Retired Investor

A series devoted to the issues that face investors in retirement.

Keep Taxes From Cracking Your Nest Egg

Retirees, have you ever wondered if there was a tax-efficient way to tap the variety of accounts your nest egg is invested in? There is. The conventional wisdom tells you to liquidate your taxable accounts first, then your tax-deferred accounts (like traditional IRAs) and finally withdraw money from your tax-free accounts (like Roth IRAs). However, there is a better way.

Odd as it may seem, minimizing taxes in any given year is not your real tax-efficiency goal. It's to manage your taxable distributions so that you minimize taxes throughout all of your retirement years. That may mean paying a little more in taxes now in exchange for saving even more on taxes in the future.

If you only had tax-deferred and tax-exempt accounts, if tax rates never changed and if you faced a flat tax, the sequence in which you tapped these accounts wouldn't matter. Life would be easy, but the world is not that simple. For example, in the current U.S. progressive tax rate system, marginal tax rates start at 0%. The next two tax brackets are at 10% and 15%, which are both modest.

"Yes, but those tax brackets are only for very low-income taxpayers," you may say. Not so fast. A married couple filing jointly in 2016 taking only the standard exemptions and deductions available to everyone can recognize $96,000 of income before their marginal tax rate exceeds 15%. Married retirees over the age of 65 are entitled to an additional standard deduction of $2,500, increasing the 15% tax bracket threshold to $98,500.

That's quite a bit of taxable income that could be subject to a modest 15% tax rate. It provides a lot of opportunity to take IRA distributions that are taxed relatively lightly. Failing to fill up these tax brackets with low-taxed income leads to missed opportunities that push retirees into higher tax brackets in future tax years.

The Low Tax Bracket Strategy

How do retirees fill up low tax brackets? The trick is to tap your traditional IRA or other tax-deferred account first (instead of your taxable accounts) until you've either met your desired annual withdrawal or until your low tax bracket is filled up, whichever occurs first. Be sure to account for any pension benefits or other taxable income to make sure you don't exceed the bracket's limits by very much.

If you'd like more retirement income, tap your standard taxable accounts next. Repeat these steps year after year until your taxable account is close to being fully depleted. Once it reaches this point, begin using your Roth IRA to top off your taxable distributions.

What is considered a low tax rate? The answer depends on the investor. A retired couple with $1 million in a traditional IRA and $700,000 in a Roth IRA, for example, would generally find it advantageous to fill up their 15% tax bracket. A couple with $2 million in a traditional IRA and $1.5 million in a Roth IRA would generally find it advantageous to fill up the 25% tax bracket as well.

This is a relatively easy and simple withdrawal strategy that can add up to 10 years to portfolio sustainability or hundreds of thousands of dollars of ending wealth over the span of 25 years.

Taking Advantage of Roth IRAs

Those who are interested in being a bit more sophisticated could take advantage of the Roth IRA conversion rules.

Taxpayers are entitled to convert traditional IRAs to Roth IRAs if they pay tax on the converted amount. If the account drops in value, taxpayers are allowed to re-characterize and switch the Roth IRA back to a traditional IRA by April 15, or October 15 if they file an extension.

If retirees decide to forgo the simple withdrawal strategy in favor of converting their traditional IRA every year and re-characterizing it if goes down in value, they can add another year or so of portfolio longevity. Doing so requires a lot of diligent attention to deadlines, however, and mistakes can be costly. So, it's not for the faint of heart.

You can put this strategy on steroids by breaking up your IRA accounts into a series of smaller IRA accounts populated with uncorrelated assets. At the end of the year, keep the conversion for those assets that increased in value and re-characterize those assets that dropped in value. This will keep you and your broker pretty busy with a lot of paperwork, however.

Be very careful about blindly following any advice without an adviser because your situation is no doubt unique. An experienced adviser can help design the strategy, navigate the deadlines and manage the tax brackets.

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