NORTHERN TRUST

TAX EFFICIENT WITHDRAWALS ACROSS RETIREMENT ACCOUNTS

Retirees may hold multiple investment accounts and thus desire an efficient strategy to manage the withdrawal of assets. Efficiency here refers to the sustainability of such a strategy in maintaining a living standard for life and the likelihood of simultaneously mitigating tax bills and other expenses (i.e., Medicare) if applicable. A conventional strategy is to withdraw assets in a sequence, exhausting the taxable investment accounts while preserving the tax-deferred accounts for as long as possible. Alternatively, the retirees could consider drawing down their assets in parallel, simultaneously from both types of accounts in various proportions. The parallel strategy could be superior to the sequential strategy for many retirees, the average or the wealthy, and the optimal composition of income is specific to the individual situation.

SEQUENTIAL VS. PARALLEL

Let's look at a few stylized retirees and take a peek at how to combine or sequence the withdrawals from their retirement accounts. The retirees are assumed to no longer receive any salary or compensation but have multiple sources of wealth to provide income. Specifically, we consider a taxable account, a tax-deferred traditional account, such as 401(k) and IRA, and a tax-free (exempt or already paid) account, such as Roth 401(k) and IRA. We include Social Security benefits in the analysis but ignore pension benefits for simplicity.

Across various withdrawal strategies, the same after-tax consumption (indexed for inflation) is expected to be sustained for as long as possible. At the end of life, the remainder goes to the heir.

Tax bracket and rate hinge on the income sources and levels. The composition of withdrawals and their respective taxable portions may change over time (on Social Security benefits, for instance). The effective, average tax rate is set to be constant, assuming that the retiree manages their incomes to be within the same tax bracket throughout retirement. We will consider some "surprise" tax changes later on.

We examine two categories of withdrawal strategies. One is a sequential withdrawal, where:

- Withdrawals are made from the taxable account, until such account is exhausted,
- Plus the retired minimum distribution (RMD) from the tax-deferred account, as set by the IRS,
- Plus withdrawals beyond RMD from tax-deferred accounts, until such accounts are exhausted
- Plus withdrawals from Roth accounts if needed.

The other is a proactive parallel withdrawal, where:

- The retiree proactively withdraws a portion from the tax-deferred account, earlier in timing or larger in amount than the RMD,
- Thus smaller withdrawals are made from taxable account than otherwise,
- A partial conversion to the Roth account would occur, if withdrawals from the tax-deferred account are greater than RMD or more than necessary to support the desired consumption, and
- Thus the retiree pays income tax on the tax-deferred withdrawals earlier than otherwise, but tries to manage the tax bill over the life time.

ILLUSTRATING THE IMPACT

We assume a nominal investment return of 5% and inflation rate of 2%. Effective average (not marginal) tax rate is assumed below for various scenarios. According to the tax code, a standard deduction ($12,400 in 2020, indexed for inflation) and the income thresholds to tax Social Security benefits differentially (a lower threshold of $25,000 and a higher of $34,000, not indexed for inflation) apply to single retirees here.

Retiree A with $1,000,000

This retiree could be viewed as a stylized representation of an average worker, who has had a fair exposure to traditional 401(k) plans and also utilized Roth accounts along their career. Specific assumptions and outcomes are reported in Figure 1. Among the statistics, we highlight whether the retiree would be better, or worse, off if a parallel withdrawal strategy was taken in contrast to the sequential withdrawal strategy.

We observe that the retiree would be financially better off by tapping a portion of the tax-deferred account early on. For instance, a 90%-10% split between the taxable and tax-deferred accounts, while still maintaining the same living standard, would save the retiree some tax payment by $6,642 and potentially leave a larger bequest by $12,562. The reason is that withdrawal from tax-deferred account would induce higher tax in early years of retirement, but would lower overall tax bill later on. A component of the improvement is that the taxable portion of Social Security benefits would be lower when some tax-deferred withdrawals were shifted earlier rather than later.

Do not over-draw from the tax-deferred account, however. For instance, a 50%-50% split of withdrawals between the two accounts would reduce the tax bill but deplete the wealth at a faster pace (i.e., thus smaller legacy). It is still wise to defer most of the tax-deferred account as late as possible in order to garner the wealth compounding over the pre-tax investment returns.

Figure 1. Comparison of withdrawal strategies –$1,000,000 combined wealth

Assumptions	
Taxable	$250,000
Tax-Deferred	500,000
Roth	250,000
Social Security (monthly)	1,500
Desired after-tax spending (annual)	55,000
Income tax rate (average)	15%

OUTCOMES

Withdrawal Strategy	Income tax over ages 65-100	Possible legacy at age 100
Sequential	$166,920	$381,974
Parallel (split between taxable and tax-deferred)	Improvement Over Sequential	
90%-10%	-6,642	12,562
75%-25%	-21,493	32,058
50%-50%	-15,437	-41,813

Source: Hypothetical illustrations, Northern Trust

Retiree B with less wealth $500,000

Even retirees with less wealth could still benefit from a well-designed withdrawal combination of taxable and tax-deferred accounts. The amount of tax savings would be smaller, naturally. Strategically exhausting the tax-deferred resources could help reduce the portion of Social Security benefits being taxed away, thus keeping more resources for own consumption or bequest.

Retiree C with more wealth $2,000,000

Likewise, tax savings could apply to retirees with substantially higher wealth through some parallel withdrawal strategies. For instance, a 90%-10% withdrawal split between the tax and tax-deferred accounts, while still maintaining the same living standard, would generate a tax savings of $34,000.

In addition, such strategies could allow retirees to save on Medicare, separate from managing the tax on Social Security benefits. For instance, a 75%-25% withdrawal split between the tax and tax-deferred accounts could save Medicare premium by nearly $4,000 throughout retirement. Arguably, this might not seem to be a big deal for the wealthy, but meaningful nonetheless from a financial optimization perspective.

Retiree D with higher net worth $10,000,000

The tax savings through a careful withdrawal strategy could be substantially greater for even higher net worth, not surprisingly. This is illustrated in Figure 2 for the case of $10,000,000 in accounts combined. Given the general contribution limits in 401(k) plans and IRAs, taxable accounts are more likely to form a lion's share of the investor's wealth, as assumed here.

The 90%-10% parallel withdrawal strategy could save the investor over $206,000 in tax in contrast to the sequential strategy. The savings on Medicare premium would be sizable too, over $26,000 throughout retirement (not reported in Figure 2).

More taxes could be saved, through faster withdrawals from tax-deferred accounts, but legacy would be sacrificed to some degree, as indicated by the 75%-25% split strategy. Aggressive withdrawals from the tax-deferred accounts would forego the opportunities of tax-deferred investment compounding. This is a tradeoff, for the retirees who prefer to use tax-deferred accounts to leave a significant portion of their wealth to heirs or charity. This may be particularly desirable for charity purpose, because no estate tax would be imposed. A compromise could be to tilt the accounts slightly to higher risk-and-return portfolios if such charity legacy is viewed as altruistic but non-essential.

Figure 2. Comparison of withdrawal strategies –$10,000,000 combined wealth

Assumptions	
Taxable	8,000,000
Tax-Deferred	1,000,000
Roth	1,000,000
Social Security (monthly)	2,500
Desired after-tax spending (annual)	300,000
Income tax rate (average)	30%

OUTCOMES

Withdrawal Strategy	**Income tax over ages 65-100**	**Possible legacy at age 100**
Sequential	1,068,516	9,118,499
Parallel (split between taxable and tax-deferred)	Improvement Over Sequential	
90%-10%	-206,634	170,508
75%-25%	-613,217	-1,183,652
50%-50%	479,654	-199,624

Source: Hypothetical illustrations, Northern Trust

Tax Surprise

Constant tax rates were assumed in the illustrations above, which meant that the investors managed their withdrawals and spending very well to remain within the same tax bracket over time. The tax savings could be substantial through such careful withdrawal strategies.

Fiscal policies could change, however, beyond the control of individual financial planning. The tax system is never static. The U.S. public debt stands now at more than 100% of gross domestic product,1 which may require future tax hikes to pay down the debt. The Democratic Party may try to reverse Republican's tax policies, and vice versa. One cannot rule out the possibility that the future tax rates may be higher than anticipated. As a reference, the top marginal U.S. individual income tax rates were above 90% in the 1950s and early 1960s.2

Suppose a tax hike of 5% strikes across the board for half of the retirement years. Figure 3 shows the additional tax the retirees would need to pay, while withdrawing the same amount as prescribed by the different strategies. These surprise tax bills could be significant. A parallel withdrawal from tax-deferred accounts (a 90%-10% split, for instance) would mitigate the surprise payment. Such tax hedging would be greater for the wealthier. By symmetry, if a tax reduction of 5% occurred, Figure 3 would indicate the surprise tax savings, in which case the sequential withdrawals would win out.

Figure 3: Additional tax if the income tax rate hiked by 5% for ages 70-90

Illustrative Scenario	**Sequential withdrawal**	**90%-10% parallel withdrawal**
Retiree A, wealth $1M, current tax rate 15%	$55,640	$53,426
Retiree D, wealth $10M, current tax rate 30%	93,036	76,583

Source: Hypothetical illustrations, Northern Trust

[1] Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/GFDEGDQ188S, September 2, 2020.
[2] Tax Policy Center, Historical Highest Marginal Income Tax Rates, http://www.taxpolicycenter.org/statistics/historical-highest-marginal-income-tax-rates

INDIVIDUAL SITUATIONS DETERMINE OPTIMAL WITHDRAWAL STRATEGY

There is a tax diversification benefit for workers to save in multiple retirement accounts. Likewise, retirees may seek to mitigate the tax bill by managing withdrawals from the multiple accounts. As the scenarios demonstrate here, it may be beneficial for the retirees to proactively withdraw a portion from the tax-deferred account in parallel to withdrawals from the taxable account, rather than exhausting the taxable, tax-deferred, and Roth accounts in sequence.

There is no rule-of-thumb that appeals to all retirees. The optimal taxable-vs.-tax-deferred withdrawal combinations are specific to individual situations. The benefit of working out a smart withdrawal strategy, independently or with the help of a financial advisor, can be significant.

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As one of the largest managers of retirement assets in the United States, our team has deep expertise in developing innovative answers to challenges faced by many plan sponsors, retirement advisors and individual investors. We take a consultative approach to addressing the needs of individual investors while offering a suite of solutions aimed at improving retirement outcomes.

NORTHERN TRUST ASSET MANAGEMENT

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With $975 billion in total assets under management,[3] and a long standing history of solving complex challenges, we believe our strength and stability drive opportunities for our clients. Our comprehensive asset class offering includes passive, factor-based, fundamental active and multi-asset class solutions that are available in a variety of investment vehicles.

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3 Asset under management as of June 30, 2019.