Tax-Efficient Withdrawals in Retirement

Leigh Bivings, Ph.D., CFP®, CDFA

When retirees have money in more than one type of account, using a tax-efficient withdrawal strategy can result in more money to provide for living expenses and potentially allow their money to last longer. In this Brief, I review what it takes to optimize tax-efficiency when withdrawing from retirement portfolios. I also review a recent study that quantifies the benefits to two different types of clients.

A tax-efficient withdrawal strategy is one that takes advantage of the fact that many retirees have money in different account types (see Table 1) and can therefore vary the amount withdrawn from each of them in a way that minimizes the overall tax bite.

But calculating how much to take from each account is no easy task. This is because the tax code is full of what are called "non-linearities" in how certain items are taxed. For example, when certain income thresholds are met, the tax on Social Security income jumps up. Another example is when a dollar of extra income causes the surtax on Medicare (called IRMAAs) to jump. And then there's the additional complexity that not all income is taxed at the same rate (e.g., long-term capital gains have different tax brackets than income).

The conventional wisdom is that taxable accounts should be depleted first, followed by tax-deferred accounts, saving the tax-free accounts for last. Using this approach, the retiree is preserving the benefits of tax-deferred compounding growth as long as possible.

With the advent of better tax planning software, however, researchers are concluding that in many cases, retirees can do better than conventional wisdom by taking a blended-distribution approach, and by undertaking some Roth conversions in the early retirement years.

The problem is that exactly how much and when to take from each account, and how many dollars to convert to Roth dollars, cannot be generalized and so must be calculated annually on a case-by-case basis.

Table 1. Typical Account Types

Taxable Accounts	Contributions are made after-tax, and earnings are taxed when realized at capital gains rates
Tax-deferred Accounts (e.g. 401(k))	Contributions are made with pre-tax dollars and both contributions and earnings are taxed when withdrawn at ordinary income tax rates
Tax-free Accounts (e.g., Roth IRA)	Contributions are made after tax, but all distributions (including earnings) are tax-free.

[1] Pfau, Wade and Joe Elsasser. "Managing Taxes in Retirement Using the Effective Marginal Tax Rate." *Advisor Perspectives*. November 15, 2023. See also Pfau, Wade and Joe Elsasser. "Effective Tax Rate Management for Wealthier Couples". *Advisor Perspectives. December 18, 2023.*

For this reason, at Artemis we recently invested in tax-planning software to assist in these calculations. But for some clients whose income fluctuates a lot from year-to-year (e.g., some of their assets are invested in private equity), it can require a lot of work and monitoring throughout the year to achieve the tax-optimal outcome for the year. Is all this work worth it?

New research out in late 2023 attempts to address this question.[1] In this study, the authors examine two different retiree couples: a mass-affluent couple with $1.5M in savings across the three account types and an annual spending need of $90k. They also examine a wealthier couple with a $5.5M portfolio and a $220k annual spending need. In each case, the authors compare the after-tax legacy value of each couple's portfolio at age 95 for both the conventional wisdom approach described earlier and a tax-optimized strategy. In both cases, the authors assume an overall portfolio rate of return of 5.06% and then tabulate the imputed after-tax rate of return realized by implementing these two strategies.

The results were somewhat surprising. For the less wealthy couple, the conventional wisdom strategy yielded an average after-tax return of 4.17% over the 33 years of retirement, while the best tax-optimized outcome resulted in a 4.58% net after-tax return. That's an impressive increase in my view. Assuming the couple is paying an advisor 1.0% in AUM advisory fees annually, the strategy alone recaptures 40% of the fee paid.

The result is primarily due to managing withdrawals across the three account types via effective tax bracket management; for example, making late-year withdrawals from the Roth account to stay underneath the next higher income tax bracket. It also involves converting some IRA dollars to Roth dollars early in the retirement years before RMDs are required (i.e., mandatory withdrawals from pre-tax retirement accounts). The taxes paid upfront with the Roth conversions also help to reduce the taxable amount of Social Security benefits received throughout retirement.

Things get more complicated for the wealthier couple as they are constrained by the income surcharge placed on Medicare (call IRMAAs) and the net investment income tax (NIIT). This latter tax is a surcharge on preferential income equal to 3.8% of income over certain thresholds. Due to these extra surcharges and our progressive tax system, the conventional wisdom strategy yielded a 3.95% after-tax return and the best tax-optimized strategy yielded 4.06%. This is only an improvement of 0.11% over the conventional wisdom strategy. In the case of the wealthy couple, important differences include that IRMAA thresholds now become the main constraint and that they can't avoid paying tax on 85% of Social Security.

In conclusion, adopting a tax-efficient withdrawal strategy is indeed worth considering, especially given its potential to significantly enhance the longevity and value of retirement portfolios for mass-affluent retirees. For wealthier couples, while the incremental gains appear modest based on the 2023 study, it may still be worth reviewing particularly for early retirees with a larger Roth conversion opportunity. Ultimately, the key lies in personalized, annual "withdrawal" planning. With the right tools and expertise, retirees can maximize their financial security and ensure their money lasts as long as possible.

Artemis Financial Advisors
115 Newbury Street
Suite 302
Boston, MA 02116

DISCLAIMER: Artemis Financial Advisors is an SEC-registered advisory firm. The material in this document is prepared for our clients and other interested parties and contains the opinions of Artemis Financial Advisors. Nothing in this document should be construed or relied upon as legal or financial advice. All investments involve risk – including loss of principal. An investor should consult with an investment professional before making any investment decisions as not all recommendations will be suitable for all investors. Factual material is believed to be accurate, taken directly from public materials believed to be reliable.