LIQUIDATING RETIREMENT ASSETS IN A TAX-EFFICIENT MANNER

By William A. Raabe and Richard B. Toolson

When you enter retirement, you retire from work, not from decision-making. Among the more important decisions you will be faced with as you start living off of your retirement savings is which savings you should withdraw from first. Here are some decision rules for a typical retiree that will keep tax liabilities to a minimum.

Individuals who are still working get plenty of advice: how much to save for retirement, asset allocation decisions for building savings, how to choose stocks or mutual funds to build a portfolio—all of these kinds of articles fill the airwaves, print publications and the Internet on a continuing basis.

Equally as important, though, are investment and cash flow decisions that individuals must make after retirement. Perhaps it is because these decisions are more difficult to consider and to execute, or because of a greater number of alternatives facing the investor, but whatever the reason, the after-retirement decision is rarely examined.

In this article, we present some of the broad decisions that an investor must address in reaching his or her financial planning goals. Many of the guidelines are relatively obvious. But it is important to understand them, since the consequences of these choices can critically affect the retiree's levels of post-retirement consumption, and the extent and makeup of assets received by heirs and beneficiaries after the retiree's death.

OUR ASSUMPTIONS

It is impossible to cover all scenarios, so this article will discuss the issues that would affect a "typical" retiree. It is important, however, that you understand the assumptions we have used concerning this typical retiree so that you can better judge how the answers may apply to your own situation.

In this article, we assume that the retiree is attempting to maximize the aftertax wealth, both during his or her lifetime and passed on to others at death. This includes maximizing investment returns and optimizing income tax liabilities of the portfolio assets.

We also assume that the retiree is receiving an income stream from at least one source other than the personal savings and deferred compensation that we address in our analysis. For most individuals, payments are simultaneously received from Social Security accounts and from defined-benefit or hybrid pension plans—these payments are expressed as monthly or annual distributions, not investment assets available in lump-sum form. Thus, our review is constrained to "other retirement assets," as illustrated in Figure 1.

We assume that the minimum distribution rules that mandate distributions from retirement plans begin no later than age 70½ are abided. We also assume that the retiree is subject to a 0% transfer tax rate on the retirement assets, due either to the use of exemption equivalents for the estate, gift and generation-skipping taxes, or to the choice of beneficiary. For instance, the use of a spouse or charity as an ultimate beneficiary can reduce the effective tax rates on such transfers to zero.

Another important assumption is that the retiree, throughout the liquidation process, continues to maintain a diversified portfolio. There is a consensus view among the financial community that it is important to maintain an adequate degree of diversification in the portfolio so as to minimize exposure

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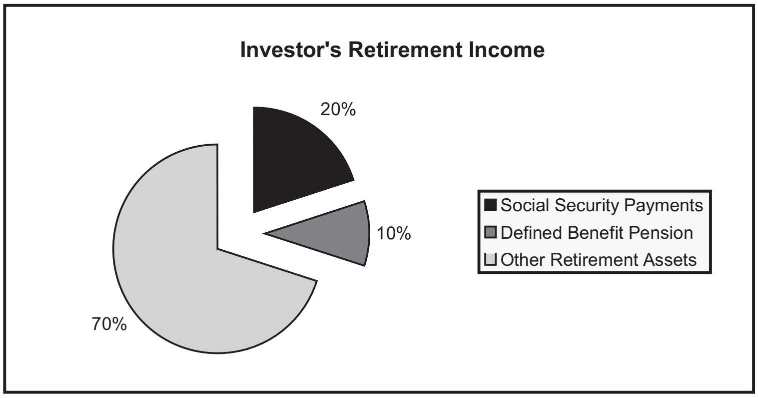
FIGURE 1. SOURCES OF RETIREMENT INCOME FOR A TYPICAL RETIREE



to various types of risk. If it is necessary to rebalance the portfolio to continue to maintain adequate diversification, it should be recognized that these adjustments might come at some cost, such as additional commissions or advisory fees.

An individual can best manage the withdrawal process if the proper records are kept, so that the resulting tax computations can apply the specific identification method of accounting for the tax basis of assets sold. We assume here that the retiree meets these requirements so that this method can be used.

DEFINITIONS

Our analysis divides assets into "taxable assets" and "tax-deferred assets."

Taxable assets generate ordinary income or loss, such as income generated by bonds, certificates of deposits, and the ordinary income element of mutual fund distributions. Municipal bonds would also fall into this category even though they qualify for a special exclusion. The holder of a tax-exempt bond effectively pays a current tax on the interest earned, although such tax is implicit in the lower interest rate that the market pays on these bonds compared with taxable bonds of comparable risk. This category would also include the dividend income component from stocks as well as individual stocks and mutual funds generating short-term capital gains or losses. Generally, the capital appreciation component from stocks and stock mutual funds would not be placed in the taxable asset category since the investor decides when to sell the asset and thus determines when the realized gain is recognized.

Tax-deferred assets include assets held in 401(k), 403(b), Keogh, and qualified retirement plans, as well as those in traditional and Roth IRAs, and Series I and EE savings bonds. This category also includes private and commercial annuities, where investment earnings are tax-deferred unless the owner withdraws assets or pledges the contract as collateral for the acquisition of another asset.

Equity investments, excluding the dividend component, are tax-deferred because the capital appreciation on the shares is not taxed until it is realized in the market. Equities held in qualified retirement plans are fully tax-deferred until withdrawal, generally after retirement. This is true even when there is turnover activity—selling one equity and purchasing another—within the plan.

Individuals holding equities in a taxable account do not have this opportunity—they can defer gross income recognition by delaying the sale of the shares, but once a sale takes place the appreciation is fully subject to tax. Thus, a third category of investment is required.

Partially tax-deferred assets for our purposes include assets that are taxable only upon a triggering event, such as an asset sale made outside a qualified retirement plan. The most commonly encountered asset in this category would be stock investments held outside a qualified retirement plan. The investor exercises a large degree of control over the taxability of these assets, because he or she and not the government generally determines when the triggering event occurs. Of course, in the case of mutual funds, while the investor decides when to sell the mutual fund, the fund manager controls when to pass taxable gain through to the shareholder.

WHICH ASSETS GO FIRST?

Retirees usually accumulate both taxable and tax-deferred investments. Thus, for most individuals, retirement income possibilities will be as represented in Figure 2.

Retirees first need to determine whether taxable investments should be distributed before tax-deferred investments or vice versa. A reasonable approach to making this determination is to calculate the length of time for a specified amount of assets to be depleted under the following two scenarios:

- All taxable assets are distributed and then all tax-deferred assets are distributed, or
- All tax-deferred assets are distributed and then all taxable assets are distributed.

If it takes longer for the assets to be depleted under the first scenario, then taxable assets should be distributed first. Conversely, if it takes longer for the assets to be depleted under the second scenario, then the tax-deferred assets should be distributed first.

Table 1 compares the length of time that assets will last under the two scenarios. A retiree is assumed to have accumulated $300,000 in total assets, made up equally of

TABLE 1. COMPARISON OF TIME TO DEPLETE ASSETS

Pretax Return/ Ordinary Tax Rate	Order of Asset Distributions: Taxable Then Tax-Deferred	Order of Asset Distributions: Tax-Deferred Then Taxable	Difference In Years (%)
6% Return/15% Rate	18.4 Years	17.3 Years	1.1 Years (6.4%)
6% Return/27% Rate	16.3 Years	15.2 Years	1.1 Years (7.2%)
8% Return/15% Rate	23.4 Years	21.3 Years	2.1 Years (9.9%)
8% Return/27% Rate	20.7 Years	18.2 Years	2.5 Years (13.7%)

Assumptions:

1) The retiree begins with a $300,000 balance, divided equally between taxable and tax-deferred assets.
2) The basis in the taxable assets is their fair market value. The basis in the tax-deferred assets is equal to 0.
3) The withdrawals are increased by 3% per year so that the retiree maintains purchasing power during retirement.
4) $20,000 in aftertax dollars is withdrawn from the taxable accounts. Withdrawals from the tax-deferred accounts are assumed to be fully taxable. Withdrawals from the taxable accounts are grossed up by (1 – tax rate) so that the aftertax withdrawal is equal to $20,000.

taxable and tax-deferred assets. The retiree requires $20,000 per year of aftertax cash flow to close the gap between spending requirements and the amount available from Social Security, plus a defined-benefit plan. If the $20,000 is drawn from the taxable account, only $20,000 would need to be withdrawn, since withdrawals would come from aftertax dollars. If withdrawals are made from a tax-deferred account, at least some of the amount (depending on the basis the retiree has in the asset distributed) would be subject to income tax. For simplicity, the analysis assumes that the withdrawals are all pretax amounts and are therefore fully taxable. To allow the retiree to have $20,000 in aftertax dollars, for the tax-deferred account it is assumed that a sufficient amount is withdrawn in excess of $20,000 to cover the income tax liability. [For example, if the retiree is assumed to be in a 15% tax bracket, the amount withdrawn would be $23,529 ($20,000 ÷ (1 – 15% tax rate)].

The analysis examines the length of time the assets will last for annual pretax returns of 6% and 8% and tax rates of 15% and 27%. It is also assumed that the retiree increases his initial $20,000 withdrawal by 3% annually, to maintain purchasing power.

Table 1 illustrates that assets last longer if taxable assets are drawn on before tax-deferred assets. This outcome is not at all surprising, since this allows the latter category of assets to continue to receive tax deferral for a longer period of time. The table also illustrates that, as the return increases, there is a bigger difference in the length of time assets will last when taxable assets are drawn down first. At a 6% return, the difference is 1.1 years (6.4% difference) if the retiree is in a 15% bracket. At an 8% return, the difference is a more significant 2.1 years (9.9% difference) for the 15% bracket.

The higher the tax bracket, the more important it is to first draw on taxable assets. For example, a retiree in the 15% bracket who earns an 8% return on assets will have assets last 2.1 years longer by first drawing on taxable assets. A retiree in the 27% bracket who earns the same return will have the assets last 2.5 years longer.

ORDER OF LIQUIDATION

Beyond merely drawing on taxable assets before tax-deferred assets, the retiree also needs to decide the order in which taxable assets should be drawn down and then, after depleting the taxable assets, the order in which the tax-deferred assets should be drawn down.

For the taxable category, assets that should be drawn down first are those where their basis is at least as great as the fair market value of the asset. This will allow the retiree to

FIGURE 2. RETIREMENT INCOME POSSIBILITIES FOR A TYPICAL RETIREE

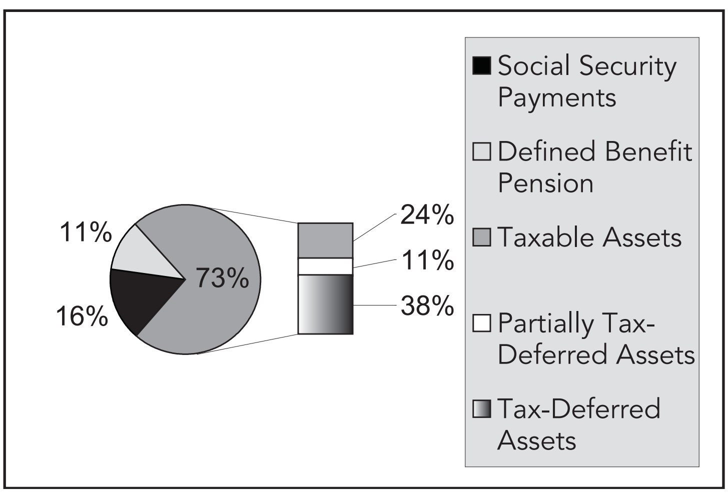


TABLE 2. WHICH ASSETS SHOULD GO FIRST? AN EXAMPLE

	Richard Inc. Stock		Office Properties Stock	
Amount Realized	$3,000	(100 shares @ $30)	$5,000	(200 shares @ $25)
Adjusted Basis	– 2,000	(100 shares @ $20)	– 4,000	(200 shares @ $20)
Recognized Gain	$1,000	$1,000		
Tax Rate	× 27%	(short-term cap gain)	× 20%	(long-term cap gain)
Tax Liability	$270		$200	
Raabe/Toolson Index	9.0% = $270 ÷ $3,000		4.0% = $200 ÷ $5,000	

continue to defer as much income tax liability into the future as possible. Virtually any asset that generates interest income, including municipal bonds, falls into this category. This also includes dividend income from stocks and mutual funds, which means that the retiree should choose to receive dividend distributions in cash rather than reinvesting the proceeds in additional shares of stock or mutual funds.

For equities, basis is not likely to be precisely equal to fair market value. Depreciated equities may be liquidated at any time so that the resultant capital loss offsets first any capital gains and then ordinary income up to $3,000.

To minimize tax liability, the order in which to liquidate appreciated equities should be from those with the lowest to the highest tax liability relative to fair market value, something we have termed the Raabe/Toolson Index:

R/T Index = Tax Liability/Market Value

The Raabe/Toolson Index is lower when the stock has relatively low appreciation and/or a long-term capital gain will be realized upon the sale. The index is higher when the equity has relatively high appreciation, and/or a short-term capital gain is realized upon the sale.

Example: Retiree Ken, to meet living expenses, must liquidate one of two stocks. His tax bracket is 27%. Ken owns 100 shares of Richards Inc., which is currently selling for $30 per share. His basis per share is $20. Ken has not held the Richards stock for more than one year. Ken also owns 200 shares of Office Properties, with a fair market value of $25 and a basis of $20. These shares have been held for more than one year. The Office Properties stock should be liquidated first, as its Raabe/Toolson Index is lower.

A retiree should follow the same logic in liquidating retirement plan assets and other tax-deferred assets. If all of the retiree's contributions to tax-deferred assets are made with pretax dollars (often the case), then all distributions are fully taxable since the retiree has no basis in these assets. The order of distributing these assets under these circumstances does not make any difference. Some retirees, however, may have used aftertax dollars to acquire retirement plan assets, particularly non-deductible IRAs, as well as such other tax-deferred assets as annuities or Series EE and Series I savings bonds.

Tax-deferred assets acquired partially with aftertax dollars should be distributed before the fully taxable retirement assets to defer more income tax liability into later years. Again, the retiree should first distribute those tax-deferred assets with the lowest Raabe/Toolson Index.

PARTIALLY-DEFERRED ASSETS

The retiree will often have both assets that are completely tax-deferred, such as retirement plan assets and assets in variable or fixed annuity accounts, as well as assets that are partially tax-deferred—most notably equities held in a taxable account. It will take longer to deplete assets if the partially tax-deferred category is drawn down before the completely tax-deferred category, since the partially tax-deferred category will generate some taxable income.

Before automatically concluding, however, that fully deferred assets should always be drawn down last, the retiree needs to consider that the step-up in basis rule does not apply to all retirement assets. The income tax basis of property acquired from a decedent is generally its fair market value at the date of the decedent's death. As a result, the basis of appreciated property, including equities held in a taxable account by a retiree is currently "stepped-up" to its fair market value when the retiree dies—regardless of the amount of property that passes through the decedent's estate.

Beginning in the Year 2010, under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the step-up in basis rule will only apply on the first $1.3 million of assets (plus an additional $3 million for property passed to a spouse). However, this provision may only be temporary since the Tax Relief Act is scheduled to sunset the following year.

Under the current rules, any items that are "income in respect of decedent" (IRD), defined as income to which the retiree is entitled at death but which has not yet been paid to the retiree at time of death, are not entitled to a basis step-up. IRD items include all retirement plans, except the Roth IRA, as well as variable and fixed annuities and Series EE and I bonds.

While no definite conclusion may be reached as to whether IRD retirement assets or partially tax-deferred equities should be drawn down first, if the retiree plans to leave significant assets to heirs, the latter is usually the better choice. Criteria that point toward first distributing partially tax-deferred equities even when the retiree expects to leave a significant estate, include a low tax bracket for the

heirs (a stepped-up basis is less significant to a low tax rate taxpayer), a high tax rate for the retiree (complete tax deferral has more value for the high tax rate individual), and modest equity appreciation (more of the equity distributions would be returned tax free and a step-up in basis would be less significant).

Also, the longer the retirement plan payments can be stretched out after the retiree dies, the more likely that first drawing down taxable equities will be the better choice. As a result of proposed regulations issued by the IRS in January 2001, payments to a retiree's beneficiary will often be stretched out longer than was previously the case.

ROTH VS. REGULAR IRAS

Roth IRAs represent a special retirement plan asset. Qualified Roth IRA distributions (distributions made after the age of 59½ years and after a five-year holding period) are excluded from taxable income. Roth IRAs, unlike traditional IRAs, are not subject to the lifetime minimum distribution rules beginning at age 70½. This means that Roth IRAs have the opportunity to compound tax-free over the entire lifetime of the accountholder. In fact, of all of a retiree's assets, the Roth IRA will usually be the last asset that should be distributed.

CONCLUSIONS

When you enter retirement, you retire from work, not from decision-making. Among the more important decisions you will be faced with as you start living off of your retirement savings is which savings you should withdraw from first. We have developed decision rules for a typical retiree that will keep tax liabilities to a minimum.

Within the constraints and assumptions that we have adopted, a retiree should consider the following broad guidelines:

- Assets from taxable accounts should be drawn down before those in tax-deferred vehicles, especially as investment returns and marginal tax rates increase.
- Within the taxable, partially tax-deferred and tax-deferred portfolios, the assets to withdraw first are those with the lowest tax liability relative to fair market value.
- If it is unlikely that the retiree will leave assets to heirs, then partially tax-deferred assets should be liquidated before fully tax-deferred assets.
- If the retiree plans to leave assets to heirs, several factors determine whether partially tax-deferred equities or fully tax-deferred assets should be distributed first.
- The benefits of first distributing the partially tax-deferred equities include: a low tax bracket for heirs, a high tax bracket for the retiree, minimal appreciation on partially tax-deferred assets where basis step-up is allowed, and the likelihood that the payments from the retirement assets will be stretched out well beyond the retiree's death.
- Factors that favor distributing the fully tax-deferred assets first include: a high tax bracket for heirs, a low tax bracket for the retiree, significant appreciation on partially tax-deferred assets where basis step-up is allowed, and the likelihood that the payments from the retirement assets will not stretch out much beyond the retiree's death.
- Traditional IRA assets should be liquidated before those in Roth IRAs. ✦