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How Withdrawal Rates Affect Estate Planning

In the current environment, most clients want to ensure they don't outlive their money.

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Deciding on an appropriate withdrawal rate in retirement could have a profound impact on a client's estate plan, especially in the current environment.

Focus for Wealthier Clients

For wealthier clients, the application might be different. Instead of worrying about running out of money in later years, their focus is on what estate planning might be appropriate for them. In the current environment of high temporary estate tax exemptions, clients of wealth should be endeavoring to use as much of their estate tax exemption before it expires. Under current law, the $10 million inflation-adjusted exemption declines by half in 2026. If the so-called Blue Wave continues from the 2018 midterm elections into the 2020 general election, a Democratic administration in Washington could significantly curtail estate planning. Senator Bernie Sanders (D-Vt.) has already proposed legislation to reduce the gift exemption to $1 million and the estate tax exemption to $3.5 million. So, those of even moderate wealth (relative to the current exemptions) may be best advised to plan now to use exemptions before they decline. But critical to the use of exemptions is assuring clients have adequate resources for their remaining years and needs. That determination requires a budget, financial plan and forecast. While access can be provided to funds transferred by making a spouse a beneficiary, perhaps by giving a spousal beneficiary a power to appoint back to the settlor/donor spouse, or using some variation of a domestic asset protection trust, a key point of the analysis is what will clients contemplating a large transfer need to live on.

In simplistic terms, if a client has a $20 million estate and spends $400,000/year, the client could transfer $10 million now to use exemptions and withdraw $400,000/year on the $10 million of retained assets and maintain her lifestyle in perpetuity. But if the above suggestion is correct and a 3% “rule of thumb” should replace the old 4% rule of thumb, then the client would require $13.33 million of retained funds, thereby lowering the amount that might be suitable to transfer to irrevocable trusts.

Influence on Planning

If this is correct, it has a profound influence on planning, the use of dynasty trusts and more. If a practitioner projects funds required to be retained by the client so that the unneeded funds can be moved outside of the estate and, perhaps, depending on the technique selected, outside of the client’s reach, then there could be transfers to dynastic trusts that the client wouldn't have access to. If forecasts are completed to determine whether life insurance should be purchased to insure the premature death of a spouse with respect to a non-reciprocal spousal lifetime access trust (SLAT) plan, a lower feasible withdrawal rate will affect the amount of life insurance that might be advisable. In fact, if a 3% withdrawal rate is correct (and there are other articles suggesting more complex and potentially higher distribution rates), perhaps every client's estate, financial and insurance plan should be revisited. Certainly, a lower withdrawal rate might be used in sensitivity analysis for forecasts.

A more complex aspect of planning analysis is what amount of funds should be retained if the transfers are made to SLATs or self-settled trusts that the clients can access. Is it still feasible to transfer the $10 million in the above example even if a 3% withdrawal rate is determined to be appropriate to use?

Another consideration is whether a higher withdrawal rate should be used if the goal is to shift as much as feasible out of the client's estate because the client fears that a new administration may reduce the reduction and make other harsh changes. What impact might the selection of a higher withdrawal rate than some would view as appropriate have as a negative implication to the characterization of the transfer as a fraudulent conveyance? Might the Internal Revenue Service challenge the analysis on the basis that an inappropriately high withdrawal rate suggests that it was more likely that there would have to have been an implied agreement with the trustee for distributions?

Understanding the client's spending pattern, likely changes in that pattern, asset allocation and how all of that might impact a long-term withdrawal rate can have important implications to planning, especially in an environment in which moderate-wealth clients should be using their current high temporary exemptions.