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Retirement Income: Which Accounts to Tap First

By Elaine Floyd, CFP®

Many clients assume that when retirement rolls around, they should draw cash from their taxable accounts first. Generally, this is a good idea; but not always.

A basic tenet of tax planning is to put off paying taxes for as long as possible. By investing money rather than turning it over immediately to Uncle Sam, your clients can earn returns that are theirs to keep; tax deferral becomes like a loan that actually pays interest to the borrower. This is why IRA rollovers are such a great idea—clients can keep deferring the taxes on their retirement distributions and put that money to work in investments, rather than losing a chunk to current taxes.

For many, in fact, the idea of tax deferral is so appealing that, when the time comes to start taking retirement income, they draw from taxable accounts first to keep tax-deferred accounts growing for as long as possible. But while this strategy may be appropriate for some clients, it's by no means a rule of thumb.

When deciding which retirement accounts a client should tap first, you'll need to consider not just the character of the

account itself— taxable, tax-deferred, or tax-free—but also the particular investments within each account. These investments, in turn, relate to the client's risk tolerance, time horizon, and income needs.

CASH BUCKET

The first order of business is to create a cash bucket that contains anywhere from two to five years of living expenses in safe, liquid investments such as money market funds, Treasury bills, short-term bonds, or CDs. Clients who know where their next few years of mortgage payments and groceries are coming from, you are far better equipped to tolerate the volatility that can go along with a diversified portfolio.

Make sure the client has set aside whatever size cushion he thinks he needs before laying the foundation for his retirement portfolio. With each passing year, he'll need to replenish that bucket. At that time, you'll need to decide which securities to liquidate and which accounts to draw from.

THE DOWNSIDE OF TAX DEFERRAL

The downside of tax deferral as it relates to IRAs, unfortunately, is that it can't go on forever. Clients must start taking required minimum distributions at age 73 and the larger the account, the larger the distributions—and the tax—will be. Prior to age 73, clients can calibrate withdrawals to strike an optimal balance between having enough income live on and not paying an excessive amount of tax. After age 73, clients no longer have this control. If the account is very large, the required distribution could throw them into a higher tax bracket, forcing them to pay more tax than if they'd drawn down the account earlier and paid some of the tax sooner but at a lower rate.

For example, let's say a client receives a lump sum distribution of \$800,000 at age 65 and rolls it into an IRA. Over the next eight years, the account grows at a compound annual rate of 8% to \$1.5 million. When the client turns 73, his first required distribution will be \$88,235. (We're assuming the client is single for simplicity's sake.) This jump in income could force the client into the 24% tax bracket, requiring him to pay more tax than if he'd started siphoning money out of

the IRA earlier. If, between the ages of 65 and 73, he had taken voluntary distributions in an amount that just topped out the 12% tax bracket—say around \$30,000 per year—he might pay less total tax than if he'd let the money ride. It's a question of paying tax at the 12% rate now, or at the 24% rate later. By siphoning off money this way, the client would have about \$1.25 million at age 73 and his first required distribution would be closer to \$65,000 instead of \$88,000.

INVESTMENTS MATTER

It is possible, of course, to achieve tax deferral in a taxable account. One way is to buy growth stocks and hold them. So if the client's risk tolerance can handle it, you could conceivably turn the taxable account into the tax-deferral vehicle and draw income from the IRA. If the client has plenty of assets and won't need to sell the growth stocks during his lifetime, his heirs will be happy, since they will receive a step-up in basis and owe no capital gains tax on the appreciation earned during the client's lifetime.

If the client is sitting on big gains in stocks he doesn't want to sell, this could be a powerful reason to take income from the IRA. Beneficiaries must pay income tax on inherited IRA assets, and if the children of your client are successful in their own right, they may end up paying federal tax at the top rate. If a client's portfolio of stocks stands to be a more valuable legacy than a fat IRA, let the client draw from the IRA and pay taxes at the (presumably) lower tax bracket while saving low-basis stocks for last.

But let's say your clients are very risk-averse and, despite your appeals to invest some of their assets for growth in order to keep up with inflation, they want mostly income-oriented investments, such as bonds and high-dividend-paying stocks. If they are already earning taxable income in the taxable account, they might as well use that for their retirement income in order to reduce or postpone taking taxable distributions from the IRA (as long as they are under 73 and have the choice, of course).

For example, let's say that, in addition to an \$800,000 IRA, the client also has \$800,000 in a taxable account, all invested in securities yielding about 6%, or \$48,000

per year. Even if that income is reinvested, the client will pay tax on it, so he might as well use it for his spending needs while letting the IRA assets ride. When investing for income in the taxable account, you will naturally determine whether the income should be taxable or tax-free depending on the client's tax bracket and investment objectives.

SAVE ROTH FOR LAST

The argument in favor of siphoning money out of an IRA account early doesn't apply to the Roth IRA because of one very important feature: no required minimum distributions at age 73. Since the client never has to pay the piper on Roth money, he'll definitely want to let it ride as long as possible, even into the next generation.

One of the most important areas of retirement counseling is helping the client decide if he can or should convert to a Roth IRA. Once a Roth IRA has been established, the only real reason to take money

out is if the client needs the income and has no other resources.

WATCH FOR LEGAL AND REGULATORY CHANGES

Clients must always understand that your recommendations are based on current laws, which could change. The main consideration, of course, is the client's individual situation. There's no magic formula for planning retirement income. You must take into account the client's income needs, tax situation, risk tolerance, life expectancy, and estate planning needs, and continue to work with the client throughout retirement to ensure that all these needs are met.

Note: *the scenarios presented here are hypothetical and the rates of return used are not indicative of any actual investment, which will fluctuate and may lose value.*

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