Improving Your Finances

When to Break the Rules on Sequencing Retirement Withdrawals

By Christine Benz | 06-20-13 |

It's a sequence tax-savvy retirees and pre-retirees have no doubt heard time and again: In order to limit the drag of taxes on their retirement assets, they should first meet living expenses by taking their required minimum distributions, then move on to taxable assets, followed by traditional IRAs and 401(k)s. Roth assets, whether IRA or 401(k), go last in the queue.

The overarching theme of the sequence is that you're better off getting rid of those assets with the highest year-to-year tax costs first, while saving the most tax-friendly asset pools for last. If you're age 70 ½ or older, RMDs from traditional 401(k)s and IRAs go to the head of the line every time because missing an RMD will subject you to a 50% penalty on the amount that you should have withdrawn but didn't. By contrast, it's standard planning advice to hold off on Roth distributions for as long as possible. Not only are qualified distributions from Roth accounts free of taxes, but these accounts don't require the owner to take RMDs, and heirs can inherit Roth assets without owing taxes.

Yet as logical as the rationale behind sequencing withdrawals is, an account order that makes sense for one person may not make sense for another. For example, a retiree who expects to be in a lower tax bracket early in retirement and a higher one later on may in fact want to tap tax-deferred assets (traditional IRA and 401(k)) before taxable, paying ordinary income tax on those distributions when tax rates are relatively benign. Tapping traditional IRA and 401(k) accounts early on has the additional benefit of reducing the amount of assets that will be subject to RMDs.

And even though you often hear that Roth assets should be tapped very last--or perhaps even better, left to children and grandchildren--pulling money from Roth accounts for income can make sense in years in which a retiree expects to be in a high tax bracket as a result of a large capital gain distribution, for example.

Finding the Best Sequence for You

Maintaining tax diversification rather than slavishly depleting assets on a one-by-one basis is arguably a best practice for all retirees. The key reason is control: By depleting each pool of assets sequentially, and in particular depleting the taxable account first, you can't be opportunistic about where you go for cash during retirement.

By contrast, maintaining taxable, tax-deferred, and Roth accounts throughout retirement gives you the ability to customize withdrawals on a year-by-year basis with an eye toward staying in the lowest possible tax bracket. Doing so also helps you limit the taxation of other sources of income that are not part of your personal retirement investments, such as Social Security.

Ultimately, the "right" sequence of in-retirement distributions is highly dependent on the individual: how much he or she holds in each asset pool, the trajectory of his or her tax bracket during retirement, what types of assets are held in which account type, and whether the goal is to limit taxes for the retiree or for his heirs. Morningstar's head of retirement research, David Blanchett, summed it up in this way: "There are obviously lots of different ways to do it. I think the key is just recognizing that IRAs are more efficient than

taxable accounts and therefore should be tapped later, if possible. But there are definitely a lot of exceptions to the rule."

As you think about sequencing your in-retirement withdrawals, keep in mind the following key situations when the standard advice may not apply. (Clearly, this is a complicated area where a tax-savvy financial advisor or accountant can earn his keep many times over.)

Situation: You have highly appreciated assets in a taxable account.

Strategy: Consider tapping Roth assets before taxable.

Roth assets are among the best assets for your heirs to inherit: Although beneficiaries will be required to take minimum distributions from the account, qualified distributions will be free of ordinary income tax. (The Roth assets are, however, potentially subject to the estate tax.) Those attributes, plus the fact that Roths don't require distributions during a retiree's lifetime, is why the standard sequence of withdrawal advice suggests that Roth assets should go last in the distribution queue.

It may be preferable to tap Roth assets earlier, however, if an individual has highly appreciated securities in his or her taxable account, as those highly appreciated securities are also ideal candidates to be left to heirs or charity after your death. Beneficiaries receive a step-up in cost basis on those highly appreciated assets, meaning that they'll pay taxes only on the appreciation beyond the securities' price at the date of death. The net effect of that is that by transferring those securities to a charity or individual upon your death, rather than tapping them for living expenses, it's possible to circumvent any tax obligation on the appreciation in the securities during your lifetime. Thus, if highly appreciated securities in a taxable account are a big part of your portfolio, pulling from Roth assets rather than potentially triggering a big tax bill by selling highly appreciated taxable assets can be a savvy strategy.

Situation: You want to make the best of a weak market environment.

Strategy: Maintain some exposure to taxable assets throughout retirement to facilitate tax-loss sales.

When the markets are down, a retiree with taxable assets could realize losses on certain holdings, thereby offsetting other taxes due that year, including those on distributions from a traditional IRA. That maneuver would be unavailable (or at the very least, undesirable) to an individual who had already depleted his taxable assets. Such opportunities, plus no RMDs, are why T. Rowe Price Group senior financial planner Christine Fahlund noted in a recent Morningstar Investment Conference session that "our research is starting to show you never want to deplete assets in a taxable account."

Situation: You expect to be in an abnormally high tax bracket in a given year

Strategy: Take RMDs from tax-deferred accounts but augment those withdrawals with Roth or taxable distributions rather than tax-deferred.

As noted earlier, Roth assets are typically considered last in the queue for distributions. But taking tax-free distributions can also be attractive in high tax years, when income from other sources is potentially bumping a retiree into a higher tax bracket. T. Rowe's Fahlund notes, "While the Roth, ideally, is the holy grail at the end, there are a lot of cases where

you may have a bad tax year and you don't want to get into the next bracket. In that case, that would be a year to take from the Roth to avoid that possibility."

Situation: You expect to be in abnormally low tax bracket in a given year.

Strategy: Expedite distributions from tax-deferred accounts while holding off on taxable-portfolio withdrawals.

On the flip side, if you find your tax burden running abnormally low in a given year, that might be reason to expedite distributions from tax-deferred accounts, and possibly consider converting traditional IRAs and 401(k)s to Roth, too. Withdrawals from IRAs and 401(k)s are taxed at your ordinary income tax rate, whereas long-term capital gains rates, which apply to taxable account withdrawals, remain quite low--15% for most investors. Moreover, expediting tax-deferred distributions has the effect of reducing your future RMDs from those accounts--a desirable outcome if you expect that you'll face higher tax rates in the future than you do today.

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