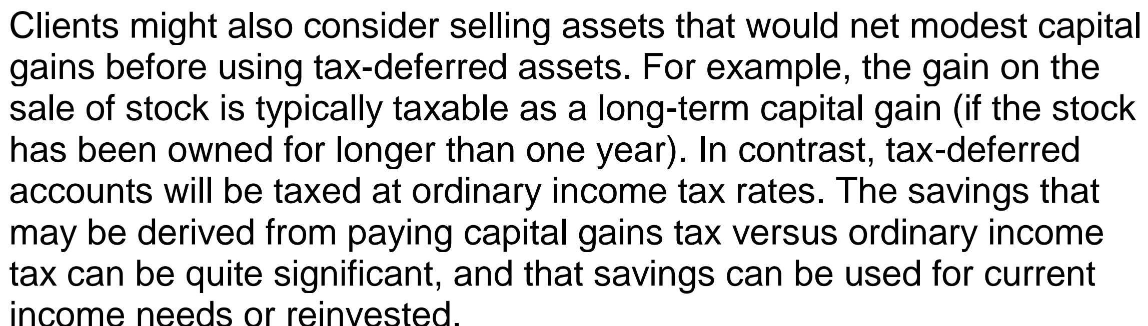
Determine Preferred Asset Liquidation Sequence

Which of the various buckets should be siphoned first—or last? Clients will not only need to gauge market conditions when deciding which assets to sell and buy, but they will also need to pay attention to withdrawing funds in a way that minimizes taxes. Generally, clients are advised to:

- withdraw taxable assets first
- draw down tax-deferred accounts next
- withdraw funds from tax-free accounts (Roth IRAs and municipal bonds) last

Financial experts generally recommend deferring taxes as long as possible. This means that if clients have a choice between paying taxes this year or next, they should choose to defer paying taxes. Therefore, as a general rule, clients should first tap into any accounts that generate taxable gains or income. This strategy gives tax-deferred and tax-free accounts more time to grow unencumbered by taxes, and interest earnings that otherwise would have been taxed remain intact to compound fully. Because tax-deferred investments' growth is not curbed by taxes, these investments will grow faster than taxable accounts.



Clients might also consider selling assets that would net modest capital gains before using tax-deferred assets. For example, the gain on the sale of stock is typically taxable as a long-term capital gain (if the stock has been owned for longer than one year). In contrast, tax-deferred accounts will be taxed at ordinary income tax rates. The savings that may be derived from paying capital gains tax versus ordinary income tax can be quite significant, and that savings can be used for current income needs or reinvested.

After taking withdrawals from taxable accounts, clients should move to tax-deferred accounts next, including traditional IRAs, qualified plans, and annuities. By turning to these accounts only after drawing down

taxable investments, your clients have allowed their nest eggs to accumulate more, due to the combined benefits of tax deferral and compounding.

Keep in mind that funds have to be withdrawn from traditional IRAs by age 70½, while distributions from qualified plans must begin by the later of age 70½ or when the client retires. Strategies for withdrawing assets must also consider any potential penalty taxes: the premature distribution penalty tax for withdrawing funds before age 59½ or the 50 percent excise tax for failing to take required minimum distributions after age 70½.

Again as a general rule, the last assets to be touched in an asset liquidation strategy are those that generate tax-free returns. These include Roth IRAs and municipal bonds. Withdrawals from Roth IRAs are tax free, provided the owner is at least 59½ years old and has owned the account for five years or more. They also are not subject to the minimum distribution rules, and Roth assets can be passed to heirs tax free. Withdrawals can be spread out over their lifetimes, which will give their inheritance additional years to grow, tax free. By tapping into Roth IRAs and municipal bonds last, a person will get the most tax-free income.