How good is your advice about how to generate retirement income? In an article we published recently with a colleague (Cook et al. 2015), we discussed how a retiree can tax-efficiently withdraw funds from taxable accounts, tax-deferred accounts such as a 401(k), and tax-exempt accounts such as a Roth individual retirement account, to make the portfolio last longer.

Conventional wisdom says that a retiree should withdraw all funds from the taxable accounts until exhausted, then from tax-deferred accounts (TDAs) until exhausted, and then from tax-exempt accounts (TEAs). The idea is to withdraw funds from the least tax-favored account first, followed by the TDAs next, preserving until last the funds in the most tax-favored TEAs. That is, the conventional wisdom is based on the idea that funds growing tax-deferred in a TDA are not as tax-advantaged as funds growing tax-exempt in a TEA.

But this idea is wrong. The largest financial services firms and all financial planning software rely on (and promote) the conventional wisdom. This article will help you understand why the conventional wisdom is never the optimal withdrawal strategy and how you can create smarter withdrawal strategies for your clients.

**Background**

Investors don’t pay taxes on tax-deferred investments until they withdraw the funds. So a TDA is best viewed as a partnership with the government. Initially, assume that each time the retiree withdraws $1 from the TDA the government gets $0.25. Here the TDA is like a partnership where the retiree, as majority partner, gets to make the investment decisions, but the government, as minority partner, gets 25 percent of the withdrawal amount. So, each $1 in a TDA is $0.75 of the taxpayer’s after-tax funds, and the government effectively owns the other $0.25.

But the after-tax value of a TDA grows effectively tax-exempt, i.e., without any taxation. Thus, contrary to the conventional wisdom, the TEA is not more tax-favored than the TDA.

Now, let us relax the assumption that the marginal tax rate on TDA withdrawals is 25 percent. In this case, it makes sense for the retiree to look for opportunities to withdraw funds from TDAs when the tax rate is unusually low. As we demonstrated in Cook et al. (2015), a taxpayer who follows the conventional wisdom will likely be in a relatively low tax bracket in the early years of retirement, when funds are withdrawn from the taxable account, and in the late years, when funds are withdrawn from the TEA. It makes sense to shift withdrawals from the middle years when funds are withdrawn from the TDA and taxed at relatively high tax rates to the early and late years to fill up the lower tax brackets.1

**A Hypothetical Example**

Cook et al. (2015) presented an example of a female retiree in her mid-60s who has funds in a taxable account, a TDA, and a TEA. For simplicity, we assumed she has no Social Security benefits, because of the complexities surrounding the taxation of these benefits. She begins annual withdrawals in 2013, at the beginning of the year. We assumed there is no inflation, so the standard deduction, personal exemption, and tax brackets remain constant.
In reality, the longevity of a financial portfolio can be affected by (1) withdrawal strategy, (2) asset allocation, (3) asset location, (4) level of asset returns, and (5) size of portfolio relative to spending level. Our goal, however, was to show that tax-efficient withdrawal strategies can add longevity to the financial portfolio while holding everything else constant. The easiest way to hold everything else constant was to assume an all-bond portfolio. However, Cook et al. (2015) also showed that its main conclusions were not affected by these assumptions. In particular, the portfolio's longevity always increases as we move from Strategies 1 to 5, which are described below.

Cook et al. (2015) examined five withdrawal strategies:

Strategy 1
Strategy 1 is the opposite of the conventional wisdom. The retiree withdraws funds from the TEA followed by the TDA, and then the taxable account. We set the beginning balances of the TEA, TDA, and taxable account such that they would be exhausted after three, 16, and 30 years. Strategy 1 is a tax-inefficient withdrawal strategy.

Strategy 2
Strategy 2 is the conventional wisdom. The retiree withdraws funds from the taxable account only for years 1–7 to meet spending needs. In year 8, she withdraws the remaining funds from the taxable account plus additional funds from the TDA to meet spending needs. In years 9–24, she withdraws $99,271.67 from the TDA with $55,521.67 being taxed at 25 percent, which meets spending needs. In year 25, she withdraws the remaining funds from the TDA plus additional funds from the TEA to meet her needs. Beginning in year 26, she withdraws $81,400 from the TEA, which meets spending needs. The portfolio lasted 33.15 years, i.e., it met 15 percent of her needs in year 34. Compared to tax-inefficient Strategy 1, the conventional wisdom extended the portfolio's longevity by an additional 3.15 years. Henceforth, when we compare withdrawal strategies to the conventional wisdom, the reader should realize that the comparison is to what already is considered to be a tax-efficient withdrawal strategy.

To understand why the conventional wisdom is never the optimal strategy, we noted that the retiree has income below the top of the 15-percent tax bracket in years 1–8. In year 1, she is in the 15-percent bracket. But in year 7 she is in the 0-percent bracket, meaning her adjusted gross income is not sufficient to offset her standard deduction plus personal exemption. She pays taxes at the 25-percent tax rate on $51,521.67 of TDA withdrawals in years 9–24 and she has an adjusted gross income of $0 for each year beginning in year 26.

In these later years, she withdraws $47,750 from the TDA to fill the top of the 15-percent tax bracket plus additional funds from the TEA. Strategy 3 adds 1.22 years of portfolio longevity compared to the conventional wisdom.

Strategy 3
In Strategy 3, for the first 19 years this retiree withdraws $47,750 annually from the TDA to fill the top of the 15-percent tax bracket (sum of standard deduction, personal exemption, and taxable income at top of the 15-percent tax bracket) plus additional funds from the taxable account. When the taxable account is exhausted, she has funds remaining in the TDA and TEA. In these later years, she withdraws $47,750 from the TDA to fill the top of the 15-percent tax bracket plus additional funds from the TEA. Strategy 3 adds 1.22 years of portfolio longevity compared to the conventional wisdom. The additional longevity comes from shifting some TDA withdrawals from years 9–24 that are taxed at 25 percent to (1) years 1–8 to fill up the top of the 15-percent tax bracket and (2) year 26 and beyond to fill up the 15-percent bracket. The idea is simple and effective. Shift TDA withdrawals that are taxed at 25 percent in the conventional wisdom to earlier and later years when they would be taxed at 15-percent or lower tax rates.

Strategy 4
Cook et al. (2015) explained two additional complex withdrawal strategies that rely on converting funds from the TDA to a Roth TEA. In Strategy 4, the retiree converts $47,750 from the TDA to the TEA at the beginning of years 1–6 plus additional funds from taxable accounts to meet spending needs. After the taxable account has been exhausted, she withdraws $47,750 annually from the TDA and additional funds from the TEA to meet her spending needs. This allows the portfolio to last 35.51 years, 1.14 years longer than in Strategy 3. After the beginning of year 1 distribution, Strategy 4 has $47,750 more in the TEA and this amount less in the taxable account compared to Strategy 3. After the year 6 distribution, Strategy 4 has $377,144 more in the TEA compared to Strategy 3. Because funds in a TEA grow tax-free, and funds in the taxable account grow at an after-tax rate of return, Strategy 4 allows the portfolio to last longer than Strategy 3.

Strategy 5
Strategy 5 examines the impact of a Roth conversion with recharacterization on portfolio longevity. This strategy, modeled in Cook et al. (2015), has the retiree convert two separate $47,750 amounts from the TDA to TEAs at the beginning of years 1–27. In one Roth TEA, she holds U.S. stocks. In the other, she holds one-year bonds. At the end of each year, the retiree keeps funds in the higher-valued TEA and recharacterizes—i.e., undoes or converts back to a TDA—funds in the lower-valued TEA. To understand why this recharacterization option is valuable, suppose the TEA...
Withdrawal Strategy | Longevity of Financial Portfolio
---|---
Strategy 1 | 30 years
Strategy 2 | 33.15 years
Strategy 3 | 34.37 years
Strategy 4 | 35.51 years
Strategy 5 | 36.17 years

Table 1 summarizes the results from Cook et al. (2015). In short, the most tax-efficient withdrawal strategy—Strategy 5—added more than six years of portfolio longevity compared to tax-inefficient Strategy 1 and more than three years compared to the conventional wisdom.

**The Role of Social Security**

The modeling in Cook et al. (2015) was complex despite simplifying assumptions. One of these assumptions was that the retiree receives no Social Security benefits. We made this assumption because it would take several pages to explain the taxation of Social Security benefits. As explained and illustrated in Meyer and Reichenstein (2013) and Reichenstein and Meyer (2015), the taxation of Social Security benefits results in a substantial hump (i.e., rise and then fall) in the marginal tax rate as additional withdrawals are made from the TDA. In short, because of the taxation of Social Security benefits there is a wide range of income wherein every time the retiree withdraws an additional $100 from a TDA it causes an extra $50 or $85 of Social Security benefits to be taxed.

Suppose the retiree is in the 25-percent tax bracket. If the additional $100 TDA withdrawal causes an extra $85 of Social Security income to be taxed, then taxable income rises by $185. And, 25 percent of $185 is $46.25. That is, the federal-alone marginal tax rate is 46.25 percent, which substantially exceeds the 25-percent tax bracket. Eventually, 85 percent of Social Security benefits are taxed, which is the maximum. After this point, the marginal tax rate is again equal to the tax bracket; i.e., an additional $100 TDA withdrawal causes taxes to rise by $25. So, the marginal tax bracket is the same as the tax bracket. For a moderate-income retiree, the marginal tax rate may rise from 15 percent (15 percent bracket but before Social Security benefits are taxed) to 22.5 percent (15 percent bracket × $1.50), to 37.5 percent (25 percent bracket × $1.50), to 46.25 percent (25 percent bracket × $1.85), before falling to 25 percent after fully 85 percent of benefits are taxed. Because this rise in marginal tax rates from 15 percent to eventually 46.25 percent before falling to 25 percent is more extreme than the 15 percent to 25 percent jump in tax bracket for the retiree in Cook et al. (2015), Cook et al. (2015) understated the value added of a tax-efficient withdrawal strategy for many taxpayers.

Cook et al. (2015) ignored the taxation of Social Security benefits as well as several other features of the tax code that can cause the marginal tax rate to exceed the tax bracket. A partial list of these other complications includes (1) substantial jumps in Medicare Part B and D premiums as income exceeds threshold levels by $1, which are de facto tax increases; and (2) the net investment income tax. Not surprisingly, these humps in the marginal-tax-rate curve often increase the value added (i.e., additional...
portfolio longevity or increase in after-tax value of the portfolio that remains for heirs after the client’s death) that a financial advisor can add to a client’s portfolio by recommending a tax-efficient withdrawal strategy compared to the analysis covered in Cook et al. (2015).

**Conclusion**
The good news is that financial advisors can use financial software to help add substantial value to their clients’ accounts.3 The bad news is that, due to the complexities of the tax code and the need to integrate these complexities into the analysis, we believe proper analysis requires specialized and detailed software to try to find the best withdrawal strategy. That is, due to the complexities of the tax code and the complex interrelated nature of withdrawal decisions, it is far too difficult to try to determine the best withdrawal strategy by yourself or with existing software packages that have only the standard rules of thumb and conventional-wisdom sequences. Instead, we believe you will need to rely on software to help with your analysis to develop a good withdrawal strategy.

It is clear that how you withdraw your clients’ assets makes a big difference, and it can be a differentiating value proposition to baby boomers. Don’t rely on the conventional wisdom, which never results in an optimal withdrawal strategy and always leads you and your clients to leave a lot of money on the table.  

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Endnotes
1. Cook et al. (2015) note that retirees should try to retain funds in a TDA to cover large medical expenses. There is a nontrivial possibility that the taxpayer or spouse will have large deductible medical expenses in some years, which tend to occur late in life. Ideally, the retiree can save TDA funds to cover expenses during high-medical cost years, when the retiree will be in a lower—possibly 0-percent—tax bracket.
2. If we assume a stock exposure, then we would have to decide what portion of unrealized capital gains was realized and taxed each year and what portion of the realized gains were short-term versus long-term gains. To keep the analysis tractable, we thus assumed an all-bond portfolio, where all returns are realized and taxed each year.
3. The software at www.incomesolver.com models numerous preset withdrawal strategies and returns the strategies that maximize the longevity of the client’s portfolio or maximizes the after-tax value of the portfolio that remains for heirs after the client’s death. In addition, advisors can test their own withdrawal strategies that may be variations from preset strategies.

References

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