MarketWatch

Best ways to draw down retirement accounts

By Robert Powell

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BOSTON (MarketWatch) — It's not what you earn, but what you keep. That old adage is true when saving for retirement and it's equally important — if not more so — when it comes to withdrawing money from your various accounts earmarked for retirement. But the conventional wisdom and advice about the best way to take money out of those accounts just might leave you with less, not more, after-tax wealth.

Taxable vs. tax-deferred

As a general rule, it's usually better to sell long-term investments held in taxable accounts instead of taking money from tax-deferred accounts before you have to, according to Rande Spiegelman, a CPA, certified financial planner, and vice president of financial planning for the Schwab Center for Financial Research.

"Withdrawals from traditional IRAs and 401(k)s are taxed as ordinary income — typically at a higher rate than the preferential long-term capital gains rate," said Spiegelman, who has written extensively on the subject. "What's more, tapping your IRA means losing opportunities for tax-deferred compound growth."

But this general rule could be hazardous to your after-tax income and after-tax wealth, according to Lewis Coopersmith, Ph.D., an associate professor of management sciences at Rider University, and Alan Sumutka, CPA, an associate professor of accounting at Rider University as well as the owner of Alan R. Sumutka, CPA.

Specifically, the so-called common rule of thumb for withdrawing retirement savings — taxable savings before tax-deferred savings — can inflate required minimum distributions (RMDs) and thus reduce tax efficiency and wealth, according to Coopersmith and Sumutka's paper.

RMDs are, of course, the distributions that older Americans must take from their retirement accounts (though not their Roth IRAs) after age 70½. Waiting until age 70½ to start withdrawing money from those accounts could force you to take large distributions that push you into a higher tax bracket.

So, instead of using the common rule-of-thumb strategy, the authors advocate for using a tax-efficient withdrawal plan. With this plan, the goal is to withdraw money in ways that maximize the final total account balance over a retirement horizon, not just one year.

In their paper, Coopersmith and Sumutka compared and contrasted the two main types of withdrawal plans, the common rule-of-thumb and tax-efficient, under a variety of scenarios (different taxable rates of return, different tax-deferred rates of return, different initial taxable savings and itemized deductions) and found the following: Contrary to conventional wisdom, taking money first from tax-deferred accounts instead of a taxable account tends to produce the greatest final total account balance.

Or at least it does under certain conditions. The authors found, for instance, that the tax-efficient plan can significantly outperform the common rule-of-thumb strategy when the taxable rate of return is greater than tax-deferred rate of return, and initial taxable wealth is greater than 10% of total retirement wealth, and itemized deductions are greater than the standard deduction.

In fact, the total remaining account balances for the tax-efficient approach was some 16% higher that the common rule-of-thumb approach.

To be fair, there are conditions under which the tax-efficient strategy doesn't perform any better than the common rule-of-thumb approach. For instance, the tax-efficient approach yields somewhat similar results to the common rule-of-thumb models when there's relatively low initial taxable savings; taxable rates of return that are less than, or very close to, tax-deferred rates of return; and standard or low itemized deductions generate a higher remaining account balance.

Read Coopersmith and Sumutka's paper, "Tax-Efficient Retirement Withdrawal Planning Using a Linear Programming Model."

Crunching the numbers is the best rule of thumb

In an interview, the authors said the upshot of their study is essentially this: Older Americans should not blindly follow either the tax-efficient or the common rule-of-thumb retirement withdrawal plan. Rather, they should crunch the numbers each year to determine which approach would yield the greatest after-tax wealth over a long-term time horizon. And more often than not, this exercise will suggest that the better approach is the tax-efficient one, the authors say.

"The conventional wisdom rule is most likely the best thing you can do if you planning one year ahead," said Coopersmith. "But the tax laws look out over a longer horizon. So, because of the brackets in the tax law and other things such as capital gains, there are definite advantages of violating that rule under various conditions which are not obvious to most people."

You need to evaluate whether it's "advantageous to take money out of a tax-deferred account early to avoid taking it out later in a higher tax bracket, which is going to affect your overall growth," Coopersmith said.

Sumutka agreed. "Conventional wisdom is saying, historically, what you want to do is take your taxable accounts first and let your tax-deferred accounts stay as long as possible in order to get the advantage of the tax deferral," he said. "Meaning the longer you wait to pull from the tax-deferred, you are not having to pay ordinary income tax rates on that. So that's at least the theory behind the conventional wisdom."

Others who are focused on building retirement income plans also suggest that letting money grow in a tax-deferred account may not be the best strategy. "As with any general rule, of course, there are plenty of exceptions," said Spiegelman.

For example, if (as Coopersmith and Sumutka suggested) your IRA balance is very large, you may want to draw from it before the age of 70½, when the RMDs kick in. "Otherwise, the RMDs may bump you up to a higher tax bracket," said Spiegelman.

And there are estate-planning reasons to withdraw money from your tax-deferred accounts before your taxable accounts. "Your taxable estate includes your IRA balance — and on top of that, your heirs will owe income tax on any distributions they take from your IRA," said Spiegelman. "Drawing down your IRA during your lifetime and leaving taxable accounts to heirs could be an effective strategy."

Another strategy to consider if you have both a traditional IRA and a Roth IRA is to draw down from the traditional IRA first. "The Roth is still included in your taxable estate, but at least your beneficiaries will be able to take distributions tax-free," said Spiegelman.

Others, meanwhile, agree that crunching the numbers is the best strategy of all. "The only rule of thumb that works when it comes to retirement planning is that here are no rules of thumb that you can rely on 100% of the time," said Kevin S. Seibert, CFP®, CRC®, CEBS, and a principal with the InFRE Retirement Resource Center. "You'll always come across a client scenario where conventional wisdom does not apply."

According to Seibert, it's important to put Coopersmith and Sumutka's study into perspective. "Based on the assumptions used in this study, the common rule for withdrawing retirement savings is not the best approach," he said. "Under a different set of assumptions, the common rule may work just fine."

Plans need to consider capital gains and asset location, too

Others praise Coopersmith and Sumutka for raising awareness of the need to create a tax-efficient retirement withdrawal plan. But they also say there's more besides the withdrawal policy to consider when constructing a tax-efficient plan.

"Coopersmith and Sumutka present clear evidence that managing the source of withdrawals and transfers between tax-deferred and taxable accounts can increase after-tax retirement income and bequests," Paul Samuelson, the chief investment officer and co-founder of LifeYield, said in an email. "In particular, they highlight that spreading withdrawals from tax-deferred accounts across time rather than concentrating them allows one to take advantage of low tax brackets in many years and to avoid higher tax brackets in a small number of years."

The authors, however, focused on just one of three legs of a stool required to increase after-tax retirement income and wealth, according to Samuelson. And the key to creating the most after-tax retirement income and wealth is to look at income results over a multidecade retirement based on three legs — withdrawal policy, asset location and capital gains.

With regard to the withdrawal policy, Samuelson said his firm's illustrations validate the authors' recommendation for excess withdrawals from tax-deferred accounts in early retirement. "However, our illustrations recommend using the withdrawals to fund conversions to tax-free (Roth) accounts (with tax-free accumulation) instead of transfers to taxable accounts (with taxable accumulation)," Samuelson said.

As for asset location, the notion of putting certain types of assets in certain types of accounts to create the highest after-tax value, Samuelson said his firm's illustrations optimally locate assets in taxable and tax- advantaged accounts, putting high-tax drag assets with high returns (high turnover stocks) in tax-free accounts, high tax-drag assets with low returns (government and corporate bonds) in tax-deferred accounts and low tax-drag assets (low turnover stocks and municipal bonds) in taxable accounts.

As for capital gains, Samuelson said his firm's illustrations "accelerate loss realization and delay capital gains realization (sometime until step up at death) in the taxable accounts."

(For the record, Coopersmith and Sumutka noted in their study that future research may show how the relative benefits of tax-efficient models might change as more details of the tax laws are considered explicitly, such as reduced taxes on capital gains and Roth IRAs. They also note that another area for further study is how best to allocate assets between stocks and bonds in light of the tendency of tax-efficient withdrawal planning to prolong the availability of taxable savings.)

Tax-efficient withdrawal software needed

Unfortunately, crunching the numbers year by year to determine the most tax-efficient withdrawals is easier said than done. Most financial services industry firms and advisers — with some exceptions — are not in a position to determine the most tax-efficient way for their clients to take distributions. What's more, it gets even more complicated when you add "estate-planning considerations to the decision-making process," said Seibert.

Ultimately, Seibert said, "User-friendly software needs to be developed that will allow clients to choose from various scenarios and make adjustments when needed because what the advisor/client assumes is going to happen tax-wise over a 30-year retirement and what actually does happen will undoubtedly be different."

Not surprisingly, such software does exist. LifeYield, Samuelson's firm, is producing software aimed at helping firms in the financial services industry help their clients create tax-efficient retirement withdrawals plans. (LifeYield's calculation engine suggests the optimal trades to make now to source withdrawals, consistent with higher after tax returns later.) And Coopersmith and Sumutka are fast at work building software too.

With millions marching toward retirement, there's one conclusion from the study that's not in dispute: There's a great need to help retirees and would-be retirees make the most of their retirement funds.

Robert Powell is editor of Retirement Weekly, published by MarketWatch.

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