

the EDUCATED INVESTOR

FEATURE ARTICLE

Retirement Withdrawal Strategies

Overview: What is the generally accepted order by which an investor should make tax-efficient withdrawals for retirement? With a focus on asset location, this article introduces several points for investors to consider when building their own prudent strategy for making withdrawals from retirement accounts, including situations in which an investor may benefit from deviating from that generally accepted sequence.

A winning investment strategy is about much more than choosing the asset allocation that will provide the greatest chance of achieving one's financial goals. It also involves what is called the asset location decision. Academic literature on asset location commonly suggests that investors should place their highly taxed assets (such as bonds or REITs) in tax-sheltered accounts and their tax-preferred assets (such as stocks) in taxable accounts.

In general, the most tax-efficient equities should be held in taxable accounts whenever possible. Holding them in tax-deferred accounts can result in the following disadvantages:

- σ The possibility of a step-up in basis for tax purposes is lost.
- σ For foreign equities, foreign tax credit is lost.
- σ The potential to perform tax loss harvesting is lost.
- σ The potential to donate appreciated shares to charities and avoid taxation is lost.

One part of this strategy includes using the most tax-efficient withdrawal sequence to fund retirement. A recent paper by William Reichenstein titled "Tax-Efficient Sequencing of Accounts to Tap in Retirement" provides some answers. For example, Reichenstein posed the question, "Should a retiree withdraw funds from the taxable account then the traditional IRA and then the Roth IRA or would another sequence be preferable?"¹

According to Reichenstein, "Returns on funds held in Roth IRAs and traditional IRAs grow effectively tax exempt, while funds held in taxable accounts are usually taxed at positive effective tax rates."² Reichenstein's paper also said that only part of a traditional IRA's principal is the investor's. The IRS "owns" the remaining portion, so the goal is to minimize the government's share.³

For those able, but not yet required to take distributions from tax-deferred accounts, it is typically most practical to withdraw from taxable accounts first. The withdrawals would be taxed at capital gains rates instead of ordinary income rates. Also, it may be preferable to sell tax-inefficient assets (such as bonds or REITs) held in taxable accounts before selling more tax efficient assets.

There are some exceptions to these rules:

- σ If the main source of income comes from tax-sheltered accounts, withdrawals should be made from these accounts until taxable income at least reaches the lowest tax bracket. This exception should apply to any year when taxable income is low. For example, an individual with sizeable medical bills due to an extended stay in a nursing home would likely be in a lower tax bracket.
- σ Other withdrawal sequences may be preferable if the IRA's beneficiaries will be in a higher tax bracket than its owner.
- σ According to the paper, "Retirees who have substantial unrealized gains on taxable assets and will await the step-up in basis at death should withdraw funds from retirement accounts before liquidating the appreciated asset."⁴ An example would be a terminally ill person. The reason: The effective tax rate on the capital gains will be zero if they await the step-up in basis at death.
- σ Delaying withdrawals from an IRA can mean a higher tax bill if the tax rate later rises to higher levels. In addition, if a retiree is in a lower tax bracket but doesn't need to withdraw funds from the IRA to meet spending needs, he or she should consider a conversion to a Roth IRA. Thus, it may not be appropriate to delay withdrawals from traditional IRAs for as long as possible (until age 70½).

Many individuals are also faced with deciding whether to withdraw from a traditional IRA or a Roth IRA. Consider what Reichenstein said about the decision.

"Withdrawing funds from the traditional IRA makes sense 1) in years when the retiree is in a low tax bracket and 2) if the retiree's beneficiary will be in a higher tax bracket. ... Withdrawing funds from a Roth IRA instead of a traditional IRA makes sense 1) in years when the retiree is in a high tax bracket and 2) if the retiree's beneficiary — whether an individual or a charity — will be in a lower tax bracket. ... In addition, Roth IRA withdrawals should be preferred if the retiree expects to have large deductible medical expenses later in retirement."⁵

Finally, he found that sequencing strategies are sensitive to the following:

- σ The higher the tax rate, the greater is the advantage from first withdrawing from a taxable account. If capital gains taxes were increased, the advantage would increase. The advantage would also increase if an investor held an actively managed mutual fund that was tax inefficient because of its turnover.
- σ The paper stated this "Taxable 1st strategy" has a strong advantage when a portfolio is generally evenly divided between retirement accounts and taxable accounts. In addition, such advantage can increase with an asset's rate of return.

Reichenstein's paper suggested it is important to fund retirement spending in the right sequence. Doing so should allow retirees' financial portfolios to last longer than would otherwise be the case. Finally, it is important for investors to consult a tax advisor before implementing any strategy.

¹ William Reichenstein, **Tax-Efficient Sequencing of Accounts to Tap in Retirement**. TIAA-CREF Institute, October 2006.

² Ibid.

³ Ibid.

⁴ Ibid.

⁵ Ibid.

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