James Investment

Strategies for Retirement Distributions

Including Times of Volatility!

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You have made it to the finish line. You saved for years and now you're ready to retire.

What an accomplishment! But now that you need to tap into your savings, which account should funds be taken from first? This is one of the most popular questions new clients ask because it depends on many complicated factors, and it can cost hundreds of thousands of dollars if the wrong choice is made. Most retirees pull money from the wrong accounts at the wrong time. With better strategies, retirees can minimize their taxes and increase the inheritance they pass to their heirs.

For starters, most retirees take their first withdrawals from their tax-deferred retirement accounts, such as IRAs and 401(k) plans, when they retire. But conventional wisdom suggests that withdrawals be taken based on the account's taxability. First are accounts with taxable capital gains, dividends, and interest, then tax-deferred accounts (distributions taxed at ordinary rates), and the Roth accounts last (qualified distributions have no taxation). This is a good place to start, but it is an oversimplified rule of thumb, and the planning should not end there. Taking funds from only a taxable account would result in minimal taxation, but a great opportunity to minimize future taxes could also be missed.

Depending on retirement income type, one could have very little taxable income due to the 0% capital gains bracket and rules for taxation of Social Security benefits. The standard deduction for married filing jointly in 2022 is $25,900. If there is no taxable income, this standard deduction is unused and gone forever. There are a few choices for utilizing this deduction by creating income now, resulting in less income in the future.

1. Complete a Roth Conversion. A no or low tax conversion could let you enjoy future tax-free growth.

2. Realize capital gains. Sell some appreciated stock with no or low taxation.

3. Take an IRA distribution. If funds are needed early next year, taking a distribution now might make sense.

Let's use an example client that needs to withdraw $120,000/year. Taking this amount from tax-deferred accounts would result in a 100% taxable distribution and the need to take even more from the portfolio to pay the taxes. By taking the funds from the taxable account instead, they avoid that taxation, but they want to simultaneously plan how to avoid this in the future as well, if the taxable accounts are depleted or when Required Minimum Distributions begin. Suppose the example client has $1 million in a taxable account and $2 million in tax-deferred accounts. In that case, he might have enough in the taxable accounts to provide withdrawals to cover his cash needs for 8-12 years, depending on growth and inflation.   If IRA distributions Roth Conversions are avoided during that time, the result is a highly appreciated IRA, little to no other assets to pull from, and full taxation of retirement distributions in the future.

In some cases Required Minimum Distributions (RMD) are larger than cash needs, causing excess tax and possibly increased Medicare premiums. The goal should be to even out the taxation to have income taxed steadily at low brackets in all years. This client could save thousands of dollars in tax by completing strategic Roth conversions over the 8-12 years that IRA distributions are unnecessary or not yet mandatory. Tax rates will likely increase in the future, which is crucial to factor in when planning how to minimize lifetime taxes. Saving taxes in the current year is good, but saving taxes in as many years as possible is better.

If significant charitable gifts are made, these should also be factored in.

Qualified charitable donations can be made after age 70.5 from an IRA directly to charities. This distribution avoids any taxation and can help reduce Required Minimum Distributions. Highly appreciated stock can be gifted directly into a charitable checking account or donor-advised fund to skip realizing the capital gain on the appreciation and provide a tax deduction for the fair market value.

Does market volatility matter when planning which account to pull from?

Yes, but asset type can be more important than account type. Start by trying to avoid distributions if possible. Perhaps dividends and interest are enough to make ends meet temporarily. As known, the taxable account should be tapped first, but there are more reasons when the market is lower. If a distribution of $120,000 is taken from a tax-deferred account when the market is down, it is still $120,000 of taxable income at an ordinary tax rate. A volatile market allows one to identify tax lots of holdings and strategically choose those with a lower tax basis in a taxable account. An important caveat here is, if it can be avoided, a stock should usually not be sold when the value is down. During a down market, typically cash on hand should be used first, cash in investment or retirement accounts second, fixed income such as bonds or bond funds, and if it cannot be avoided, stocks last.

Additionally, Roth conversions can be especially beneficial during a low market since the appreciation that follows when the market recovers will be tax-free.

Tax laws are complicated, so a Certified Public Accountant (CPA) should always be included before taking any action.

- The James Team

If you have questions or would like help with your strategy, contact our Wealth Management team.

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