How to make your retirement account withdrawals work best for you

Make Your Plan
October 2024

Roger Young, CFP®
Thought Leadership Director

William Reichenstein, Ph.D.
Thought Leadership Director

Key Insights

- There are alternatives to the conventional strategy of drawing on a taxable account first, followed by tax-deferred accounts (e.g., Traditional individual retirement accounts) and then Roth accounts.
- A variety of strategies can be employed at different phases of retirement, such as filling low tax brackets, taking tax-free capital gains, and executing Roth conversions.
- Coordinating a withdrawal strategy and a Social Security claiming strategy can drive even more tax efficiency than either approach alone.
- If planning to leave an estate to heirs, consider which assets will ultimately maximize their after-tax value.

Many people will rely largely on Social Security benefits and tax-deferred accounts (TDAs)—such as Traditional individual retirement accounts (IRAs) and 401(k) plans—to support their lifestyle in retirement. However, a sizable number of retirees will also enter retirement with assets in taxable accounts (such as brokerage accounts) and Roth accounts. Deciding how to use that combination of accounts to fund spending is a decision likely driven by tax consequences, because distributions or withdrawals from the accounts have different tax characteristics (see Figure 1).

A commonly suggested approach, which we'll call the conventional wisdom strategy, is to withdraw from taxable accounts first, followed by TDAs and, finally, Roth accounts. There is some logic to this approach:

- If you draw from taxable accounts first, your TDAs have more time to grow tax-deferred and your Roth accounts have more time to grow tax-exempt.[1]
- Leaving Roth assets until last provides potential tax-free income for your heirs.
- It is relatively easy to implement.

[1] Qualified distributions, which are tax-free, generally, means that the owner will be over age 59½ and the Roth account will have been open for at least 5 years.

Tax characteristics of different assets

(Fig. 1) The tax treatment varies significantly by type of account

	Income tax on earnings	Income tax on distribution or liquidation	Tax treatments for heirs
Tax-advantaged accounts			
TDAs (e.g., 401(k)s)	Deferred	Ordinary rate	Beneficiary's ordinary tax rate
Roth accounts	Usually exempt	Contributions tax-free; earnings tax-free if qualified	Tax-free if at least 59½ and you meet the five-year rule
Taxable accounts			
Appreciation	None until liquidated	Return of cost basis tax-free; gains at capital gains rates	Step-up in basis, so gains during life of original owner are tax-free
Ordinary income generating (e.g., interest)	Ordinary rate	Return of cost basis tax-free; gains at capital gains rates	Step-up in basis, so gains during life of original owner are tax-free
Qualified dividend	Qualified dividend rate	Return of cost basis tax-free; gains at capital gains rates	Step-up in basis, so gains during life of original owner are tax-free

■ Potentially tax-free ■ Likely to benefit from lower capital gains and qualified dividend tax rates
■ Taxed at ordinary income tax rates

> Investors with more than one type of account can do better than following the conventional wisdom strategy when withdrawing funds in retirement.
>
> – William Reichenstein, Ph.D.
> Thought Leadership Director

Unfortunately, the conventional wisdom strategy may result in income that is unnecessarily taxed at high rates. In addition, this approach does not consider the tax situations of both retirees and their heirs.

This paper considers two broad objectives that retirees may have and how to achieve these through strategic account withdrawals:

- Spending more in retirement (either annually or by extending the life of their portfolio)[2]
- Bequeathing assets efficiently to their heirs

In the first objective, the focus is on the retiree, not the heirs. For people focused on the second objective—leaving an estate—the withdrawal strategy can include techniques to minimize taxes across generations.

So what can investors do, and how can advisors navigate these conversations? We evaluated different withdrawal strategies for a variety of situations and summarized the key techniques for four scenarios (types of people). Our evaluation was based on the assumptions on page 11, key among them:

- Because the results depend so heavily on federal taxes, we took into account tax rules on Social Security benefits, qualified dividends, long-term capital gains (LTCG), and ordinary income. See "**What to Know About Social Security Benefits and Your Taxes**," as well as the second example in this paper, for further discussion of how these tax effects are interrelated.
- All of these households begin retirement at the start of 2025.
- The household uses the standard deduction.[3]
- State taxes and federal estate taxes are not considered.
- All accounts earn the same constant rate of return before taxes.
- All amounts are expressed in today's dollars (USD) and generally rounded to the nearest $1,000.

[2] In terms of the analysis, longevity of the portfolio is the metric evaluated.
[3] We used the tax brackets (adjusted for inflation) effective January 1, 2024, as well as the tax rates that are scheduled to revert to pre-2018 levels after 2025.

Scenario 1: Retirees focused on their spending and taxes rather than on leaving a legacy

Strategy: Spread out TDA distributions to take full advantage of income at lower ordinary and capital gains tax rates.

Many people—including a good number with household incomes above the U.S. median—may be in a low tax bracket in retirement. They are probably more concerned about meeting their own needs than with leaving an inheritance. And even if they might leave a legacy, they may not be too worried about the taxes their beneficiaries will pay. Those who have done a solid job of saving in different accounts can probably withdraw funds more tax efficiently than they could by following the conventional wisdom strategy.

When following the conventional wisdom strategy, you start by relying on taxable account withdrawals and Social Security benefits (if already claimed). Since withdrawals from taxable accounts are partly, if not entirely, tax-free and Social Security benefits are never fully taxed, you may find yourself paying little or no federal income tax early in retirement before required minimum distributions (RMDs) begin. That sounds great—but you may be leaving some low-taxed income "on the table." And then after RMDs kick in, you may be paying more taxes than necessary.

A better approach is to "fill up" a low tax bracket with ordinary income from TDA distributions. For example, this income could fill the "0% bracket," where adjusted gross income (AGI) is less than deductions, or the 10%–15% brackets. Any spending needs above those provided by TDA distributions and Social Security benefits can be met with distributions from taxable accounts and/or Roth accounts.

To illustrate this, scenario 1 is a married couple. Both turn 65 in January 2025 and live to age 95. That is, they plan for a lifetime of 95 years, in case they live that long. They can maintain their lifestyle by spending $120,000 per year (after taxes). Their total annual Social Security benefits would be $46,600 if claimed at their full retirement age (FRA), with similar amounts for each spouse. Their retirement portfolio of $2.0 million includes 40% in taxable accounts, 50% in TDAs, and 10% in Roth accounts. The cost basis in their taxable account is only 25% of its value, so selling those investments will result in meaningful capital gains. The couple expects their beneficiaries will be in the 15% bracket, so minimizing their taxes is not a top priority.

Figure 2 shows how this couple would meet their spending needs using the conventional wisdom strategy. The illustration assumes both spouses will claim Social Security at age 70, which we have identified as their best strategy.[4] Taxes paid are shown as negatives in red. Throughout this paper, we will use these graphs to help explain strategies and show the tax impact.

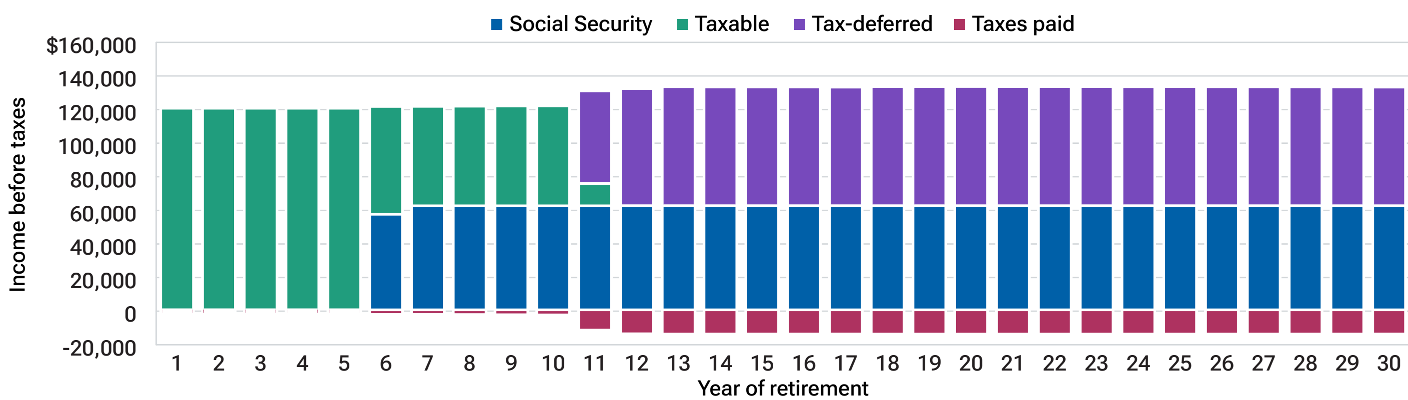
With this approach, the couple first exhausts the taxable account (green) then the TDA (purple). In this case, they do not need to draw upon Roth assets. In the first five years, before they claim Social Security benefits, they have negative taxable income—that is, their AGI is less than their standard deduction. So they pay no federal income tax. For the next five years, they only pay around $1,000 per year in taxes. However, once they run out of money in their taxable account, they pay over $12,000 per year in federal taxes.

If they follow a more tax-efficient strategy, the withdrawals (shown in Figure 3) are quite different. In this strategy they spread out tax-deferred distributions by combining them with taxable account withdrawals or Roth distributions in different phases of retirement.

[4] Strategies and calculations for all cases in this paper were generated by the Income Solver™ tool, which is used by advisors for the T. Rowe Price Retirement Advisory Service™. While this paper will refer to the "best" strategies as identified by the tool, those are not guaranteed to be the absolute optimal solutions. Previous versions of this white paper were based on a spreadsheet model. For comparable examples, the results and strategies using the Income Solver™ tool and the spreadsheet model were similar.

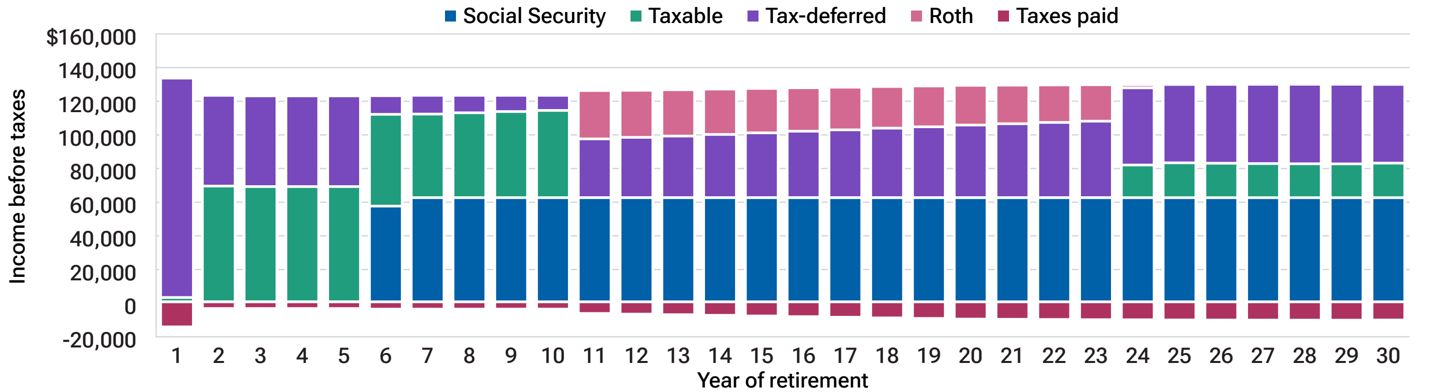
Sources of retirement income for scenario 1, under conventional wisdom strategy

(Fig. 2) This approach results in unnecessary taxes in the latter part of the couple's retirement years.



Sources of retirement income for scenario 1, under bracket-filling method

(Fig. 3) By spreading out TDA distributions, the household pays less tax than under the conventional wisdom strategy.



More specifically, the strategy relies mostly on TDA distributions to take full advantage of the 12% bracket in the first year, before expiration of the Tax Cuts and Jobs Act (TCJA). Then it combines TDA and taxable account distributions to stay within the 10% bracket until they start RMDs in the year they turn 75. At that point, spending needs not met by RMDs are satisfied with tax-free Roth distributions until that account is exhausted, then with the taxable account.

This strategy incurs around $13,000 of taxes in the first year, but then $2,000–$3,000 in the next nine years and $5,000–$9,000 per year thereafter. The strategy stays well within the 10%–15% brackets, whereas much more income is taxed at 15% under the conventional wisdom strategy. As a result, the better strategy saves $63,000 in taxes versus the conventional wisdom strategy.

Our methodology aims to maximize the after-tax legacy (if the household's spending needs are met). This after-tax legacy is the sum of all accounts after the death of the last spouse, but where TDA balances are reduced by an estimate of the heirs' marginal tax rate. Using this strategy, the couple's beneficiaries get an $80,000 larger after-tax inheritance than with the conventional wisdom strategy. While this may not be the couple's top priority, the strategy delivers the highest after-tax legacy—even though it does not leave any tax-free Roth assets to the next generation, as the conventional wisdom strategy does. (See the assumptions and results for all examples in the Appendix.)

Since this couple has a significant taxable account with unrealized gains, it's also important to understand the impact of capital gains taxes. Even though this is a fairly affluent couple, their income level does not result in capital gains taxes after the first year.

Key insight: Moderate-income people with multiple types of accounts may want to draw down Roth and/or taxable account assets along with TDAs to consistently stay in a low tax bracket (0% to 15%).

Scenario 2: People who may be affected by high marginal tax rates on Social Security benefits

Strategy: Use Roth conversions early in retirement before Social Security benefits begin to limit income taxed at high marginal tax rates in later years.

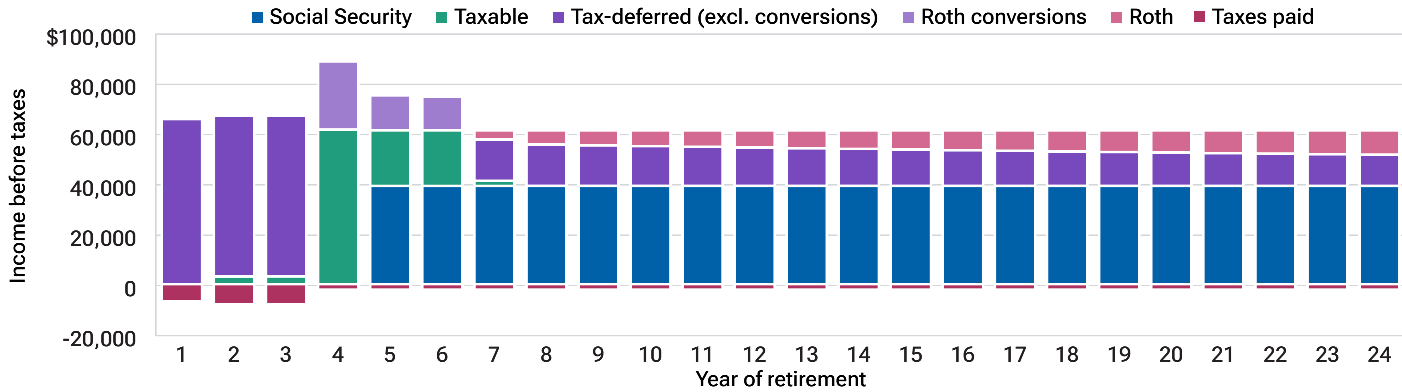
In the first scenario, the couple did not need to use Roth conversions to keep their marginal tax rates reasonable throughout retirement. In other situations, however, investors may rely more heavily on TDA withdrawals and Social Security benefits. In those cases, the complex calculation of taxes on Social Security benefits becomes important, especially for people who are not particularly wealthy. Therefore, it can make sense to convert some TDAs to a Roth account early in retirement.

> "Selling appreciated assets held in taxable accounts in low-income years could eliminate capital gains taxes if those gains would eventually be taxed upon sales later in life.
>
> – William Reichenstein, Ph.D.
> Thought Leadership Director

Consider scenario 2, a single person retiring at age 66 (born in December 1958) who plans for a life expectancy of 90 years. Of her $600,000 in assets, 75% ($450,000) is in tax-deferred accounts, $100,000 is in taxable accounts (with a cost basis of $80,000), and $50,000 is

Sources of retirement income for scenario 2, utilizing a Roth conversion strategy

(Fig. 4) Converting tax-deferred assets to Roth accounts at an opportune time can help reduce taxes on Social Security benefits.



in Roth accounts. Planned spending is $60,000 per year, and her annual Social Security benefits would be $30,000 if claimed at her FRA.

If she uses the conventional wisdom strategy, she will be in the 15% federal bracket during the years where her TDAs are drawn down. That tax bracket, however, does not tell the full story.

The amount of Social Security benefits subject to taxes depends on how much "combined" (also referred to as "provisional") income someone has. For most taxpayers, that number is essentially half of the Social Security benefits plus all other income included in AGI. At low levels of combined income, no Social Security benefits are taxed. But as combined income increases, the amount of Social Security income that is taxable increases: first at 50% of incremental income, then at 85%. At most, 85% of benefits are taxable. Therefore, for this person in the 15% bracket, there is a range of income where each additional dollar of income causes an additional $0.85 of Social Security benefits to be taxable. So, taxable income rises by $1.85. Thus, the marginal tax rate on that dollar of income may be 27.75%, (15% tax bracket x $1.85). Such spikes in marginal tax rates caused by the taxation of Social Security benefits are sometimes referred to as the "tax torpedo." Avoiding significant income subject to marginal tax rates that are 185% of the tax bracket can meaningfully improve the outcome.

The best strategy we found is depicted in Figure 4. It starts by using only tax-deferred assets in the first year, which takes advantage of the 22% bracket before expiration of the TCJA (and before she claims Social Security benefits at age 70). While this 22% tax rate may seem high for someone in this income range, remember that it is lower than the potential 27.75% marginal tax rate we just discussed. For the next two years, most spending is satisfied using TDA distributions, but some taxable assets are sold in order to keep her income within the 15% tax bracket.

In years four through six, before RMDs take effect, the strategy employs a total of $55,000 of Roth conversions from TDAs. The largest conversions are in year four, before Social Security benefits start. Taxable accounts are used to fund spending and pay taxes on the Roth conversions (within the 10% bracket). Once RMDs begin in year seven, this strategy combines TDA distributions with Roth account distributions. Due to the early-year Roth conversions, she has enough Roth assets to stay within the 10% tax bracket for the rest of her retirement years.

It's important to note that the tax torpedo also affects this person in the 10% bracket. However, the marginal rate is only 18.5%, (10% tax bracket x $1.85), which is much lower than 27.75%. Therefore, taxes are only around $1,200 per year after year three.

By making Roth conversions in years before Social Security benefits begin, this strategy results in only 33% of Social Security benefits being taxed, on average. That compares with 51% for the conventional wisdom strategy. Largely because of that, lifetime taxes are $44,000 lower using the better strategy compared with the conventional wisdom strategy, and the after-tax legacy improves by $33,000. (See the Appendix for further details.)

Key insight: Roth conversions aren't only for people in high tax brackets who will leave large estates. In some cases, they can also help people at lower income levels reduce taxes on their Social Security benefits.

Scenario 3: People who expect to leave money to beneficiaries with higher tax rates

Strategy: Consider your heirs' tax situations when deciding whether to leave them tax-deferred assets or Roth assets. Also consider preserving taxable assets for the step-up in basis.

People who have accumulated significant assets may have confidence that they are unlikely to run out of money. Therefore, they can plan a strategy with their heirs in mind. These people aren't necessarily ultra-wealthy, but they have been strong savers relative to their income or spending needs. While these households may have a relatively small portion of assets in Roth accounts, any Roth assets they do have can be beneficial in planning.

A strategy to consider involves choosing whether to take TDA distributions beyond your RMDs. When accumulating assets, it usually makes sense to choose between making contributions to TDAs or Roth accounts based on whether you think your tax rate will be lower or higher in retirement than in your preretirement years.

Similarly, to leave your heirs the largest after-tax inheritance, consider their potential tax rate. If it's higher than yours, it may be better to leave them Roth assets or taxable account assets and draw on TDA assets for your own spending needs.

Of course, there are some challenges with implementing this approach. First, it can be difficult to predict your heirs' tax rates 30 years down the road. Second, your own marginal tax rate can change over the course of your retirement. That said, if your heirs' tax situation is even somewhat predictable, it can be a factor to consider.

An important facet of this strategy to consider is preserving taxable assets. Under current tax law, the cost basis for inherited investments is the value at the owner's death. This is known as a step-up in basis, and it effectively makes gains during the original owner's lifetime tax-free for heirs. This can be a major benefit for people with wealth that won't be spent in their retirement years.

There are four major factors that determine the attractiveness of **holding taxable assets for the step-up** compared with preserving Roth assets:[5]

- Cost basis, as a percentage of value (lower basis favors holding the taxable assets);
- The tax rate on capital gains and dividends (higher rate favors holding the taxable assets);
- Life expectancy of the owner (holding taxable assets becomes more attractive closer to the end of life); and
- The investment's dividend yield (lower dividend yield favors holding the taxable assets).

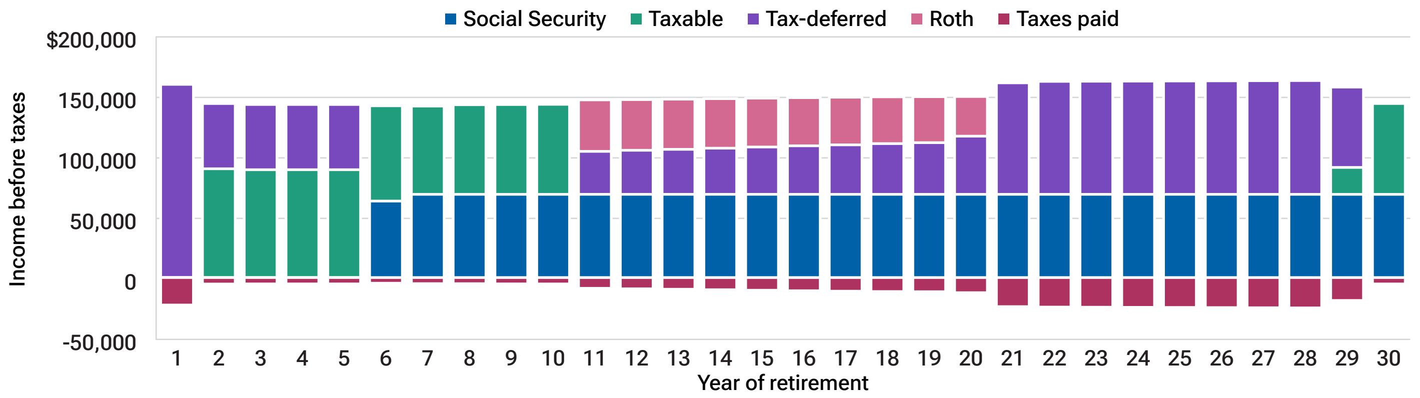
One tricky part about this decision is that the capital gains tax rate depends on your taxable income. Therefore, it can change based on how you use different accounts to meet your spending needs. As we discussed in the first scenario, some people can take advantage of untaxed capital gains, especially before RMDs. To the extent that gains are untaxed, there is no benefit in holding those assets for the step-up. Another caveat is that we assume the same investment returns for all accounts; if your low-basis taxable investment has lower growth potential or higher risk, holding it obviously becomes less attractive.

> People leaving an estate should consider holding on to stock investments that will eventually go to their heirs in taxable assets, so their heirs get the step-up in basis—that is, the tax-free gains.
>
> – William Reichenstein, Ph.D.
> Thought Leadership Director

[5] DiLellio, James, and Dan Ostrov, "Toward Constructing Tax Efficient Withdrawal Strategies for Retirees with Traditional 401(k)/IRAs, Roth 401(k)/IRAs, and Taxable Accounts," 2020, *Financial Services Review* 28 (2): 67–95. Also see Young, Roger, "**Leaving Assets to Your Heirs: Could You Benefit From a Step Up in Basis**."

Sources of retirement income for scenario 3, drawing down tax-deferred accounts before death

(Fig. 5) Heirs with a high tax bracket can benefit from the step-up on taxable investments rather than inheriting tax-deferred accounts.



> Drawing down TDAs during your lifetime can help your highly taxed heirs later. But proceed with caution.
>
> – Roger Young, CFP®
> Thought Leadership Director

For scenario 3, some facts are similar to the first example: This couple, both born in January 1960, start their retirement at age 65 in January 2025, and they plan for a life expectancy of 95 years. They have $2.5 million in assets: 40% in tax-deferred accounts, 50% in taxable accounts (with a 25% cost basis), and 10% in Roth accounts. They plan to spend $140,000 per year and would have total annual Social Security benefits of $54,000 if they claim at FRA (with similar amounts for each spouse). Based on these facts, they are highly likely to leave assets to beneficiaries, who we assume will have a marginal tax rate of 28%. That is higher than the couple's top rate even under the conventional wisdom strategy. Therefore, it makes sense for this couple to draw down their TDA assets before death. As illustrated in Figure 5, the best strategy carefully chooses when to take those TDA distributions.

The couple's best Social Security claiming strategy is for both spouses to begin benefits at age 70. Before that point, TDA distributions would be taken, up to the top of the 22% bracket (year one) or 10% bracket (years two through five). In the next five years, before RMDs begin, the strategy primarily uses taxable account distributions to keep the household in the 10% bracket. Thereafter, spending needs above the RMD level are met by Roth account distributions (until depleted) and then TDA distributions, which are depleted shortly before death. That leaves taxable accounts to meet their spending needs at the very end, and the remaining taxable account assets pass to their heirs with the benefit of the step-up.

This strategy actually results in slightly higher taxes during the couple's lifetime compared with the conventional wisdom strategy. However, due to the beneficiaries' higher tax rate and timing of taxes paid, the after-tax legacy of the recommended strategy is 12%, or $147,000 higher than with the conventional wisdom strategy.

The incremental taxes for this strategy, compared with the conventional wisdom strategy, are significant in years 21 through 29. That suggests a few caveats about using this type of approach:

- A retiree will want to be highly confident they're not going to run out of money.
- They should also be pretty sure their heirs will have higher marginal tax rates.
- There are good reasons to keep some tax-deferred assets in reserve. For example, if a person incurs large, deductible medical expenses later in life, they can use those deductions to offset tax-deferred distributions.[6]

Key insight: Techniques to optimize heirs' after-tax inheritance are not simple to evaluate, but they're worth considering if an individual expects that their heirs will have a significantly different tax rate than them.

Scenario 4: An affluent couple, where one spouse is expected to outlive the other by several years

Strategy: Make large Roth conversions, while both partners are still alive, to avoid higher taxes and higher Medicare premiums for the survivor after the death of the first spouse.

So far, our two examples for couples have assumed both spouses die at the same time. While we don't know how long we will live, there is a significant chance one spouse (often a wife) will live many years longer than the other. That's particularly true if there's a large gap in their ages or a large difference in their levels of health.

When a spouse dies, many things happen from a financial perspective. In general, Social Security benefits decrease, to the higher of the two spouses' benefits. Typically, the surviving spouse the beneficiary of TDAs. That can change the calculation of RMDs but perhaps not dramatically. And spending levels probably decrease somewhat, but many fixed costs, such as housing, could stay the same.

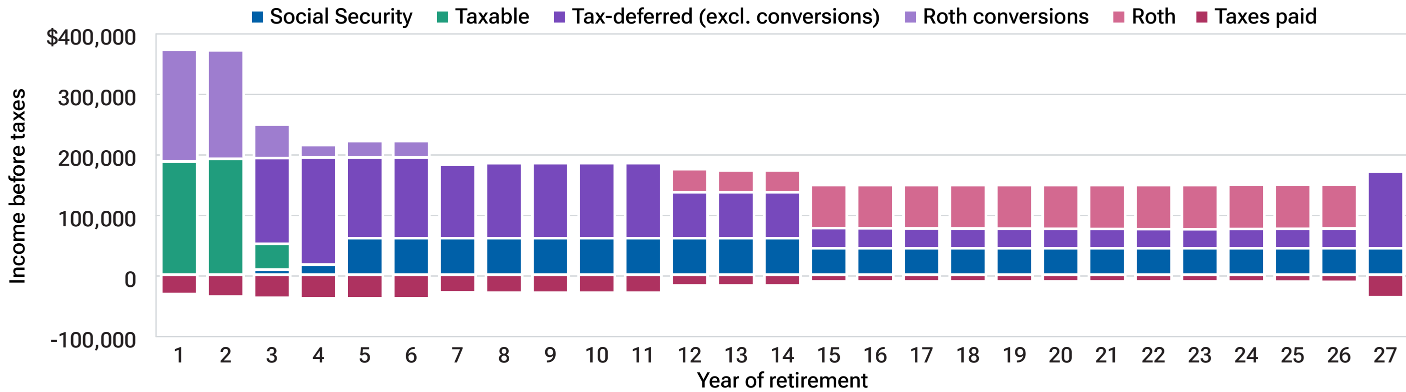
After the year of death, a survivor (who doesn't remarry) will start filing taxes as a single individual rather than as part of a married couple filing jointly. Currently, the tops of the first five tax brackets for singles are half as high as for married couples filing jointly. Since total spending (and income) will likely fall by much less than 50%, the survivor can easily be pushed into a higher bracket. Similarly, since the first four income threshold levels where Medicare premiums spike are half as high for singles as for married couples, the surviving spouse may pay sharply higher Medicare premiums beginning three calendar years after the death of the first spouse.

For scenario 4, the husband (age 66 at retirement) is three years older than his wife (63). His life expectancy is 80, whereas hers is 90, so she is expected to have a 13-year survivorship period. Their $2.5 million portfolio is largely (80%) in tax-deferred accounts, with 16% in taxable accounts and 4% in Roth accounts. The cost basis in the taxable account is 90% of its value. They plan to spend $159,000 per year, but that amount drops by 10% when the husband dies. Unlike the other scenarios, the husband's annual Social Security benefit ($33,600 at FRA) is much larger than the wife's ($18,000).

[6] Cook, Kirsten A., William Meyer, and William Reichenstein, "Tax-Efficient Withdrawal Strategies," 2015, *Financial Analysts Journal* 71 (2):16–29.

Sources of retirement income for scenario 4; Roth conversions to benefit a surviving spouse

(Fig. 6) When one spouse is expected to outlive the other by many years, Roth conversions can prevent a sharp increase in income taxes and Medicare premiums for the surviving spouse.



In a case like this with an expected long survivorship period, it is very important that the higher earner wait until age 70 to start Social Security benefits. Unlike the other examples, in this scenario, our software recommends that the lower earner claim earlier, starting at age 65 and six months, because benefits based on her earnings record will cease at the death of the first spouse.

Using the conventional wisdom strategy, the widow would rely on TDA distributions to meet her spending needs for all but her last few years. That pushes her into the 28% bracket and causes her to pay higher Medicare premiums (income-related monthly adjustment amounts, or IRMAAs) for 11 years.

The best strategy we identified uses an aggressive Roth conversion approach in the early years of retirement, while both partners are still alive (see Figure 6). It calls for conversions up to a point where modified adjusted gross income (MAGI) is slightly below the level that would trigger the first spike in Medicare premiums, which is $206,000 (in 2024). In the first two years, the couple still has taxable assets to fund spending and pay for taxes on the large Roth conversions. Therefore, the vast majority of conversions are in those two years, totaling $364,000. In the subsequent four years, smaller amounts are converted (still keeping the couple under that MAGI threshold).

The strategy then relies on TDA distributions (staying within the 25% bracket) for five years. From that point on, the strategy aims to stay within the 15% bracket, through a combination of TDA and Roth account distributions. For the three years until the husband's death, that doesn't require large distributions from the Roth accounts. However, once he dies and she files as a single taxpayer with the lower tax bracket thresholds beginning in year 15, she needs to rely more on Roth account distributions. Those distributions were made possible by the large Roth conversions early in retirement, while both partners were still alive.

Despite significant taxes paid in the early years, the recommended Roth conversion strategy would incur $204,000 lower lifetime income taxes than in the conventional wisdom strategy. In addition, total Medicare premiums would be $24,000 lower using the Roth conversion strategy. Instead of coming close to running out of money with the conventional wisdom strategy, the Roth conversion strategy would leave an after-tax legacy of $227,000, which is an improvement of $162,000 compared with the conventional wisdom strategy.

Key insight: An aggressive Roth conversion strategy in early retirement years when both spouses are still alive requires some serious thinking due to the large up-front tax burden, but it can pay off handsomely when one spouse outlives the other by several years.

Other observations and considerations

The examples we've shown highlight the benefits of strategies for specific situations. In addition to these examples and techniques, retirees should consider the following:

- The Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 limited the ability to stretch distributions from Inherited IRAs and retirement plan accounts over time. Rather than taking RMDs over their expected lifetime, most beneficiaries will need to draw down the account fully within 10 calendar years of the original owner's death.[7] The loss of "stretch" distributions for heirs may have a significant effect on withdrawal strategies for many retirees. A large inherited TDA is more likely than before to force a beneficiary to pay a higher marginal tax rates. Therefore, it is increasingly important to understand the tax situation of potential beneficiaries. Consider leaving **different types of accounts to different beneficiaries** (e.g., leave Roth accounts or taxable accounts to higher-income children and leave TDAs to lower-income children). In addition, dividing retirement accounts among several beneficiaries can reduce the risk of higher taxes due to the 10-year rule.

[7] This does not apply to some beneficiaries, such as spouses and those who are less than 10 years younger than the original owner.

- If an investor has a significant portion of assets in TDAs (as in all of our examples), RMDs significantly limit their flexibility after the relevant age. As a result, retirees need to plan early and take advantage of the pre-RMD years for most strategies to have a significant impact. Fortunately, the SECURE Act and SECURE 2.0 Act extended the RMD age to 73 or 75 for most people currently entering retirement, allowing more time to execute a strategy. However, due to the taxation of Social Security benefits (i.e., the tax torpedo), it is often important to plan a strategy that begins before the household claims their Social Security benefits.

- This paper shows results for the conventional wisdom strategy assuming the same (best) Social Security claiming decisions as the recommended withdrawal strategy. However, many people think about claiming Social Security early, and they should be aware that there is often synergy generated when they coordinate their Social Security claiming decision with their withdrawal strategy. In some of the cases shown, delaying Social Security not only increases lifetime benefits, but it also enables households to execute Roth conversions at attractive tax rates early in retirement.

- We assumed all accounts have the same investment return. In real life, it is important to consider asset allocation and location across the accounts. Using TDAs or Roth accounts for rebalancing or allocation changes, if possible, may minimize tax-triggering events in the taxable account.

- We assumed a fairly tax-efficient taxable account composed of stocks or stock funds. If an individual's taxable account includes investments such as bonds that generate ordinary income, they generally want to liquidate those investments sooner. That makes the point above about managing asset allocation and location particularly important.

> “
> It's important to plan before RMDs limit your flexibility.
>
> – Roger Young, CFP®
> Thought Leadership Director

- State income taxes should also be considered, but they may not be a driving factor in an investor's decision. Most states do not tax Social Security income, and some exclude at least a part of pension benefits or retirement account distributions. Those provisions could put an individual in a low state tax bracket in retirement. That would make it slightly more preferable for them to take TDA distributions if their heirs will be subject to higher marginal tax rates.

- Taxes on different types of retirement income are complicated and interrelated. Therefore, we highly recommend consulting with a tax or financial professional.

- We assumed constant spending (in today's dollars). To deal with major changes in spending (e.g., major purchases, medical expenses), having a borrowing source, such as a home equity line of credit, may be useful. That liquidity may enable an individual to avoid large distributions or withdrawals that would significantly increase their taxes.

Conclusion

Retirees with solid savings and a mix of investment account types are well positioned to take advantage of the tax code. Rather than settling for the conventional wisdom withdrawal strategy, they can benefit from one or more of these strategies:

- Drawing from TDAs to take advantage of a low (or even 0%) tax bracket, especially before RMDs begin.

- Executing Roth conversions early in retirement to reduce future RMDs and enable the household or beneficiaries to avoid high marginal tax rates (including the tax torpedo).

- Selling taxable investments when income is below the taxation threshold for LTCG (often supplementing with tax-free Roth distributions to meet their spending needs).

- Considering heirs' marginal tax rates when deciding between TDA and Roth account distributions (if an individual is confident there will be an estate).

- Evaluating whether to hold taxable assets until death to take advantage of the step-up in basis (again, only if the assets won't be needed for spending in an investor's lifetime).

Appendix

Summary of scenario assumptions and results (rounded)

(Fig. 7) Particularly important assumptions are highlighted in green

	Scenario 1: Focus on lifetime, not legacy	Scenario 2: Limit the tax torpedo	Scenario 3: Consider beneficiaries with higher tax rate	Scenario 4: Focus on survivor's tax situation
Assumption				
Portfolio value at retirement	$2,000,000	$600,000	$2,500,000	$2,500,000
Annual spending need (after taxes)	$120,000	$60,000	$140,000	$159,000
Annual total Social Security benefits (if claimed at FRA)[1]	$46,600	$30,000	$54,000	$51,600
Account mix (percent taxable/deferred/Roth)	40/50/10	17/75/8	40/50/10	16/80/4
Age at retirement in January 2025, years in retirement	65/65, 30/30	66, 24 (single)	65/65, 30/30	66/63, 14/27
Initial percentage of taxable account in cost basis	25%	80%	25%	90%
Heirs' marginal tax rate	15%	20%	28%	20%
Summary of strategy				
Social Security claiming	Both at age 70	Age 70	Both at age 70	Ages 70 and 65½
Withdrawal sequence	Fill 12% bracket with tax-deferred distributions in 2025, then 10% bracket. When RMDs start, use Roth and then taxable accounts for additional spending needs.	Tax-deferred distributions and Roth conversions before RMDs, enabling Roth distributions (to stay in 10% bracket) thereafter.	Rely mostly on tax-deferred assets, then taxable accounts, before RMDs. At that point, deplete the Roth account and then the tax-deferred account before death.	Large Roth conversions early, enabling a mix of Roth and tax-deferred accounts for the widow.
Total Roth conversions	None	$55,000	None	$495,000
Results (and change from conventional wisdom strategy)				
After-tax value to heirs	$1,014k (+ $80k or 9%)	$106k (+$33k)	$1,402k (+$147k or 12%)	$227k (+$162k)
Federal taxes paid	$198k ($63k or 24% better)	$45k ($44k or 49% better)	$330K (-$7k or 2% worse)	$478k ($204k or 30% better)

Notes: All amounts are in today's dollars, rounded. Retirement begins January 2025. In all examples, the portfolio lasts the entire expected lifetime (for both the recommended strategy and the conventional wisdom strategy). Annual spending includes Medicare premiums without any potential income-related premium adjustments. Percentage change in value to heirs is not shown for the cases where the household is in danger of running out of money using the conventional wisdom strategy. See full list of assumptions below.

[1] For couples, Social Security benefits are assumed to be similar, except in scenario 4, where the FRA benefit is $33,600 for the husband and $18,000 for the wife.

Assumptions

(Unless otherwise noted)

- All accounts earn the same 6% constant nominal rate of return before taxes.
- Inflation is 3% annually.
- All amounts are expressed in today's dollars. Therefore, while Social Security benefits in the analysis appropriately reflect cost-of-living adjustments (COLAs) equal to inflation, the benefits at FRA stated in this paper do not include any COLAs. Tax brackets are assumed to adjust with inflation. However, Social Security taxability thresholds do correctly reflect the fact that those are not indexed to inflation.
- Taxes are based on rates effective January 1, 2024, including the fact that some rates are scheduled to revert to pre-2018 levels (adjusted for inflation) after 2025.
- The household uses the standard deduction.
- While there are other potentially tax-exempt sources, such as Health Savings Accounts and municipal bond interest, our analysis only considers Roth distributions (which are assumed to be qualified).
- State taxes and federal estate tax are not considered.
- All taxable investment account earnings are either qualified dividends or long-term capital gains. Taxable investments pay a 1.5% qualified dividend yield annually as part of the return, which is reinvested.
- Gains upon liquidation of taxable investments are based on the average cost basis for the account.
- Spending requirements, including Medicare premiums before any income-related adjustments, remain constant (in today's dollars) throughout retirement.
- The couple has no additional sources of income beyond Social Security and investments.
- All RMDs are fulfilled, and any RMDs not needed for spending are invested in the taxable account. RMDs are based on the Uniform Lifetime Table effective beginning in 2022. Based on the assumed ages, all people in the scenarios begin RMDs at either age 73 or 75.
- Scenarios were intended to reflect reasonable Social Security benefits relative to assets and spending needs.

INVEST WITH CONFIDENCE®

T. Rowe Price identifies and actively invests in opportunities to help people thrive in an evolving world, bringing our dynamic perspective and meaningful partnership to clients so they can feel more confident.

Important Information

This material has been prepared for general and educational purposes only. This material does not provide recommendations concerning investments, investment strategies, or account types. It is not individualized to the needs of any specific investor and is not intended to suggest that any particular investment action is appropriate for you, nor is it intended to serve as the primary basis for investment decision-making. Any tax-related discussion contained in this material, including any attachments/links, is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding any tax penalties or (ii) promoting, marketing, or recommending to any other party any transaction or matter addressed herein. Please consult your independent legal counsel and/or tax professional regarding any legal or tax issues raised in this material.

The views contained herein are those of the authors as of October 2024 and are subject to change without notice; these views may differ from those of other T. Rowe Price associates.

This information is not intended to reflect a current or past recommendation concerning investments, investment strategies, or account types, advice of any kind, or a solicitation of an offer to buy or sell any securities or investment services. The opinions and commentary provided do not take into account the investment objectives or financial situation of any particular investor or class of investor. Please consider your own circumstances before making an investment decision.

Information contained herein is based upon sources we consider to be reliable; we do not, however, guarantee its accuracy. **Actual future outcomes may differ materially from any estimates or forward-looking statements provided.**

Past performance is not a reliable indicator of future performance. All investments are subject to market risk, including the possible loss of principal. All charts and tables are shown for illustrative purposes only.

The T. Rowe Price Retirement Advisory Service™ is a nondiscretionary financial planning and retirement income planning service and a discretionary managed account program provided by T. Rowe Price Advisory Services, Inc., a registered investment adviser under the Investment Advisers Act of 1940. Brokerage accounts for the Retirement Advisory Service are provided by T. Rowe Price Investment Services, Inc., member FINRA/SIPC, and are carried by Pershing LLC, a BNY Mellon company, member NYSE/FINRA/SIPC, which acts as a clearing broker for T. Rowe Price Investment Services, Inc. T. Rowe Price Advisory Services, Inc. and T. Rowe Price Investment Services, Inc. are affiliated companies.

T. Rowe Price Investment Services, Inc., distributor. T. Rowe Price Associates, Inc., investment adviser. T. Rowe Price Investment Services, Inc., and T. Rowe Price Associates, Inc., are affiliated companies.

ID0007486
202410-3892964