WEALTH MANAGEMENT INSIGHTS

Tax-Efficient Withdrawal Strategies

Schwab Center for Financial Research

Rob Williams, CFP®, CPWA®
Managing Director

Hayden Adams, CPA, CFP®
Director

Eric Tarkin
Senior Researcher

Key Takeaways

- Taxes can have a significant effect on how long your retirement accounts last.
- Utilizing a tax-efficient withdrawal strategy can result in more money to provide for living expenses and potentially allow your money to last longer.
- The traditional withdrawal strategy is not necessarily the most tax-efficient strategy, especially if your future RMDs push you into a higher tax bracket.

Overview

Retirement income and the United States tax code are both complex topics on their own. Combine them, and it is easy to get overwhelmed. Something seemingly as simple as which accounts a retiree draws from first — and in what amounts — can have a meaningful impact on their tax bill throughout retirement and on the success of their retirement plan or longevity of their retirement savings.

The conventional wisdom of withdrawing funds from taxable brokerage accounts first, then tax-deferred accounts, followed by tax-exempt accounts may not be best for all retirees. Our research suggests another option.

Testing the conventional wisdom

Previous industry studies have suggested that in order to maximize growth in tax-advantaged retirement accounts, the optimal withdrawal strategy is to withdraw funds first from taxable accounts,[1] then from tax-deferred accounts such as 401(k)s or traditional IRAs, and finally from tax-exempt accounts such as Roth IRAs. Subsequent studies have suggested alternatives to this advice.[2]

The conventional wisdom may be sub-optimal for some people after considering the tax implications of two important issues: (1) required minimum distributions (RMDs) and ordinary income tax treatment on distributions, and (2) Social Security benefits.

Tax implications of RMDs. Contributions into traditional tax-deferred IRA and 401(k) accounts are most often made before taxes (pre-tax), which reduces current taxable income. Pre-tax contributions and potential growth of the investments held in traditional tax-deferred IRAs or 401(k)s can grow without taxes for as long as they're held in the account, but they are taxed as ordinary income when withdrawn. As a result, RMDs obligate account owners to realize a certain amount of ordinary taxable income every year. A consequence of a large or growing balance in a tax-deferred account, such as a traditional IRA, is the possibility that future RMDs will trigger a higher tax bill than the investor would have experienced had they taken distributions from that IRA earlier than RMD age (currently age 72) and smoothed out taxes over time. Depending on the size of traditional IRA or 401(k) balances relative to balances in taxable accounts, if any, it may make sense to withdraw money from both taxable and tax-deferred accounts before age 72 in the same calendar year.

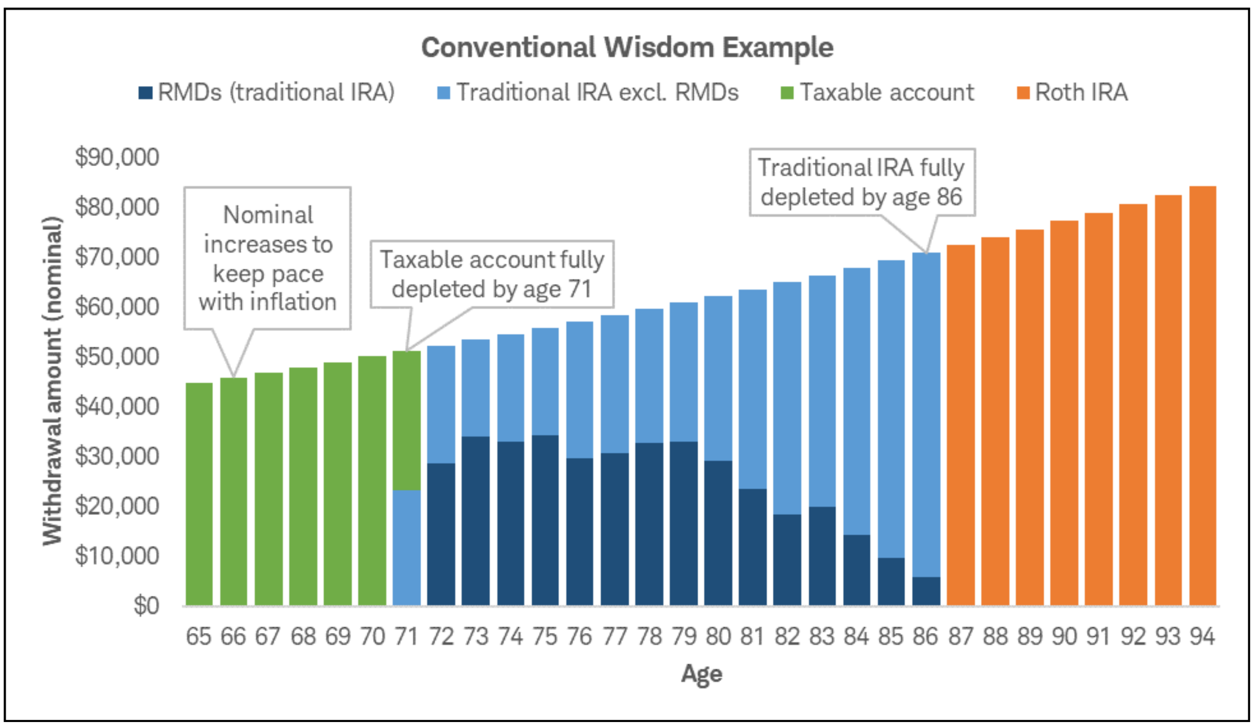
3 Account Types

- **Tax-deferred accounts (traditional 401(k) and traditional IRA).** Contributions are generally made on a pre-tax basis; however, they also can be made with after-tax amounts. Generally, earnings (e.g., interest, dividends, appreciation) are not taxed until distributed. Pre-tax contributions and earnings are taxed when withdrawn, at the ordinary income tax rates.
- **Taxable accounts (brokerage account).** Contributions are made after-tax and earnings are taxed when realized. Depending on the type and/or holding period of the asset, the ordinary income or capital gains tax rates may apply.
- **Roth accounts (Roth 401(k) and Roth IRA).** Contributions are made after-tax. Generally, all distributions (including earnings) are tax-free.[5]

Tax implications of Social Security benefits. If taxable income is close to or below the taxable income thresholds that guide the taxation of Social Security, it may be helpful to consider the tax implications of current and future distributions from traditional 401(k)s and IRAs to reduce the amount of Social Security taxed.

An increase in taxable income can cause a jump in the amount of Social Security benefits included as ordinary taxable income from 0% to 50% (or 50% to 85%).[3] After $34,000 of "combined income" for an individual or $44,000 of "combined income" for a couple, Social Security benefits reach the maximum level of 85% taxable.[4] Above this taxable income level, the amount of distributions from tax-deferred accounts, such as a traditional IRA or other taxable income, has no additional impact on the amount of Social Security taxed. Below these thresholds, taking a distribution from a taxable account may have less of an impact on the taxation of Social Security, because it's possible the distribution can be met by selling positions at either a loss or a small gain.

Schwab and the Schwab Center for Financial Research (SCFR) recommend that retirees younger than age 72 consider tapping traditional IRAs and 401(k)s early in retirement to manage their current and future tax bracket using a multi-year strategy. In addition, we



Note: This hypothetical example is for illustration purposes only and should not be considered or used as specific financial, investment, or tax advice.

recommend working with a financial planner and tax advisor. For example, retirees may choose to distribute amounts from traditional IRAs and 401(k)s enough to stay in a lower tax bracket (e.g., 10% or 12%) or close to it, thereby reducing the overall balance in those retirement accounts and, as a result, reducing future RMDs and their future tax bill.

An example

To illustrate the impact that withdrawal order can have on retirement outcomes, consider a 65-year-old married couple with $1 million of retirement savings, planning for a 30-year retirement.

Assume the couple has:

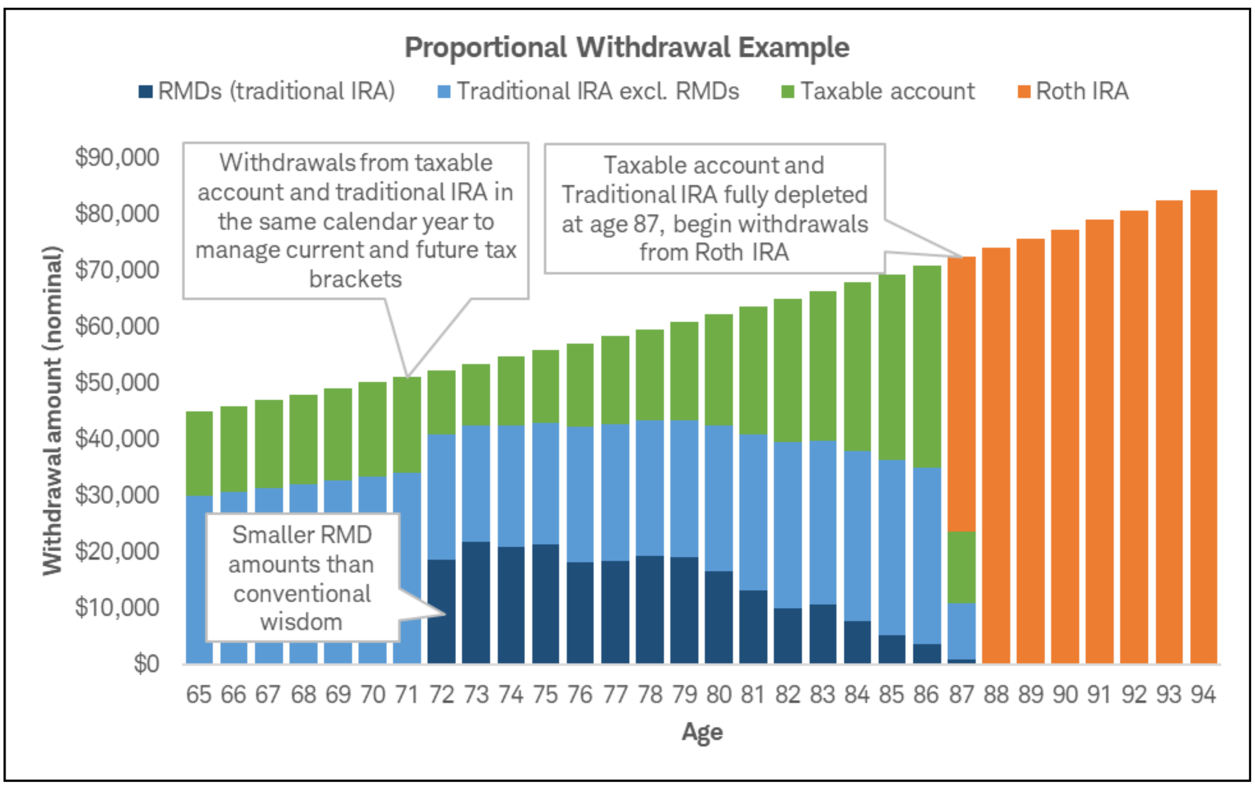
- $250,000 in a joint taxable brokerage account
- Combined balance of $500,000 held in traditional IRAs
- Combined balance of $250,000 held in Roth IRAs

The couple is receiving $30,000 per year in Social Security benefits before tax, and will need to start taking RMDs beginning at age 72. The couple anticipates a total need of $75,000 for retirement spending per year (adjusted for an assumed inflation rate of 2% each year).

We simulated the future, after-tax performance of three general strategies for retirement withdrawals.[6]

Conventional wisdom withdrawal strategy. This sequential withdrawal strategy taps taxable accounts first until depleted, then tax-deferred accounts, and finally Roth accounts. This strategy seeks to make full use of the benefits of tax-deferred growth in tax-deferred accounts, such as traditional IRAs and 401(k)s, and in Roth accounts.

Proportional withdrawal strategy. This strategy draws proportionally from taxable accounts and tax-deferred accounts first, then from Roth accounts. Withdrawals are taken proportionally from taxable and tax-deferred accounts based on the account balance at the time of the withdrawal. Once taxable and tax-deferred accounts are drained, withdrawals are taken from Roth accounts. All else equal, compared to the conventional wisdom, this easy-to-implement, rules-based strategy will withdraw earlier from traditional IRAs, especially in instances where a retiree has a large concentration of their assets held in tax-deferred accounts. Taking early withdrawals from tax-deferred accounts may help retirees manage current and future tax brackets.



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Personalized withdrawal strategy. A more personalized strategy takes withdrawals in a manner that directly manages a retiree's tax bracket. This strategy withdraws from tax-deferred accounts up to the amount where any additional distribution would push the retiree into a higher tax bracket. If additional withdrawals are needed, they are taken next from taxable accounts and then from Roth accounts. This strategy is an example of more personalized advice, and something that could be implemented with help from a financial advisor or tax professional, before selling investments or making decisions about withdrawals by account type, annually.

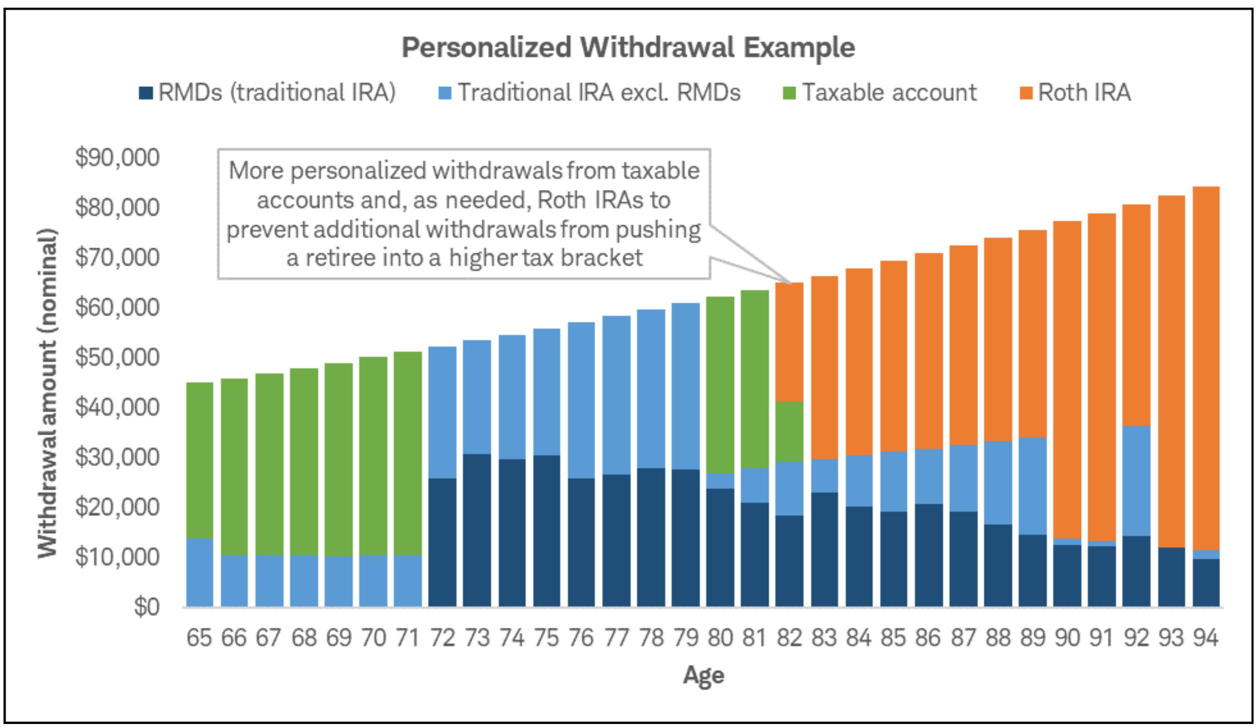
Using the example of a 65-year-old married couple with $1 million of retirement savings planning for a 30-year retirement, our analysis shows that both the proportional withdrawal strategy and the personalized withdrawal strategy are improvements over the conventional wisdom, increasing the average projected account balance after 30 years and reducing the couples' estimated cumulative tax bill through retirement.

In this example, the proportional and more personalized withdrawal strategies reduce the married couples' average estimated tax bill by $28,174 or $33,458 over 30 years (or approx. $1,000/year), respectively, compared to the conventional wisdom, resulting in an account balance at age 95 that is, on average, $54,678 or $112,569 higher and contributing to increased asset longevity of one to three years (see the table on page 5). Note, this is a hypothetical, simulated example, not a guarantee of future results.

Bottom line

No single withdrawal strategy will be optimal for every retiree and address the details of investing or tax for every individual. With any retirement withdrawal strategy, there is a trade-off between tax-deferred growth and future tax liabilities. Decisions about "from which account" and "how much" to withdrawal can have a meaningful impact on longevity of assets and a retirement income plan's success.

For retirees with large IRA or 401(k) balances as well as savings in brokerage accounts, a proportional strategy can make sense as a simple approach. For others with more complex needs, working with a financial advisor and tax professional can help. Either way, retirees or soon-to-be retirees can work with a Schwab professional in collaboration with a tax professional to create, and manage, a tax-efficient retirement withdrawal strategy.



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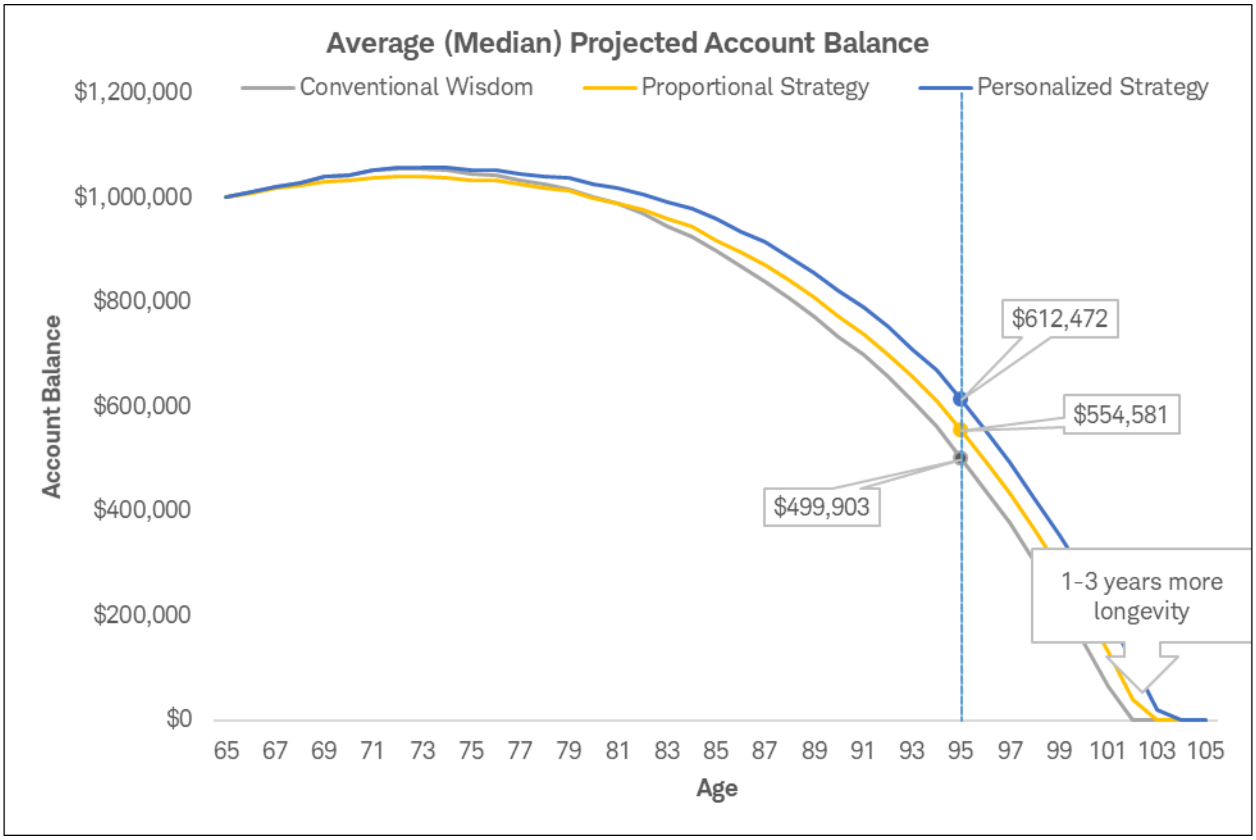
	Conventional Wisdom	Proportional Strategy	Personalized Strategy
Projected remaining account balance after 30 years (median)	$499,903	$554,581	$612,472
Estimated total taxes of 30 years (median)	$99,524	$71,350	$66,066
Estimated annual taxes (median)	$3,317	$2,378	$2,202

All dollars are nominal values



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Endnotes

1. After satisfying any required minimum distributions from traditional IRAs or 401(k)s, if a retiree reached age 72. Failure to take RMDs could result in a 50% penalty on the amount not taken.

2. For example, see DiLellio and Ostrov (2020), as well as Geisler and Hulse (2018), Kitces (2016); and Cook, Meyer, and Reichenstein (2015).

3. See Meyer and Reichenstein (2013).

4. “Combined income” is defined as adjusted gross income + non-taxable interest + ½ of Social Security benefits. See www.ssa.gov/planners/taxes.html.

5. Individuals must have the Roth account established for five years and be over the age of 59½ for tax-free withdrawals.

6. After fulfilling RMD requirements, if the retiree is age 72 or older. Analysis based on 10,000 simulated Monte Carlo paths, assuming an annual (nominal) portfolio expected return of 6% with volatility of 10%. Spending amount is increased by 2% per year to account for inflation. Analysis further assumes a 2.5% portfolio yield, which is comprised half of qualified dividends and half of taxable interest. Withdrawal amounts are grossed up for any estimated taxes. Federal income taxes are estimated based on 2021 tax tables and standard deduction amounts for a married couple filing jointly. Tax tables and standard deduction amounts are assumed to increase annually to keep pace with inflation. Analysis does not include any estimates of state or local taxes.

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Rob Williams, CFP®, CPWA®

As Managing Director of Financial Planning, Retirement Income, and Wealth Management for the Schwab Center for Financial Research, Rob leads a team that develops research, insights, methodology, and training for Schwab clients, representatives, and advisors. These focus on financial planning and wealth management across an investor's life cycle, including saving for, preserving, and distributing assets in retirement.

Hayden Adams, CPA, CFP®

As Director of Tax and Financial Planning for the Schwab Center for Financial Research, Hayden provides analysis and insights on topics including income tax planning, tax-smart investing, asset allocation, and retirement withdrawal strategies for a range of Schwab clients and advisors.

Eric Tarkin

As a Senior Researcher in Schwab Asset Management, Eric is focused on multi-asset research and investment products.

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