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Which account should I withdraw from?

Many that are in or near retirement ask: Which accounts should I withdraw from to cover my expenses? Usually, the question originates from the desire to minimize taxes. But a good answer for this year may not be the best answer if we consider one's expected lifespan. It's beneficial to have a long-term withdrawal strategy to minimize taxes throughout a lifetime.

Minimizing tax is helpful but the primary goal for many in retirement is asset preservation. Paying less tax helps preserve principal and increases the length of time that assets will last. Withdrawal strategies that add to the resilience of assets over time provide longevity alpha. In some cases, retirees do not need to rely on retirement account withdrawals and are focused on minimizing taxes. A withdrawal strategy, in this case, provides tax alpha.

There are other considerations for asset preservation and withdrawal strategy. Investment performance is crucial and usually necessary to maintain asset levels or to slow the attrition rate as funds are withdrawn. The type of income generated in a taxable account can also be a factor. Long-term capital gains and qualified dividends are typically taxed at lower rates than interest income.

Of course, there may be personal preferences and events to consider. For example, fixed income from annuities or bonds may give some in retirement a sense of security. Events such as property sales or larger-than-expected withdrawals may also complicate a withdrawal strategy. Another factor to consider is estate planning. Some may prefer to keep low-basis assets in their estate and wait for a step-up in basis at death. Others may be inclined to convert pre-tax IRAs to Roth IRAs and pay income taxes now to gift their heirs tax-free assets.

Returning to the original question, which accounts should retirees withdraw from? There are three types of accounts: taxable, pre-tax retirement accounts, and Roth IRAs. All gains and income from taxable accounts are subject to tax. Pre-tax accounts, such as IRAs, 401ks, and qualified annuities, are only taxed when withdrawals are made at ordinary income rates. Lastly, the gains, income, and withdrawals from Roth IRAs are non-taxable. The amount a person may withdraw also depends on other taxable income and deductions.

There is a plethora of research on optimal withdrawal strategies. Withdrawal strategies are both a science and an art, there are technically correct solutions, but an optimal strategy also depends on the retiree's goals. For instance, the technically correct solution may be to take funds from a Roth IRA, but some prefer to leave Roth IRAs to their heirs. Many investors think the optimal strategy is to deplete taxable assets first and then withdraw from pre-tax retirement accounts. The justification is to avoid paying the taxes on withdrawals and to let the assets grow tax-free for a longer period. This may be kicking the tax 'can' down the road.

So how does one arrive at the best withdrawal strategy while honoring their goals? A common approach is tax bracket management. Based on balance sheet and cash flow projections, it's possible to strategize and avoid triggering income that is taxed at a higher level or in the next tax bracket. That might mean withdrawing more than necessary from an IRA in a year where income is low to avoid bumping into a higher tax bracket later. This is called 'income smoothing,' or spreading out taxable income over time. Realizing a little bit of ordinary income every year instead of leaving it all for later years may be the most beneficial strategy.

Income smoothing can be beneficial when the alternative allows pre-tax accounts to grow to very large levels. When this happens, Required Minimum Distributions (RMDs) could increase dramatically. RMDs are determined by a formula, and beneficiaries do not have much control over the size of the distributions. Savers sometimes locate all their assets into tax-deferred IRAs. The conventional wisdom is to take the deductions now, when income and tax rates are higher, and withdraw later when income and tax rates are likely lower. But when IRAs are the only source of funds, every dollar withdrawn is taxable, and inevitable RMD grow very large. Stashing all the savings in an IRA may not be an optimal strategy in the long run. One may have been better off contributing some assets to a taxable account or making Roth conversions over time.

Withdrawal strategies are unique to the individual and their circumstances. There’s no rule of thumb, and we recommend contacting your wealth manager to discuss.