Nerd’s Eye View

Tax-Efficient Spending Strategies from Retirement Portfolios

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For most retirees, the tax efficient liquidation of a retirement portfolio requires coordinating between both taxable brokerage accounts and pre-tax retirement accounts like an IRA or 401(k).

The conventional view is that taxable investment accounts should be liquidated first, while tax-deferred accounts are allowed to continue to compound. Except in practice, it’s possible to be “too good” at tax deferral, where the IRA grows so large that future withdrawals (or even just RMD obligations) actually drive the retiree into higher tax brackets!

As a result, a more tax-efficient liquidation strategy is to tap IRA accounts earlier rather than later. Not so much that the tax bracket is driven up now, but enough to reduce exposure to higher tax brackets in the future.

However, the optimal approach is actually to preserve the tax-preferenced value of retirement accounts *and* to fill the tax brackets early on, by funding retirement *spending* from taxable investment accounts but doing systematic partial Roth conversions of the pre-tax IRA to fill tax brackets in the early years.

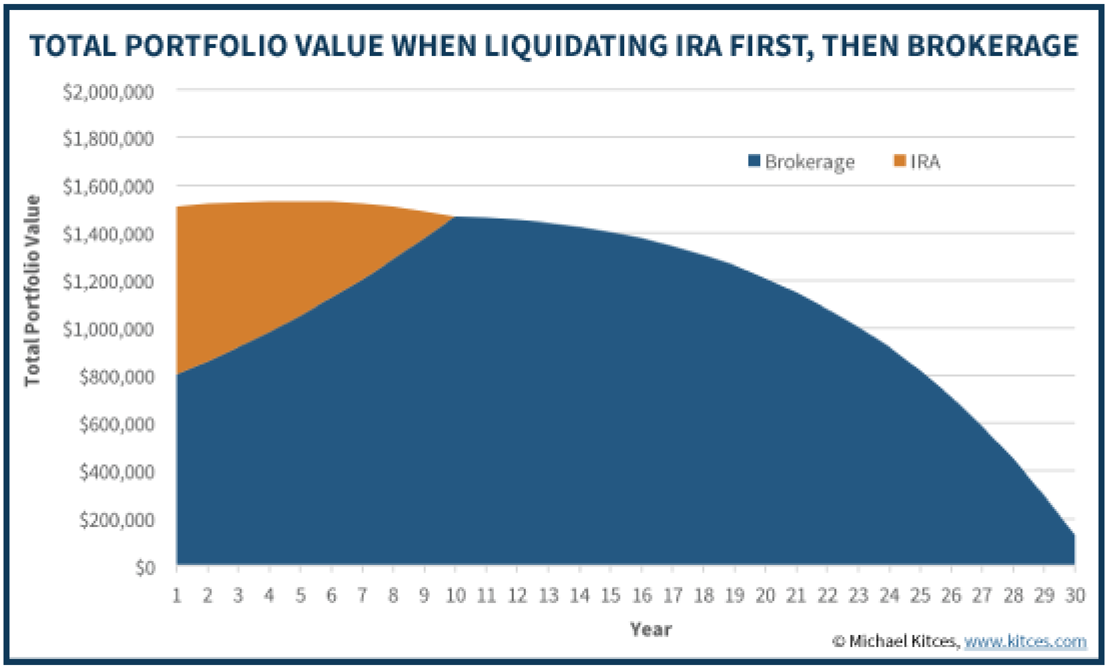
The result is that the retiree will tap investment accounts for retirement cash flows in the early years, a combination of taxable IRA and tax-free Roth accounts in the later years, and in the process avoid ever being pushed into top tax brackets, now or in the future!

The Conventional View Of Retirement Liquidations – Let The IRA Compound!

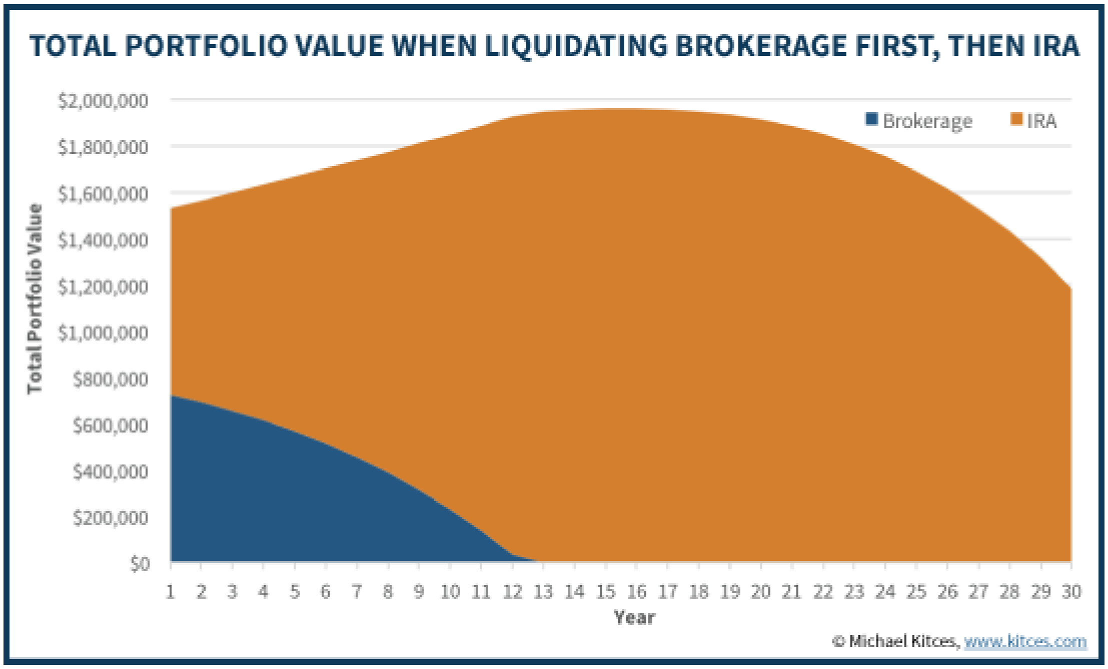
The classic approach to liquidating investment accounts in retirement is fairly straightforward: after-tax "taxable" brokerage accounts should be liquidated first, while retirement accounts like IRAs and 401(k) plans receive preferential (tax-deferred) treatment and should be liquidated last. This allows the retiree to spend down the least tax efficient portion of the portfolio first – the brokerage account with annually taxable interest and dividends, and potential capital gains – while preserving tax-deferral (and the benefits of tax-deferred compounding growth) as long as possible.

For instance, imagine a retiree who has $750,000 in a brokerage account and $750,000 in an IRA, and plans to withdraw $80,000/year from the portfolio (with spending adjusted annually for inflation) on top of other available income sources (e.g., Social Security).

If the IRA is liquidated first, even at an 8% growth rate the retiree quickly spends down the account (as at an average 20% tax rate, it actually takes close to $100,000/year of withdrawals to support $80,000/year of net spending). At that point, the retiree must rely on the brokerage account – which will never grow quite as quickly in the first place, as the annual drag of taxation on interest, dividends, and capital gains will reduce the ability of the account to compound. (The example below assumes a 7% net rate of return on the taxable account, assuming a combination of ordinary income interest and non-qualified dividends and short-term capital gains being taxed at 15%, and qualified dividends and long-term capital gains eligible for 0% rates.)



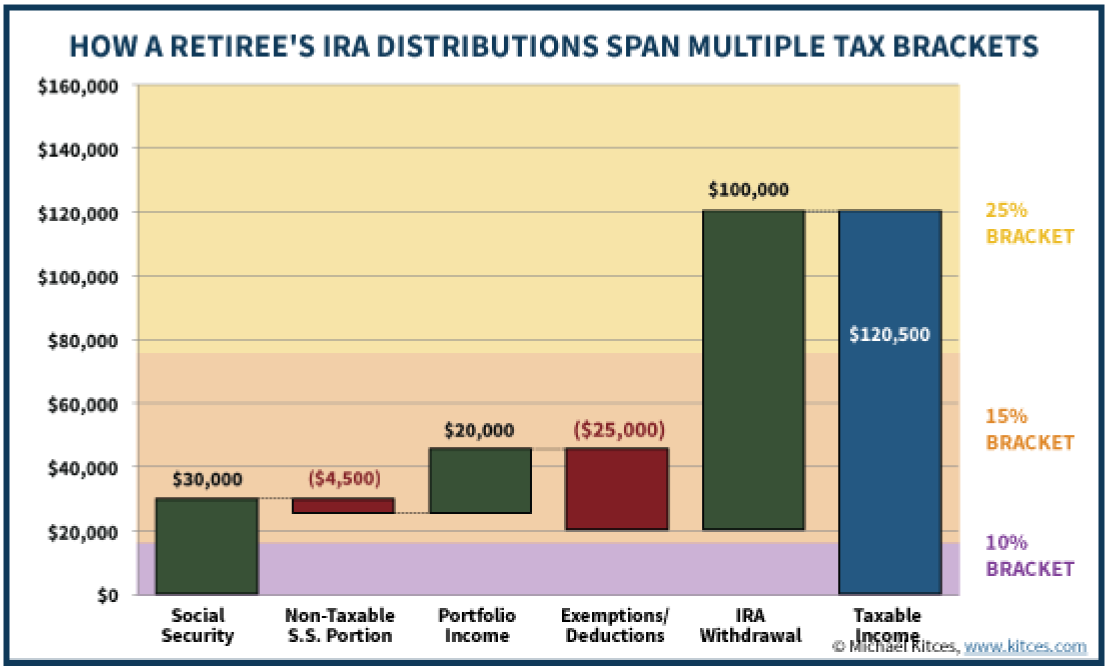
By contrast, if the retiree reverses the order, the results are more favorable. By drawing on the brokerage account first – which is growing in a less tax efficient manner anyway – and allowing the pre-tax IRA more time to compound, the strategy of spending the brokerage account first and the IRA second allows the portfolio to sustain withdrawals for a longer period of time, retaining a significant remaining balance even after 30 years (while the prior spenddown strategy was nearly depleted by the end of the 30th year).



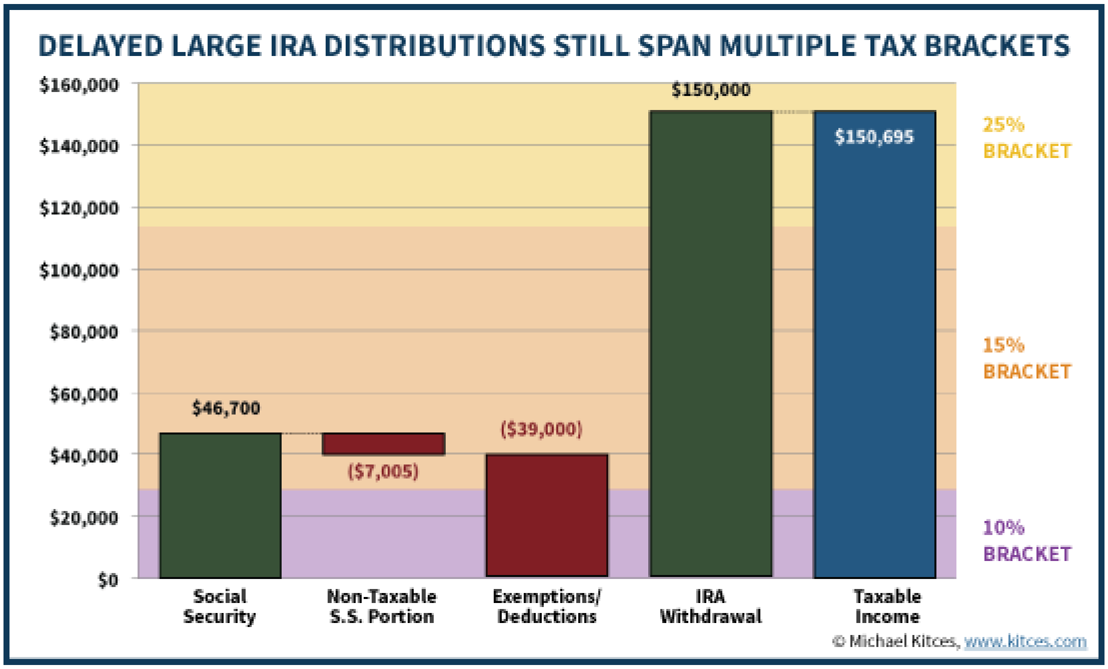
Big IRA Distributions Drive Up Tax Brackets

While the example above shows how deferring withdrawals from a pre-tax IRA can allow more wealth to compound, there is a significant caveat: the IRA is being subjected to a 20% average tax rate because the withdrawals are happening from the IRA all at once (either earlier or later) and driving a portion of the distributions into the 25% tax bracket.

For instance, continuing the prior example, the reality is that initially the couple would likely only be in the 15% ordinary income tax bracket. After all, if the couple is receiving $30,000/year of Social Security benefits (of which 85% would be taxable), and the taxable portfolio generates about $20,000/year of interest and dividends, and available exemptions/deductions are $25,000, their taxable income after all deductions would be barely over $20,000/year. This would put them at the bottom of the 15% tax bracket, and would actually mean [any qualified dividends (and long-term capital gains) are eligible for a tax rate of 0%]! It's only by stacking a $100,000 gross withdrawal from the IRA on top that drives them into the 25% bracket, with technically about half of the withdrawal taxed in the 15% bracket, and the other half of the IRA distribution taxed at 25%. (Notably, this would also cause any of the qualified dividends or long-term capital gains to lose their 0% tax rate and be subject to 15% rates as well.)



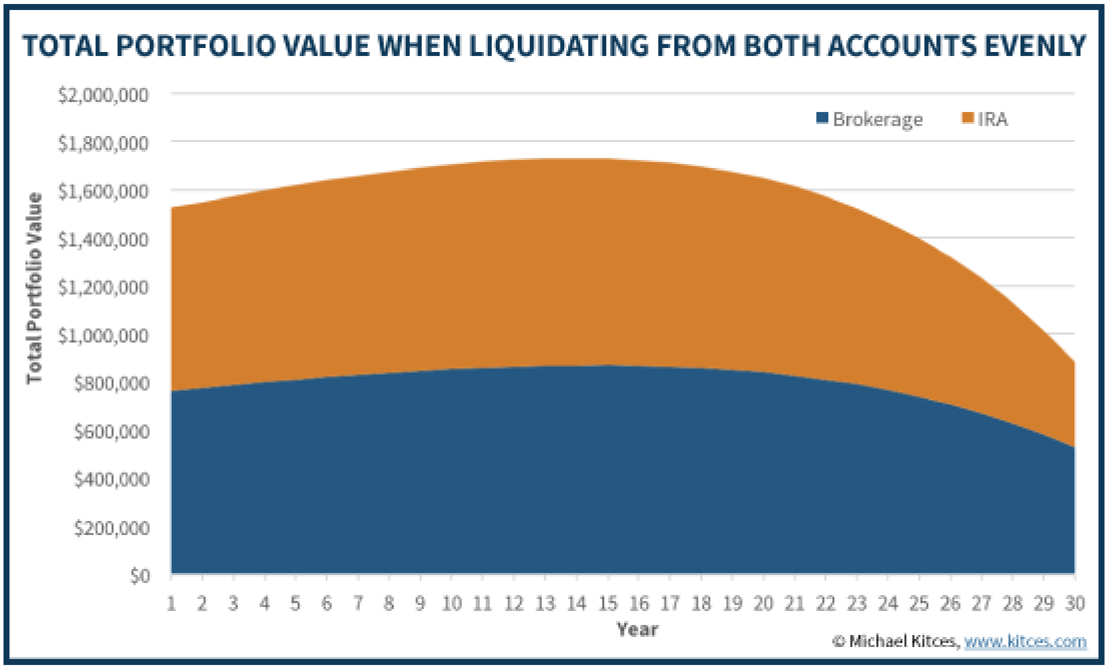
Similarly, if the retiree waits to tap the IRA until the later years, the tax bracket is driven up again as retirement cash flows must be almost fully funded from IRA distributions. For instance, after 15 years, the inflation-adjusted spending need would be nearly $125,000, and the requisite gross IRA withdrawal would be over $150,000. Of course, by definition at this point any passive portfolio income from interest, dividends, and capital gains would be eliminated (as the brokerage account was assumed to be spent down first), and the tax brackets (and standard deduction and personal exemptions) would be higher due to inflation adjustments as well. Still, while the portfolio withdrawals dip down to the bottom of the 10% bracket, they are mostly taxed at a blend of 15% and 25%.



Blending Withdrawals From IRA And Taxable Accounts

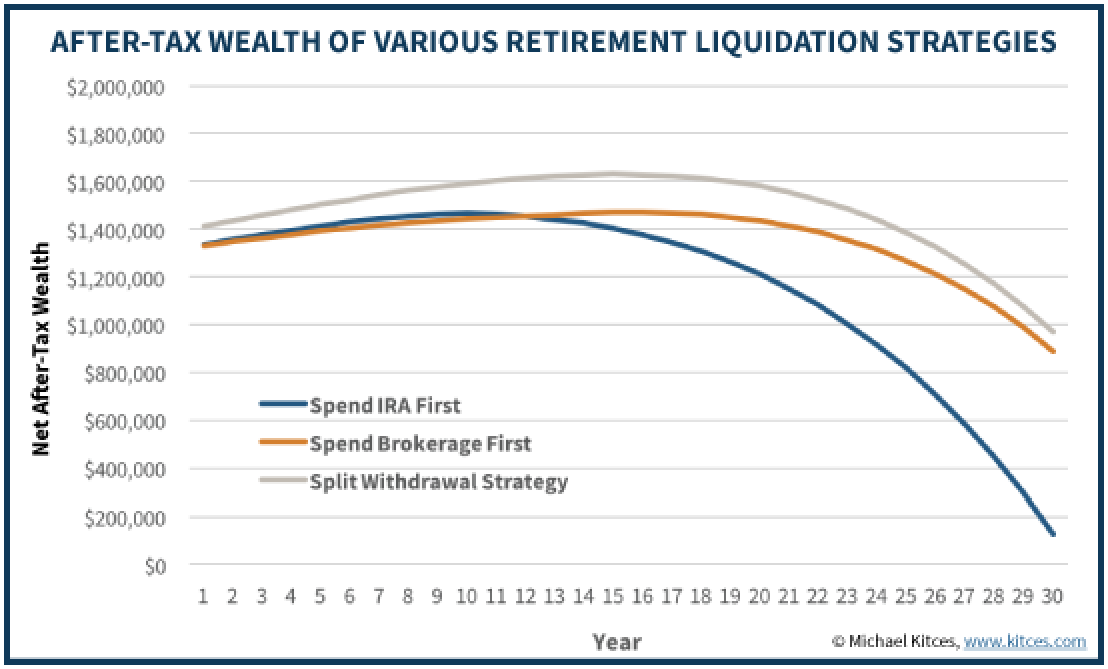
Given that taking full distributions from the IRA up front can drive the couple into higher tax brackets, and taking full distributions from the IRA in the later years will also drive the couple into higher tax brackets, the solution is actually remarkably simple: to take distributions from*each* account along the way.

The benefit of this tactic is that by taking only partial distributions from the IRA each year, the distributions can occur at "only" the 15% bracket without ever reaching the 25% bracket. Yet by taking at least some withdrawals from the IRA every year, the brokerage account lasts longer before it is ever depleted (avoiding the point where the retiree *must* take all distributions from the IRA because there's no other money left). For instance, the chart below shows the results when the retiree takes half the desired spending from each account every year, assuming their tax-savvy withdrawals keep them in the 15% tax bracket throughout.



By taking the blended-distribution approach, this portfolio lasts significantly longer than either of the preceding examples, driven by both the fact that "most" of the IRA still enjoys tax-deferred growth for an extended period of time, and more significantly because the annual distributions are modest enough to avoid ever hitting the 25% bracket!

Notably, the spend-brokerage-account-first scenario still had a higher final account balance, but this is due in large part to the fact that the IRA still has a significant looming tax liability that will have to be spent someday (i.e., the still-intact IRA will still be subject to taxes someday!). On a net after-tax basis, the split-strategy that allows the IRA withdrawals to be blended across the 10% and 15% brackets (assuming an average rate of just 13%) actually fares *better*than *either* of the alternatives!

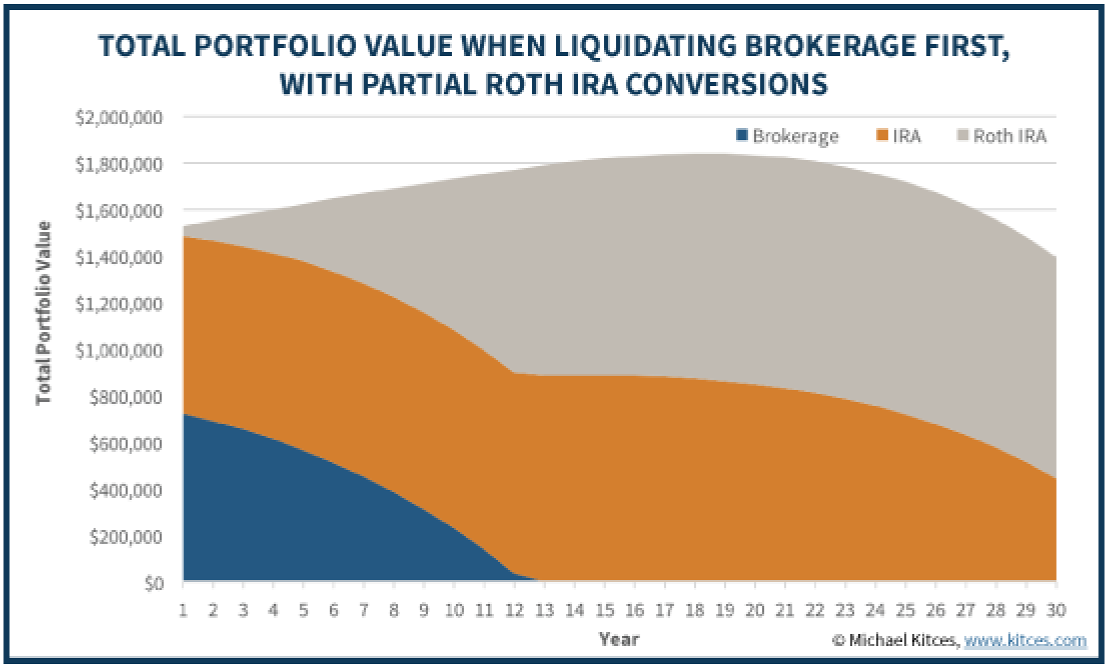


Filling Lower Tax Brackets With Partial Roth Conversions

While the strategy of taking partial distributions from an IRA earlier rather than later can be an effective means to enhance the longevity of the portfolio by reducing the average tax rate paid on the IRA, the one caveat to the strategy is that it still depletes a tax-preferenced account earlier than may have been necessary. In other words, the strategy faces a fundamental tension between the desire to take withdrawals earlier (to avoid "wasting" unused low tax brackets in the early years) versus the desire to benefit from tax-deferred compounding growth (by leaving the money in the IRA to compound tax-efficiently over time).

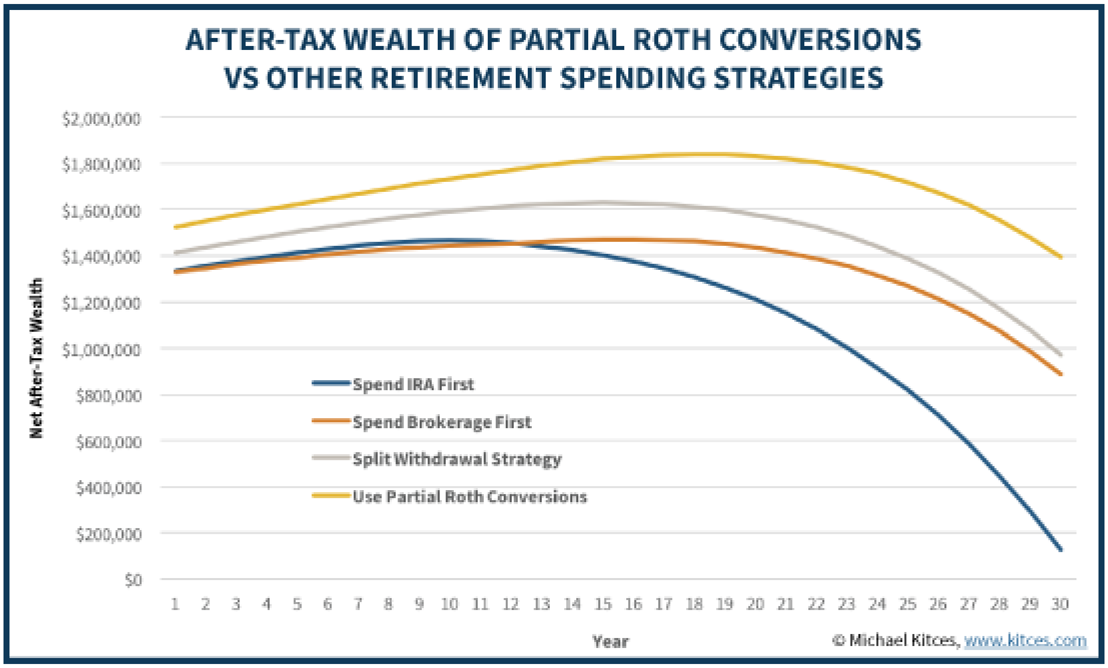
The resolution to this dilemma is to recognize that it's possible to "fill up" the lower tax brackets in the early years from the IRA, without actually liquidating the tax-preferenced account. The solution is to engage in systematic partial Roth conversions in the early years, moving the dollars from the IRA to a Roth

IRA, and generating the taxable income that fills the 15% tax bracket in the early years.



The end result of this approach is that the brokerage account will still be depleted throughout the first half of retirement, but the retiree's tax rate isn't driven up at that time because distributions can be partially supported from the newly-created Roth IRA. (In the example above, distributions are assumed to come 50/50 from the Roth and traditional IRAs, once the brokerage account is depleted, and all Roth conversions stop at that point.) In other words, by engaging in partial Roth conversions, the retiree can have the benefits of the "split" strategy to keep IRA distributions from ever reaching the 25% tax bracket, but done in a manner that still spends down the brokerage account first and allows tax-preferenced IRA and Roth IRA accounts to compound as long as possible.

Ultimately, the combination of taking advantage of lower tax brackets (and avoiding higher brackets) *plus* the additional tax-favored compounding in the traditional and Roth IRA accounts means that the partial Roth conversion strategy produces greater (net after-tax) wealth than any of the other scenarios.

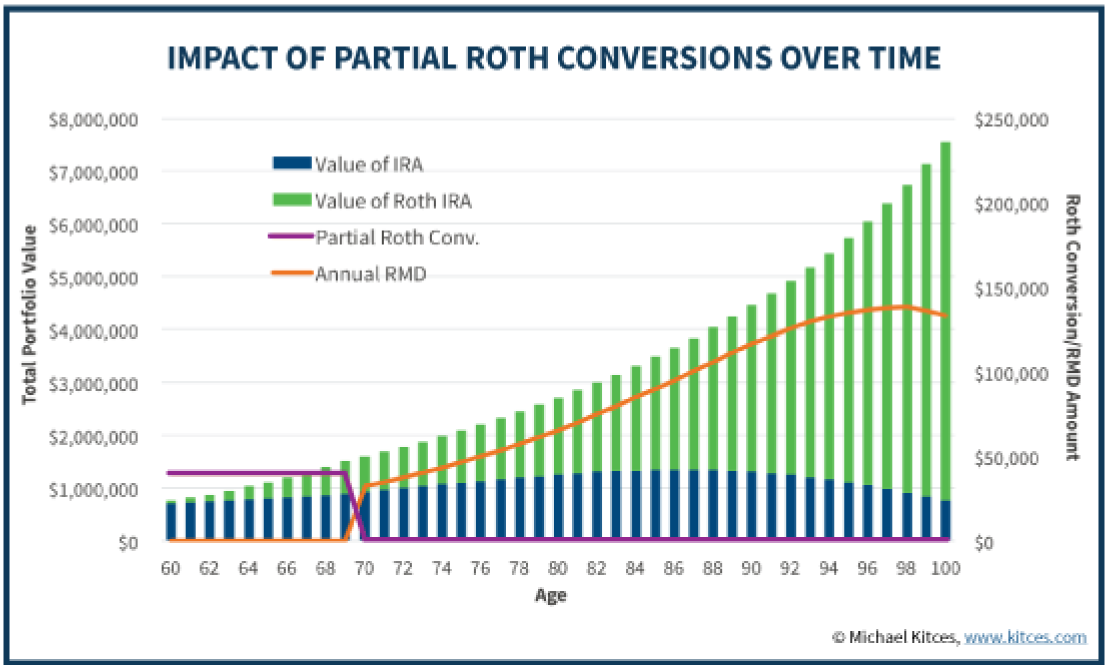


Maximizing Partial Roth Conversions To Minimize RMD Obligations

Another benefit of the approach of spending taxable/brokerage accounts first while doing partial Roth conversions is that if there's enough funds in the brokerage accounts that the IRA may not be needed *at all*, doing partial Roth conversions still helps to maximize long-term wealth, by minimizing the future impact of Required Minimum Distribution (RMD) obligations.

After all, for the retiree who doesn't *need* the IRA account, taking no distributions from the IRA and allowing the account to compound can actually create *less* wealth in the long run. The reason is that, as noted earlier, taking large IRA distributions all at once can drive up the retiree's tax bracket. And this is equally true regardless of whether the "large" IRA distributions are because the retiree *needed* the withdrawal, or was simply *forced* to take it as a required minimum distribution.

By contrast, doing partial Roth conversions not only ensures that the distributions themselves occur at more favorable tax rates in the early years, but can whittle down the IRA to the point that by the time the RMDs actually kick in, the IRA has been reduced to the point that the RMDs aren't actually very large. Which allows the retiree to remain in that lower tax bracket!

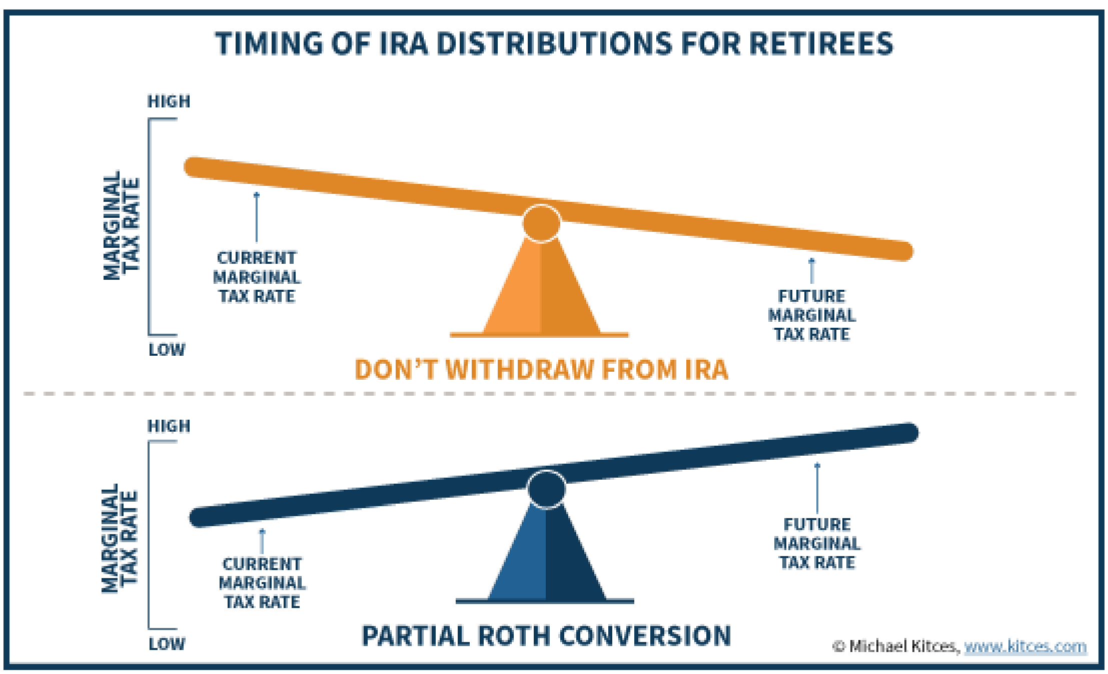


In addition, the fact that a Roth IRA does not have any RMD obligation also allows more dollars to stay in a tax-preferenced account for a longer period of time, [which indirectly helps the Roth to enhance long-term wealth as well](#)! (At least, [until/unless Congress changes the rules and implements an RMD requirement for Roth accounts, too](#)!)

Finding The Optimal Amount For Early Partial Roth Conversions And Avoiding Too Much Tax Deferral

Ultimately, the key concept to recognize in the tax-efficient liquidation of retirement accounts is that there really is such thing as "too much" tax deferral. An IRA (or 401(k), or other pre-tax retirement account) that is allowed to compound long enough will eventually be so large that the retiree is driven into even higher tax brackets just trying to tap the account, whether it's to generate retirement spending or simply because the distributions are "forced" out when RMDs begin.

Accordingly, the fundamental goal to spend from the portfolio in a more tax-efficient manner is to find constructive ways to whittle down a pre-tax account and stop it from growing too large, either by taking distributions outright at an earlier phase, or by doing partial Roth conversions. Of course, if "too much" is withdrawn or converted in the early years, the retiree may drive up their tax rate *now*, which doesn't help the situation either. In other words, the end goal is to find the balance point between the two.



Of course, where that balance point is will depend on the retiree's overall income and wealth levels. For some, the balancing point may be to "just" fill up the 15% ordinary income tax bracket, and try to avoid any rates that are 25% or higher. For those with more significant retirement accumulations, the sheer size of the family balance sheet may make it impossible to avoid being in at least the 25% bracket, and the goal will just be to stay there and not drift up into the 28% or 33% brackets. For those with *very* significant wealth, any tax bracket that's less than the top 39.6% bracket may be appealing to fill with partial Roth conversions!

Nonetheless, the strategy for the tax-efficient spend-down of a retirement portfolio remains the same – to allow for maximal tax-preferenced growth in retirement accounts by spending from taxable brokerage accounts first, but not letting low tax brackets "go to waste" by filling them with partial Roth conversions along the way!