Four Tax-Efficient Strategies in Retirement

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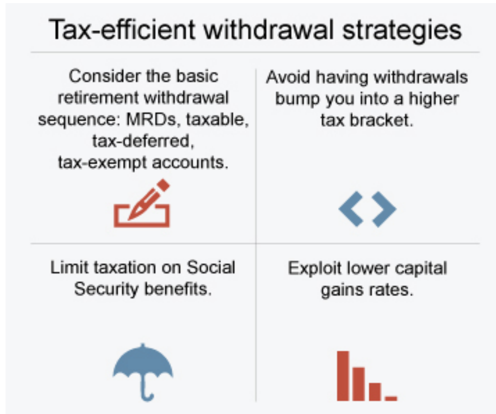
How to plan your income withdrawal strategy with taxes in mind.



Having enough money to savor your retirement years is a critical component of a successful retirement. That's why it's important to consider the impact that taxes may have on your savings in retirement. Although you won't incur payroll taxes anymore, you will likely continue to owe income tax on some of the withdrawals you take.

On the positive side, you may be in a lower tax bracket in retirement because you won't be receiving a full-time salary anymore. However, you still may have significant levels of taxable income from withdrawals from your investment and retirement savings accounts, pension payments, Social Security benefits, and possibly a part-time job.

One important element of tax-sensitive investing is developing a withdrawal strategy, which aims to minimize the effect of taxes while helping to provide you with the income you need. Being tax aware is especially important these days, as tax reform continues to receive attention in Congress.

"Most investors are familiar with the idea of maximizing their assets by minimizing taxes during their earning and wealth-building years," says Ken Hevert, vice president of retirement products at Fidelity. "Limiting taxes on those savings in retirement is equally important."

Here are several different tax-efficient withdrawal strategies to consider.

Strategy #1: Consider the basic retirement withdrawal sequence.

The simplest withdrawal strategy is to take assets from your retirement and savings accounts in the following order:

- Minimum required distributions (MRDs) from retirement accounts[1]
- Taxable accounts
- Tax-deferred retirement accounts, such as a traditional IRA, 401(k), 403(b), or 457
- Tax-exempt retirement accounts, such as a Roth IRA or Roth 401(k)

This approach offers several advantages. First, it ensures that you take any MRDs, which are required for traditional and Roth 401(k) plans and traditional IRAs if you're older than 70½.[2] (Roth IRAs don't have MRDs while the original owner is alive.) If you don't take the full MRD, you'll pay a penalty worth half the amount you failed to withdraw.

If you've held the investment for longer than a year, you'll be taxed at long-term capital gains rates, which currently range from 0% to 20%, depending on your tax bracket. Generally, for most taxpayers, net capital gain is taxed at rates no higher than 15%. Long-term capital gains rates are significantly lower than ordinary income tax rates, which in 2014 ranged from 10.0%

to 39.6%, for withdrawals from traditional retirement accounts. What's more, using your taxable assets for retirement withdrawals leaves your money in tax-advantaged accounts, where it has the potential to grow tax deferred. "Compounding earnings on a tax-deferred basis is a powerful way to help grow assets over time," says Hevert.

If you've used up your assets in taxable accounts, turn to your traditional, tax-deferred accounts. You'll pay ordinary income tax on withdrawals, but this allows you to continue to leave any Roth accounts untouched, which may have significant benefits. Qualified withdrawals from Roth accounts won't be taxed, making them a useful vehicle later in retirement. For example, if you have a significant medical bill, you can withdraw money from the Roth account to pay for it without triggering a tax liability.[3] Moreover, Roth accounts can be effective estate-planning vehicles, because any heirs who inherit them generally won't owe federal income taxes on their distributions. But this could change, because Congress is considering reforming retirement provisions.

The basic withdrawal strategy does have a potential disadvantage, however. Your tax burden may increase when you start taking money from taxdeferred retirement accounts. If that tax bump is a source of concern, consider the following strategy.

Strategy #2: Avoid having withdrawals bump you into a higher tax bracket.

If you want to be a little more active in your withdrawal strategy, you may consider taking simultaneous withdrawals from taxable, tax-deferred, and possibly Roth accounts. The objective here is to monitor the effect of the withdrawals on your tax rate so you won't move into a higher tax bracket.

If you decide to manage your taxable income with a target marginal tax rate–or the rate on the last dollar of income earned–in mind, consider following these steps:

Step 1: Identify your expected gross income, living expenses, and income gap (the difference between gross income and expenses) for the coming tax year, before considering any withdrawals from your investment accounts. Then determine your expected level of deductions and exemptions, and subtract them from your gross income, arriving at an estimate of your taxable income before withdrawals from investment accounts.

Step 2: Choose a marginal tax rate you'd like to target in the coming tax year. A reasonable place to start is the marginal rate associated with the taxable income estimate you identified in Step 1. For example, if you expect $48,000 in taxable income before tapping your investment accounts, you could target a marginal rate of 15%, because $48,000 of taxable income is subject to a marginal rate of 15% for joint filers in 2014.

Step 3: Identify and withdraw the amount of additional taxable income (above the level determined in Step 1) you can recognize without affecting your target marginal tax rate and withdraw it from a tax-deferred account.

Step 4: Draw any additional amount needed to fund your income gap (as well as the amount needed to cover the tax liability itself) from a taxable or Roth account. If using a taxable account, try to avoid liquidating securities at a gain, because this can generate additional tax liability; if using a Roth account, make sure that you've met the requirements for qualified distributions, or you may face both additional taxes and penalties.

"This strategy may help you generate the cash flow you need to help meet expenses, while potentially minimizing your tax rate," says Matthew Kenigsberg, vice president in Fidelity's Strategic Advisers. "If performed consistently over time, it may help you preserve more of your retirement assets for the future."

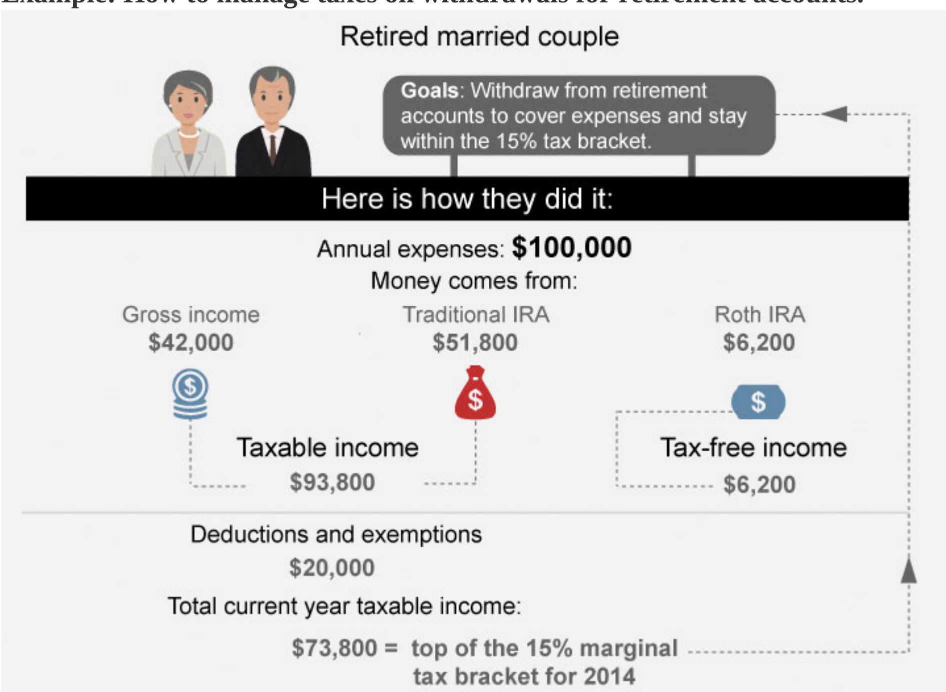
See page 6 for important information

Finally, be sure to keep abreast of your state's tax laws. Some states offer favorable tax treatment for certain sources of retirement income, such as some 401(k) plans and pensions (several states have no state income tax and many have favorable treatment for retirement income).

As a way to help minimize the taxes you'll pay, consider the following hypothetical scenario.[4] It illustrates the way a retired married couple whose annual expenses total $100,000 might seek to manage their taxes. Our hypothetical couple expects $42,000 in gross income (all taxable) before tapping their retirement accounts, so their income gap is $58,000. They anticipate $20,000 in deductions and exemptions, so their expected taxable income before withdrawals is $22,000. If they withdraw $51,800 from their traditional IRAs, it would bring their taxable income to $73,800—the top of the 15% bracket for 2014. They could then withdraw the remaining $6,200 that they need to cover their income gap from a Roth IRA, which does not generate taxable income (assuming the withdrawal is qualified). The chart belows their cash flow and taxable income:

Other

Example: How to manage taxes on withdrawals for retirement accounts.



This hypothetical example is for illustrative purposes only.

options for our hypothetical couple

The hypothetical couple in this scenario leaves the bulk of Roth IRA assets alone, leaving them in place to potentially generate tax-free growth. In certain situations, however, it may be advantageous to tap Roth assets instead of tax-deferred or taxable accounts. These include situations when:

- Distributions from a tax-deferred account would cause your taxable income to exceed your target marginal tax rate
- Withdrawing from a taxable account would require selling assets, resulting in short-term capital gains, which are taxed at ordinary income tax rates

- You are also trying to minimize taxes on Social Security benefits, as in Strategy #3 (see below), and withdrawals from a tax-deferred account would have an impact on the taxability of those benefits

Your circumstances may be considerably different from those described in the scenario. Nevertheless, you may be able to apply the principles involved in them to your own situation. A tax professional can help you explore the implications of different withdrawal strategies, help minimize the amount of taxes you pay on hard-earned savings, and, of course, help you maximize your ability to live the retirement you envision.

Strategy #3: Limit taxation on Social Security benefits.

This strategy again involves actively managing your distribution strategy. The government considers up to 85% of your Social Security benefits to be taxable, depending on a formula that takes into account most other income sources, plus one-half of your benefits. The objective of this approach is to manage your income so that a smaller percentage of your Social Security benefits will be taxable.

Follow the same approach as outlined in Strategy #2, with two exceptions. You'll target the income thresholds that determine whether your Social Security benefits are taxable, rather than income levels associated with a particular tax bracket. And in Step 5, you'll withdraw additional funds from either a Roth IRA or an HSA (health savings account); qualified distributions from these accounts are excluded from the formula used to determine whether your Social Security benefits are taxable, but realized capital gains from taxable accounts are not.

Strategy #4: Exploit lower capital gains rates.

You also may have the opportunity to eliminate taxes on the capital gains you realize from taxable accounts. In 2014, taxpayers in the 10% and 15% income brackets can realize long-term capital gains (or receive qualified dividends) without being taxed. (In 2014, the 15% bracket tops out at taxable income of $73,800 for married couples filing jointly.) The result: If your taxable income falls into one of the two lowest tax brackets, selling stocks held longer than a year could be a highly tax-efficient way to generate cash flow. This strategy is potentially most feasible if you have a relatively high proportion of retirement assets in taxable accounts and a lower amount of recurring annual income, such as Social Security, a pension, or annuity income.

Tax implications for high-income individuals

It is becoming increasingly important for high-income individuals to manage taxable income with a target tax rate in mind. Joint filers earning more than $250,000 per year and single filers earning more than $200,000 in modified adjusted gross income (MAGI) per year now face a 3.8% Medicare surtax on net investment income (capital gains, interest, dividends, etc.) to fund health care reform.

In both cases, taxpayers may be able to significantly reduce their tax burden by carefully managing their annual income so it remains below these levels. For example, if a couple is below the $250,000 level in a given year but expects to exceed it the following year, they may want to consider accelerating the recognition of taxable income into the current year up to the $250,000 limit. In addition, tax-exempt municipal income is not subject to the 3.8% surtax, so investors who are over the limits may wish to consider replacing taxable bonds and bond funds in their taxable accounts with municipal proxies in order to reduce their exposure to the surtax. Of course, taxes aren't the only consideration—be sure to look at the risks as well before making a decision.

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1. This is a hypothetical example for illustrative purposes only. In actuality, the withdrawal hierarchy considers inherited accounts, annuities, HSAs, etc.

2. The list of account types mentioned here is not comprehensive. Other account types, such as 403(b), 457(b), SIMPLE, SEP, and others, are subject to MRD rules. For Roth 401(k) accounts, an employee's after-tax contributions will not be subject to MRD rules, but the employer's pretax match, if any, will be subject to MRD rules.

3. A distribution from a Roth IRA is tax free and penalty free provided that the five-year aging requirement has been satisfied and at least one of the following conditions is met: you reach age 59½, die, become disabled, or make a qualified first-time home purchase.

4. The hypothetical scenario relies on the following assumptions: 2014 federal tax figures, married filing jointly filing status, standard deduction for married couples who are age 65 or older, two personal exemptions, no alternative minimum tax, no state income tax, taxable account has a 80% basis-to-value ratio, tax-deferred account has no basis, tax liability is funded from a taxable account, and gross income is total reported income prior to tax deductions and exemptions.

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