Retire Right: The Critical Importance of Tax-Efficient Withdrawal Strategies to Portfolio Longevity

Your clients worked hard to get it. Now ensure they keep it. Incorrect 'de-cumulation' can devastate a portfolio, and the retirement it's meant to fund. Here's how to ensure that doesn't happen

By **William Reichenstein, Ph.D.**

The accountancy profession is celebrated for its competence, not its humor, yet it can be credited for the oft-repeated quip, "It's not what you earn, it's what you keep." That includes smart drawdown strategies, where accumulated gains are too-often needlessly sacrificed on the altar of the IRS.

Asset location is routinely subordinated to its older sibling, asset allocation, but it's no less important. Where financial advisors park their clients' assets—in taxable, tax-deferred and tax-free accounts—and the order in which they're removed can have an exhilarating or devastating impact on the retirement portfolio, depending on how they're taken.

This whitepaper illustrates the importance of withdrawal sequencing. It provides an example of the number of years that can be added to the longevity of a retiree's portfolio by withdrawing money from accounts in a tax-efficient manner. Note that for simplicity's sake, we ignore Social Security, and assume all retirement funds come from withdrawals from a 401(k) (or other tax-deferred accounts), a Roth IRA and a taxable account.

The example describes two critical principles that must be followed. Generally, the first principle is to withdraw funds from the taxable account before the 401(k) or Roth IRA. The second principle is to withdraw funds from the 401(k) whenever those funds would be taxed at an unusually low tax rate for that retiree.

Beginning with the first principle, assume that the underlying asset is a bond earning 4% per year. The balances in the 401(k) and Roth IRA grow at 4%, but the balance in the taxable account grows at 4% (1-t), where t is the retiree's marginal tax rate. For someone in the 25% tax bracket, the retiree gets 4% return on funds held in the 401(k) and Roth IRA, but only 3% on funds held in the taxable account. Due to the lower return on funds held in taxable accounts, therefore, the retiree should withdraw funds from the taxable account before retirement accounts.

There are, of course, exceptions. One is that the retiree should withdraw funds from the tax-deferred 401(k) whenever these funds would be taxed at an unusually low tax bracket for a particular investor.

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Table 1. Summary of Portfolio Longevities with Three Withdrawal Strategies

Withdrawal Strategy	Longevity of Financial Portfolio
Strategy 1: 401(k) then Roth IRA then taxable account	30 years
Strategy 2: Taxable account then 401(k) then Roth IRA	36.17 years
Strategy 3: Withdrawals each year from taxable account and 401(k) and then Roth IRA and 401(k)	37.5 years

Table 1 summarizes the results of three withdrawal strategies. For the interested reader, the details of these results are explained in the remainder of this paper. In Strategy No. 1, she withdraws funds from the 401(k) until it is exhausted, then from the Roth IRA until it is exhausted and lastly from the taxable account. Her portfolio would

last 30 years. In Strategy No. 2, she withdraws funds from the taxable account until it is exhausted, then from the 401(K) until it is exhausted and lastly from the Roth IRA; her portfolio would last 36.17 years. Strategy No. 3 dictates that in early retirement she withdraws funds each year from the 401(k) and taxable account. After the taxable account has been exhausted, she withdraws funds each year from the 401(k) and Roth IRA. This strategy results in her portfolio lasting 37.5 years.

In short, by implementing two principles, she can extend the longevity of her financial portfolio by 7.5 years.

BEHIND THE NUMBERS—DETAILS OF EXAMPLE

Let's put some numbers to the results above.

We assume a single retiree will spend $67,400 in today's dollars each year. Spending requires after-tax dollars. The initial amounts in her 401(k), Roth IRA and taxable account are $997,826.34, $248,628.07, and $435,720.02. The investments earn 3% interest per year and inflation is 0%.[1] As we shall see, she will typically be in the 25% tax bracket in retirement.

So, she should withdraw funds from the 401(k) whenever they will be taxed at less than 25%. In 2011, her first retirement year, the first $10,650 of income is tax free. This is the sum of standard deduction, personal exemption and 65-and-over deduction. The maximums of the 10% and 15% tax brackets were $8,500 and $34,500. So, she can withdraw $45,150 from a 401(k) each year, [$10,650 + $34,500], that would be subject to a tax bracket below her usual 25% tax bracket in retirement.

In strategy No. 1, and at the beginning of year No. 1, she withdraws $81,500 from the 401(k). This provides $67,400 after taxes to meet her spending target.[2] The remaining funds grow at 3%. At the beginning of year No. 2, she withdraws another $81,500 from the 401(k), and the remaining funds grow at 3%. This process continues until the 401(k) is exhausted after the withdrawing $81,500 at the beginning of the 15th year. Funds in the Roth IRA have grown at 3%. At the beginning of year No. 16, she withdraws $67,400 from the Roth IRA to fund her spending needs. The remaining funds grow at 3% for that year. This process is continued until the Roth IRA is exhausted after a $67,400 withdrawal at the beginning of the 20th year. The taxable account has been growing at 2.25%; a 3% pretax rate-of-return less taxes at 25%. At the beginning of year No. 21, she withdraws $67,400 from the taxable account, which funds her spending needs (each year, she paid taxes on the 3% pretax return. So, withdrawals are tax-free returns-of-principal). She continues this process until her funds are exhausted after the withdrawal of $67,400 at the beginning of year No. 30. By design, we set the beginning balances in the 401(k), Roth IRA, and taxable account so these accounts would be exhausted in strategy No. 1 after the beginning of year withdrawals at the start of years 15, 20, and 30. This allows us to calculate how much longer the retiree's portfolio will last under more tax-efficient withdrawal strategies.

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1. This inflation assumption simplifies the analysis because it means the spending goal and tax brackets do not need to increase with inflation. However, as long as returns are 3% above inflation, the longevities of the portfolio in Strategies 1 through 3 would be the same. For example, if inflation is 2% then returns would be 5.06%, [(1.03)(1.02) − 1].
2. The $81,500 is separated into $10,650, $8,500, $26,000, and $36,000 that are taxed at 0%, 10%, 15%, and 25%. The after-tax amounts of $10,650, $7,650, $22,100, and $27,000 total $67,400.

Table 2. End-of-Year Balances in Three Accounts for Each of the Three Withdrawal Strategies (Year-end totals are rounded to the nearest dollar)

Year	Str 1 401(k)	Str 1 Roth IRA	Str1 Tax Acct	Str 2 401(k)	Str 2 Roth IRA	Str 2 Tax Acct	Str 3 401(k)	Str3 Roth IRA	Str 3 Tax Acct
1	944177	256087	445524	1027761	256087	379370	981257	256087	417916
2	888917	263770	455548	1058594	263770	321329	964190	263770	399712
3	832000	271683	465798	1090352	271683	261547	946611	271683	381098
4	773376	279833	476278	1123062	279833	199971	928505	279833	362065
5	712993	288228	486995	1156754	288228	136548	909855	288228	342604
6	650798	296875	497952	1191457	296875	71223	890647	296875	322705
7	586737	305781	509156	1241428	305781	3937	870862	305781	302358
8	520755	314955	520612	1195087	314955	0	850483	314955	281554
9	452793	324403	532326	1147355	324403		829493	324403	260282
10	382793	334135	544303	1098191	334135		807873	334135	238530
11	310692	344159	556550	1047552	344159		785605	344159	216290
12	236428	354484	569072	995394	354484		762669	254484	193549
13	159936	365119	581876	941672	265119		739044	365119	170296
14	81150	376072	594968	886337	376072		714711	376072	146520
15	0	317932	608355	829343	387354		689648	387354	122210
16		258048	622043	770639	398975		663833	398975	97352
17		196368	636039	710173	410944		609856	410944	71935
18		132837	650350	647894	423273		581647	423273	45946
19		67400	664983	583746	435971		552592	435971	19372
20		0	611029	517674	449050		522665	441193	0
21			555860	449620	462521		491841	426619	
22			499451	379524	476397		460091	411607	
23			441772	307325	490689		427390	396146	
24			382795	232960	505410		393707	380220	
25			322491	156365	520572		359014	363817	
26			260831	77471	536189		323280	346921	
27			197783	0	549433		286473	329519	
28			133317		496494		248563	311594	
29			67400		441967		209515	293132	
30			0		385804		169296	274116	
31					327956		127871	254530	
32					268373		85202	234355	
33					207002		41254	213576	
34					143790		0	192173	
35					78681			164441	
36					11620			99952	
37								33529	

In strategy No. 2, the retiree withdraws funds from the taxable account until it is exhausted, then from the 401(K) and lastly from the Roth IRA. This is a preferred strategy to that of strategy No. 1 because she is withdrawing funds from the less-tax-efficient taxable account before the more-tax-efficient retirement accounts, which include the 401(k) and Roth IRA. We assumed the taxable account earned 3% pretax return and it was tax-free, since this would be her only taxable income in her early retirement years. At the beginning of year No. 11, the taxable account is exhausted and remaining funds are withdrawn from the 401(k) to meet that year's spending goal. Beginning in year No. 12, she withdraws $81,150 from the 401(k) until it is exhausted with the withdrawal at the beginning of the 27th year. Remaining withdrawals that year come from the Roth IRA. In future years, distributions come from the Roth IRA. This withdrawal strategy means her financial portfolio will last 36.17 years; it finances all of her spending needs for 36 years and 17% of her needs in the 37th year.

In strategy No. 3, she withdraws funds in a tax-efficient manner each year from her financial accounts. In years early in retirement, she withdraws $41,150 from the 401(k) and $27,000 from the taxable account. The $41,150 withdrawal from the 401(k) provides $40,400 after taxes; the first $10,650 is tax free, the next $8,500 is taxed at 10%, and the remaining $26,000 is taxed at 15%. Withdrawals from the taxable account are tax-free returns of principal. The 401(k) and Roth IRA grow at the 3% pretax rate of return, while the taxable account grows at 2.25% after taxes. At the beginning of the 20th year, the taxable account is exhausted and some funds are withdrawn from the Roth IRA. At the beginning of the 21st year, $41,150 is withdrawn from the 401(k) and $27,000 from the Roth IRA to meet the after-tax spending goal. This process continues. At the beginning of the 34th year, the 401(k) is exhausted. After that, all funds are withdrawn from the Roth IRA. Strategy No. 3 provides all funds for 37.5 years, that is, all funds for 37 years plus half of the $67,400 after taxes for the 38th year.[3] Table No. 2 presents year-end balances (rounded to the nearest dollar) in the 401(k), Roth IRA, and taxable account for strategies 1 through 3.

WHAT IT MEANS

We examined the longevity of the same financial portfolio for three withdrawal strategies. The difference in longevity between the least tax-efficient and the most tax-efficient strategies was 7.5 years. By withdrawing funds tax efficiently, retirees may be able to extend their portfolio's longevity by several years.

Key takeaways are as follows:

First, generally, withdraw funds from taxable accounts before tax-deferred accounts such as the 401(k) and tax-exempt accounts (Roth IRA), because the taxable account is the least tax-efficient.

Second, funds in tax-deferred accounts are best thought of as a trust, where the retiree owns (1-t) the trust's principal and the government "owns" the remaining t, where t is the retiree's marginal tax rate in retirement. The objective is to look for opportunities for the retiree to withdraw funds from tax-deferred accounts whenever she would be taxed at a low rate.

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3. In Strategy 3, the 401(k) is exhausted in the 34th year. In practice, the retiree could have extended the portfolio longer by switching about year 32 to a strategy of withdrawing funds from the 401(k) only part way into the 15% tax bracket and additional funds from the Roth IRA.

During several years in strategies 1 and 2, the retiree withdrew $81,150 from the 401(k), the last $36,000 of which was taxed at 25%. In strategy No. 3, she avoided withdrawals from the 401(k) that were taxed at 25%. This allowed her portfolio to last longer.

Your clients will have an unusual tax bracket in retirement. The objective is to look for opportunities to withdraw funds from tax-deferred accounts when they will be subject to a lower-than-usual tax rate.

But the complicated nature of portfolio coordination and tax-efficient withdrawal strategies means algorithm-based software is highly recommended.

New features in our **SSAnalyzer** software add to our long line of innovation in the investing and coordination of the retirement portfolio. Our new revolutionary **Income Solver** software brings these tax-efficient withdrawal strategies to life. Our firm continues to be the leader in coordination research, and our software is the best available and easiest to use in helping to determine the optimal strategy. Our software is not only backed by research published in the leading financial journals, it is recommended by some of the most re-spected technology analysts in the media.

To learn more about **SSAnalyzer** and **Income Solver** and how these tools help with coordination and drawdown strategies, contact us at the number below.

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For more information, call us today at 866-762-7526, extension 20, or visit www.SSAnalyzer.com

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Dr. William Reichenstein, CFA, is head of research for Social Security Solutions, Inc. He holds the Pat and Thomas R. Powers Chair in Investment Management at Baylor University. His recent work concentrates on the interaction between investments and taxes. He advocates calculating an individual's after-tax asset allocation that is based on after-tax balances in each savings vehicle. He is the author of In the Presence of Taxes: Applications of After-Tax Asset Valuations (FPA Press, 2008), and coauthored with William Jennings Integrating Investments & the Tax Code (John Wiley & Sons (2003).

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Headquartered in Leawood, Kan., Social Security Solutions, Inc. (www.SocialSecuritySolutions.com) delivers advice and education about Social Security retirement benefit claiming strategies to consumers and practitioners. Social Security Solutions, Inc. leverages its expertise, research and technology to help clients determine the best strategy for collecting benefits in line with their overall retirement goals.