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A Closer Look at Withdrawal Strategies

Investors can get more out of their retirement savings using a tax-savvy approach.

KEY POINTS

- The conventional wisdom of withdrawing from taxable accounts first isn't always the best strategy.
- Limiting tax-deferred distributions to match tax deductions can help you stay in a lower tax bracket.
- Some individuals pay no taxes on long-term capital gains, making withdrawals from taxable accounts a beneficial option.

One of the challenges we face in retirement is finding the most advantageous way to draw down savings while minimizing taxes. Many people have investments in a variety of accounts that have different tax characteristics. These can include Traditional IRAs or 401(k)s, Roth IRAs, and taxable brokerage accounts. In retirement, you probably will need to withdraw money from these accounts to supplement your Social Security income.

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Conventional wisdom

"The conventional wisdom is to withdraw from taxable accounts first, followed by tax-deferred accounts, and, finally, Roth assets," explains Roger Young, CFP®, a senior financial planner with T. Rowe Price. "This approach affords your tax-advantaged accounts more time to grow tax-deferred—but also could present you with more taxable income in some years than in others." As your tax rate is dependent on your income, this could mean more taxes in those high-income years than you originally anticipated.

Federal income tax matters for retirees can be complicated. For example:

- Withdrawals (distributions) from Traditional (pretax) IRAs or 401(k) accounts are fully taxed as ordinary income.
- Qualified distributions from a Roth account are tax-free.*
- For taxable accounts, interest received is ordinary income. However, if you sell investments, you only pay taxes on the gains (i.e., not on the invested principal, which is tax-free). Long-term capital gains and qualified dividend income generally are taxed at lower rates than ordinary income.

A thoughtful approach

Everyone has different financial goals in retirement, but if you're concerned about outliving your assets, you might focus on extending the life of your portfolio or increasing what you can spend in retirement. Here are two ways you can use tax savings to help achieve these goals:

1 Take full advantage of income subject to very low, or even zero, tax rates.

People with relatively modest incomes may think it's best to follow the conventional model. After all, you may pay little or no taxes at first. However, once the taxable accounts are exhausted, you may end up paying a higher tax rate because you are generating more taxable income from tax-deferred account withdrawals.

Instead, consider using your low tax bracket strategically by consistently "filling up" that bracket with ordinary income from tax-deferred account distributions, such as your Traditional IRA. If you need more than these withdrawals to support your lifestyle, you can sell taxable account investments, then take money from Roth accounts. This idea isn't new, but following the Tax Cuts and Jobs Act of 2017, more people may be able to limit their incomes to match their deductions—thus paying zero taxes—or stay within a low bracket. As an example, assume a married couple:

- Has $750,000 across their investment accounts: 60% tax-deferred, 30% Roth, and 10% taxable
- Spends $65,000 (after taxes) each year
- Collects $29,000 in Social Security benefits

Using the approach described above, they could completely avoid federal income taxes and save $42,000. This strategy adds over two years to the life of their portfolio. (See "Filling Up Your Tax Bracket" on page 3.)

*Generally, distributions are tax-free once you reach age 59.5 and have held the Roth account for at least five years.

2 Make the most of untaxed capital gains.

Did you know that some people don't have to pay taxes on capital gains? If your taxable income is $39,375 or less (for single filers) or $78,750 or less (for married couples filing jointly), long-term capital gains and qualified dividends aren't taxed. This is another area where people may benefit from the recent increase in the standard deduction.

We've found that those who have a lot of assets in taxable accounts may be better served by taking advantage of untaxed capital gains than by taking tax-deferred distributions to fill up ordinary income brackets.

Let's look at an example with a married couple that has significant taxable investments. We'll assume the couple:

- Has $2 million across their investment accounts: 50% tax-deferred, 10% Roth, and 40% taxable
- Spends $120,000 per year
- Collects $45,000 from Social Security

The best strategy we found was to tap in to the taxable account before taking required minimum distributions (RMDs), then a combination of taxable investments and Roth distributions along with the RMDs. By doing so, the couple can avoid capital gains taxes until the Roth account runs out. (See "Targeting Capital Gains First" on page 4.)

Implement your strategy

As you approach retirement, keep in mind that taxes are complicated, so you probably will want to consult with a tax advisor for help determining a withdrawal strategy. Roth conversions also are an option, but our research indicates they usually are better suited for people focused on leaving an estate. Tax diversification—having assets in multiple types

Filling Up Your Tax Bracket

Limiting income to match standard deductions can help reduce tax liability.

Assumes a $750,000 portfolio and $65,000 annual spending in retirement.

	Conventional Wisdom	Bracket-Filling Method
Account withdrawals (specific to this example)	Taxable account (years 1–3) Tax-deferred account (years 3–18) Roth account (years 18–30)	Tax-deferred distributions $21,000–$23,000 each year Supplement with taxable account (years 1–6) and Roth account (years 6–32)
Federal taxes paid over 30 years	$42,000	$0
Longevity of portfolio with constant returns	29.4 years	31.6 years (7% improvement)

The chart is for illustrative purposes only and is not indicative of any specific investment. Additional assumptions: Amounts are in today's dollars and rounded; investment returns (before taxes) of 3% above inflation; taxable account generates only qualified dividends and long-term capital gains; couple retires at age 65; federal taxes remain at 2019 levels; state taxes not considered. Withdrawal years reflect approximate timing and don't fall exactly at the year mark, so overlapping years are intentionally included in this illustration.

of accounts—can improve your flexibility in retirement. In both examples, having some Roth assets is key to implementing the strategy. RMDs can significantly reduce your flexibility to manage taxes after age 70½, so you need to develop a plan well ahead of that milestone. "With a little planning and a variety of accounts in your portfolio, you can save on taxes and better sustain your retirement lifestyle," says Young. ■

Targeting Capital Gains First

Rates on long-term capital gains are 0% for some taxpayers, making withdrawals from taxable accounts a good option for people with relatively modest incomes.

Assumes a $2 million portfolio and $120,000 annual spending in retirement.

	Conventional Wisdom	Utilizing Untaxed Capital Gains
Account withdrawals (specific to this example)	Taxable account (years 1–26) Tax-deferred account (starting with RMDs year 6, running out year 34), Roth account (years 34+)	Before RMDs (years 1–5), use taxable account. Thereafter, supplement RMDs with $11,000–$17,000 per year from Roth account. Taxable account withdrawals are small until Roth account is depleted (year 27)
Federal taxes paid over 30 years	$266,000	$205,000 (23% reduction)
Longevity of portfolio with constant returns	41.6 years	42.6 years (2% improvement)

The chart is for illustrative purposes only and is not indicative of any specific investment. See previous table for additional assumptions. Withdrawal years reflect approximate timing and don't fall exactly at the year mark, so overlapping years are intentionally included in this illustration.

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