades. But retirement during a down year can wreak havoc on a retirement portfolio. Let's begin with a $500,000 portfolio and the retiree withdrawing 5% of the starting balance each year, or $25,000. If there is a bull market when the withdrawals begin, the account will continue to grow despite the partial consumption. The following example uses an average return of 5%, but ranges from a gain of 25% to a loss of 28%.

Withdrawals begin during a strong market

Year	Withdrawal	Return	Value
1	$25,000	25%	$593,750
2	25,000	18%	671,125
3	25,000	8%	697,815
4	25,000	12%	753,553
5	25,000	10%	801,408
6	25,000	3%	799,700
7	25,000	8%	836,676
8	25,000	-2%	795,443
9	25,000	-4%	739,625
10	25,000	-28%	514,530

After taking $250,000 out of the account over ten years, this retiree still has $514,530 to work with for the balance of the retirement. However, a colleague who retires during a down market is not so fortunate. The same annual returns are used, but in reverse order.

Withdrawals begin during a weak market

Year	Withdrawal	Return	Value
1	$25,000	-28%	$342,000
2	25,000	-4%	304,320
3	25,000	-2%	273,734
4	25,000	8%	268,632
5	25,000	3%	250,941
6	25,000	10%	248,535
7	25,000	12%	250,360
8	25,000	8%	243,388
9	25,000	18%	257,698
10	25,000	25%	290,873

At the ten-year mark, this retiree's portfolio is not quite 60% of the value of that of someone who retired during a bull market. The years of high returns are applied to a much lower account balance. When even modest withdrawals are coupled with poor investment return, a retirement nest egg can shrink quickly.

Playing the audit lottery

The “tax gap” is defined by the IRS as the amount of tax liability that is not paid on time, or not paid at all. The best-known strategy for closing the gap is the IRS tax audit.

Rise and fall of tax audits

Back in 2001 only 0.6% of tax returns were audited. More than 1% received an examination in 2011, but only 0.96% received the unwelcome notice in 2013. The rate has fallen as Congress has restricted the IRS’ funding in light of evidence of partisanship in tax administration, highlighted when a senior IRS official refused to testify before Congress based upon her Fifth Amendment right to avoid self-incrimination. Only about a quarter of the audits require face-to-face meetings with IRS agents, as most examinations are handled through the mail.

Like Willie Sutton, the IRS directs most of its efforts to where the money is. The audit rate for higher-income taxpayers is still more than ten times the average rate, and for larger companies it’s much higher than for small companies. What’s more, the emphasis on examining the wealthy has grown in recent years. The audit rate on million-dollar earners was just 6% in 2009. The IRS denies that this is in any way related to President Obama’s proposals to boost taxes on the rich.

Audit rates are not likely to climb in 2014. The IRS’ resources are being squeezed from two directions. First, the operations budget was reduced by more than $500 million from 2013 to fiscal 2014, to $11.3 billion. At 19,531 revenue agents, the IRS bench is no larger than it was in 2004. But in addition to its usual duties, the IRS now is charged with assisting in the implementation of the Affordable Care Act. There will be Regulatory projects and Forms development, not to mention the enforcement of penalties for those without health care coverage. The impact that a diversion of resources to these tasks will have upon the traditional auditing function is not known.

If you are audited

IRS Publication 1, *Your Rights as a Taxpayer,* includes a section on your rights during an audit. These include:

- A right to professional and courteous treatment by IRS employees.
- A right to privacy and confidentiality about tax matters.
- A right to know why the IRS is asking for information, how the IRS will use it and what will happen if the requested information is not provided.
- A right to representation, either by oneself or by an authorized representative.
- A right to appeal disagreements, both within the IRS and before the courts.

Unless the amount in controversy is nominal, professional representation by an experienced tax lawyer or accountant during an audit is highly recommended. ☐

Odds of a tax audit fell slightly from 2011 to 2013

	2011	2013
Income over $1 million	12.48%	10.85%
Income below $200,000	1.02%	0.88%
Income between $200,000 and $1 million	3.93%	3.26%
Corporation with less than $10 million in assets	1.02%	0.95%
Corporation with more than $10 million in assets	17.64%	15.84%

Source: IRS; M.A. Co.

Data points

In February the Tax Foundation released a review of government taxes and spending over the past century. That the federal government grew dramatically to fight World War II is well known. More obscure points of interest include:

- In 1900, the federal government's receipts were just 3.0% of the country's gross domestic product, versus 16.5% in 2012.
- Before 1930, the federal government generally ran surpluses. Since 1950, it generally has run deficits.
- Average federal expenditures from 1950 through 2006 exceeded the peak of expenditures during World War I.
- During the last recession, federal spending topped out at 26.2% of GDP, the highest level since World War II. At the same time, revenues fell to 15.6% of GDP, the lowest level since the late 1940s, due to the economic contraction.
- State and local governments have grown dramatically as well. In 1930, their revenue came to 8.0% of GDP. By 2006 it had grown to 13.0%. Expenditures during the same period rose from 9.1% to 14.8% of GDP.
- The total government receipts in 2012, federal, state and local, came to 26.4% of GDP, down from a high of 30.8% in 2000. Total government expenditures in 2012 stood at 35.6% of GDP, down slightly from 38.3% in 2010.

The percentages are poised to go higher, the report concludes, as the wide array of new taxes and fees associated with the Affordable Care Act is still being rolled out. The report also points out that upward pressure on spending will come from the many government pension programs that are underfunded.

No, that's not deductible

According to a recent report in a trade magazine, Minnesota CPAs last year had to tell their clients that there is no tax deduction for:

- wedding rings;
- the cost of dogs, even if they are used as "burglar alarms";
- an all-terrain vehicle, even if it used upon medical advice to reduce stress;
- family vacations;
- family employees who are infants;
- home theatres, even if they can be used for video conferencing;
- a personal car that has been made into a mobile billboard with advertising;
- botox or tanning treatments. ☐