CLEARWATER CAPITAL
Thought · Leadership
THINK19

May 2019

Retirement Insights

Addressing Cash Flow Needs During Retirement – Which Accounts Should I Withdraw From and in What Order?

In a recent white paper titled "Asset Location", I touched on some of the important things to consider regarding the placement of certain types of assets within different accounts in order to optimize the long-term tax efficiency of one's retirement pool of assets.

Along with asset location within retirement savings accounts, another important question to consider upon retirement is the following – Which accounts should I tap into and in what order should I take withdrawals from my various accounts in order to meet my ongoing cash flow needs in retirement? Asked another way, what is the most advantageous way for me to draw down retirement savings while minimizing taxes?

In retirement, many people will have investments in a variety of accounts that have different tax characteristics. Those might include tax-advantaged accounts such as traditional IRAs, 401(k)s and Roth IRAs, as well as taxable accounts such as those titled individually, jointly or in the name of a trust. In retirement, one will probably need to withdraw money from some or all of these accounts in order to supplement Social Security or pension-type income.

Taxes matter: How different accounts are taxed

	Taxable	Traditional*	Roth
Examples	Brokerage, savings	Traditional 401(k), Traditional 403(b), IRA, Rollover IRA, etc.	Roth 401(k), Roth 403(b), Roth IRA
Taxes to keep in mind when withdrawing	Capital gains taxes	Income taxes	None*
Important factors	0% long-term capital gains rate if ordinary taxable income is within applicable ranges	• Taxed at ordinary income tax brackets • Potentially higher tax rates the more you withdraw • Part of calculation to determine Social Security tax and Medicare premiums	Has no impact on any tax calculation

Source: Fidelity

The most commonly used approach is to withdraw from taxable accounts first; followed by tax-deferred accounts (traditional IRAs, 401(k)s); and, finally, Roth IRA assets. This enables the tax-advantaged accounts more time to grow and compound in a tax-deferred manner over time, potentially providing the opportunity to pass on Roth balances tax-free to heirs (Because Roth IRAs are funded with after-tax dollars, the assets and the growth of those assets can be distributed tax-free in most instances).

Greg W. Davis

Greg Davis is a Director - Senior Wealth Advisor at Clearwater Capital partners. As a CERTIFIED FINANCIAL PLANNER™ professional and Certified Trust Financial Advisor (CTFA) with a unique work history of over 25 years within the financial industry. Greg's varied experiences have provided him with the opportunity to serve as an advisor to high net-worth individuals, families, closely-held and family-owned businesses, trusts and foundations.

This approach also allows for the spending down of the least tax-efficient portion of the portfolio first (those accounts that are generating taxable interest, dividends and potential capital gains along the way).

It is quite possible that, because the tax rate is dependent on the level of income, a situation may occur down the road where the tax-deferred bucket has grown so large that when the time comes for required minimum distribution (RMD) obligations at age 70 ½, the retiree may be forced into a higher tax situation.

Keep in mind that, while nobody can accurately predict what future income tax rates will be after 2025 (the 2018 Tax Cuts and Jobs Act will need to receive Congressional approval to be extended past 2025), it is fair to say that tax rates will not be declining in the future based on the fiscal demands at the Federal level.

As a result, depending on one's situation, a more tax-efficient liquidation strategy might include beginning to take withdrawals from IRA accounts earlier than the mandatory withdrawal age of 70 ½ (at age 59 ½, there are no penalties for early IRA withdrawals).

Table 1. Tax Brackets and Rates, 2019

Rate	For Unmarried Individuals, Taxable Income Over	For Married Individuals Filing Joint Returns, Taxable Income Over	For Heads of Households, Taxable Income Over
10%	$0	$0	$0
12%	$9,700	$19,400	$13,850
22%	$39,475	$78,950	$52,850
24%	$84,200	$168,400	$84,200
32%	$160,725	$321,450	$160,700
35%	$204,100	$408,200	$204,100
37%	$510,300	$612,350	$510,300

Source: TaxFoundation.org

Traditional approach: Withdrawals from one account at a time

To help get a clearer picture of how this could work, let's take a look at a hypothetical example: John is 62 and single. He has $200,000 in taxable accounts, $250,000 in traditional 401(k) accounts and IRAs, and $50,000 in a Roth IRA. He receives $25,000 per year in Social Security and has a total after-tax income need of $60,000 per year. Let's assume a 5% annual return (Note: This and the following illustration assume that no taxable interest, dividends or capital gains are realized that would generate taxes within the taxable accounts).

As you can see in the table above, if John takes a traditional approach, withdrawing from one account at a time, starting with the taxable, then the traditional and finally the Roth, his savings will last slightly more than 22 years. He will also pay an estimated $74,000 in taxes throughout his retirement (based on his 22% marginal income tax bracket, see Table 1, Tax Brackets and Rates).

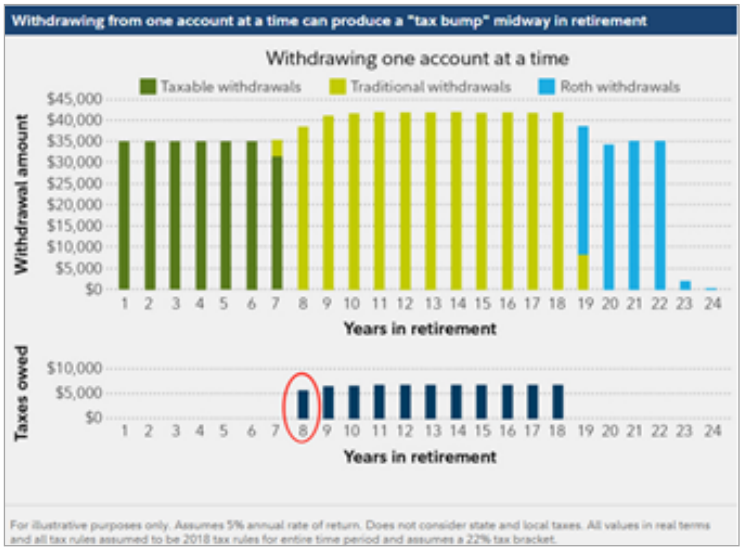
Please note that with the traditional approach, John hits an abrupt "tax bump" in year 8 where he pays over $5,000 in taxes for 11 years while paying nothing for the first 7 years and nothing when he starts to withdraw from his Roth account.

Proportional Withdrawals Across Various Accounts

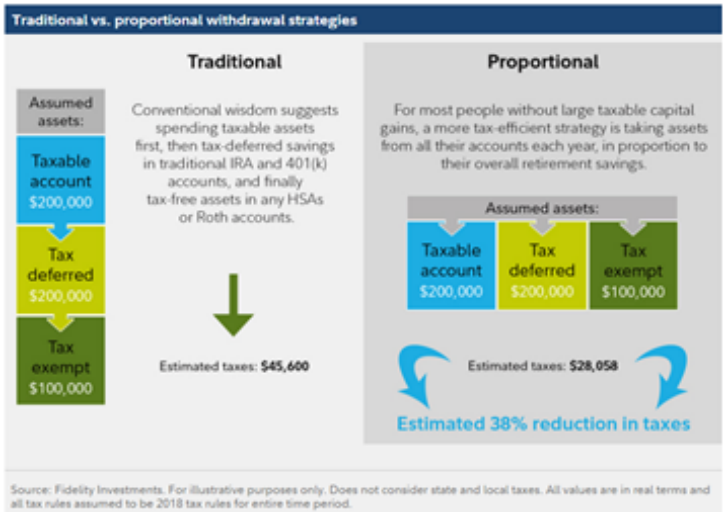
For many people with multiple retirement saving accounts and relatively level retirement income needs year after year, it might make sense to use a proportional withdrawal approach. With a proportional approach, once a target spending amount is determined, an investor would withdraw from every account based on that account's percentage of their overall savings bucket.

The effect from this is likely a more stable tax bill over retirement, potentially lower lifetime taxes, and higher lifetime after-tax income.

As you can see in the graph to the right (Source: Fidelity.com), this strategy spreads out and dramatically reduces the tax impact, thereby extending the life of the portfolio from slightly more than 22 years to slightly more than 23 years. This approach provides John an extra year



of retirement income and costs him only $46,000 in taxes over the course of his retirement. That is a reduction of almost 40% in total taxes paid on his income in retirement.



Also, keep in mind that by spreading out taxable income more evenly over retirement, one may also reduce potential taxes due on Social Security benefits and the premiums paid for Medicare.

Consider Filling Lower Tax Brackets With Partial Roth Conversions

Along with the traditional and proportional methods of distributing retirement account assets, another approach to consider which can help preserve the value of tax-advantaged retirement accounts is to make partial Roth IRA Conversions from your traditional, pre-tax IRA bucket. Converting traditional IRA assets into a Roth IRA realizes taxable income (equal to the amount that is converted) in the year when the conversion takes place.

The idea here is to do systematic partial Roth conversions of the pre-tax IRA up to the point of filling lower tax brackets in the early years, while attempting to cover as much of the retirement spending needs from taxable investment accounts.
This strategy avoids "wasting" unused lower tax brackets in the early years without actually liquidating the overall tax-preferenced account bucket. The reason for this is that the systematic partial Roth conversions in the early years are made by moving dollars from the IRA to a Roth IRA, up to a certain income threshold in those years.

The end result of this approach is that while the taxable account may be depleted during the first half of retirement, the retiree's tax rate isn't driven up in the later years because distributions can be partially supported from the newly-created Roth IRA (i.e. not solely from the pre-tax IRA bucket).

In summary, by engaging in partial Roth conversions, the retiree is able to avoid the high income tax brackets because the taxable RMDs will be reduced in future years as the potential value of the traditional IRA goes down. This lower tax liability along the way, along with the fact that the overall tax-preferenced bucket (IRA and Roth IRA accounts combined) is able to grow and compound for a longer period, should help to maximize long-term wealth. (Source: Kitces.com; June, 2016),
Due to the complexities involved, please consult with a tax professional prior to implementing a long-term partial Roth IRA conversion strategy.

What if I have large unrealized long-term capital gains?

Spreading traditional IRA withdrawals over the course of one's retirement years may make sense for many people. However, if an investor is in a situation where he has a relatively large amount of unrealized long-term capital gains from taxable account investments, it might also make sense to realize those gains over several tax years depending one's tax situation.

The purpose of this strategy is to take advantage of zero or low long-term capital gains rates based on one's income level. The tax rates on long-term capital gains realized on assets that are held over 1 year range from 0% to 20% and depend on one's taxable income and filing status.

For 2019, the long-term capital gains rates for a married couple, filing jointly, are 0% (taxable income $0 - $78,750), 15% (taxable income $78,751 - $488,850) and 20% (taxable income above $488,851).

Assuming a married couple, filing jointly, has both ordinary income and capital gains income. The ordinary income level, in this example, would need to exceed $78,750 in 2019 before any capital gains taxes would be due.

Subsequently, one strategy for retirees which can help to reduce taxes over time is to realize capital gains in a tax year when they are in a lower income tax bracket.

Assume that this couple had $60,000 in ordinary income and $10,000 in long-term capital gains. After taking advantage of the $24,400 standard deduction, they will have $36,600 ($60,000 - $24,400) subject to the 10% and 12% marginal income tax brackets, but their $10,000 in long-term capital gains will be taxed at 0%.

Next year, if this married couple is to begin RMDs pushing them into a situation where their ordinary income level is projected to be $120,000, they would then have income that is subject to the 10%, 12% and 22% marginal income tax brackets. If they realized $10,000 in long-term capital gains next year, those gains would be taxed at 15% due to their higher income level.

Based on one's income scenario, for those who can take advantage of the 0% long-term capital gains rate, they may also want to consider filling up the lower income tax brackets through IRA withdrawals or partial Roth IRA conversions. By doing this, multiple goals can be addressed simultaneously (lower taxes now, and as mentioned earlier, potential greater after-tax wealth creation over time).

Summary

This white paper touches on just a few of the many issues and strategies to consider when devising an optimal plan for withdrawing account assets in retirement. The tax-efficient withdrawal ideas mentioned above are worth considering, but consult with a tax advisor to determine the best course of action for your unique situation.

Note: Nothing contained herein is offered as tax advice. Please consult qualified professionals with any tax planning needs or tax questions you may have.

CCP | CLEARWATER CAPITAL PARTNERS

IMPORTANT DISCLOSURES

THIS COMMENTARY HAS BEEN PREPARED BY CLEARWATER CAPITAL PARTNERS. THE OPINIONS VOICED IN THIS MATERIAL ARE FOR GENERAL INFORMATION ONLY AND ARE NOT INTENDED TO PROVIDE OR BE CONSTRUED AS PROVIDING SPECIFIC INVESTMENT ADVICE OR RECOMMENDATIONS FOR ANY INDIVIDUAL.

ALL ECONOMIC DATA IS DERIVED FROM PUBLIC SOURCES BELIEVED TO BE RELIABLE. TO DETERMINE WHICH INVESTMENTS MAY BE APPROPRIATE FOR YOU, PLEASE CONSULT WITH US PRIOR TO INVESTING. INVESTING INVOLVES RISK WHICH MAY INCLUDE LOSS OF PRINCIPAL.

This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The opinions expressed are as of May 2019, and may change as subsequent conditions vary. The information and opinions contained in this material are derived from proprietary and nonproprietary sources deemed by Clearwater Capital Partners to be reliable, are not necessarily all-inclusive and are not guaranteed as to accuracy.

www.ccpwealth.com (847) 841-8650