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THE TAX-CONSCIOUS ADVISER

Robert N. Gordon

Managing tax brackets a potent tool

Where clients withdraw income from in retirement is critical to making their money last longer

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Now that we again have so many tax brackets, it's time for a refresher on what these brackets are and how to make the most of them.

If a married couple had taxable income of $150,000, they would be in the 28% tax bracket. However, only $1,150 would actually be taxed at 28%.That's because we have a progressive tax system. The first $18,150 of taxable income is taxed at a 10% rate whether you make $50,000 a year or $1 million a year. The next $55,650 is only taxed at 15% — and so on. The couple would pay $29,247 in tax for an overall tax rate of just 19.5%, not 28%.

Only married couples with taxable incomes above $457,600 would have any income taxed at the highest rate of 39.6%. The long-term capital gain rate maxes out at 20% for those same folks.

But there is a 0% tax on long-term gains if your income is below $73,800 and only a 15% long-term gains tax if you have taxable income of $457,600 or less.

Even when you or your clients are in their earning years, they would be fortunate to have income of $500,000 annually. In retirement, even those with $5 million in assets might not hit the highest bracket from interest and dividends. And it is in the retirement years that managing tax brackets becomes most powerful.

My eyes were opened to this in 2008 when I organized a one-day conference at New York University to develop the optimal strategy on where to take money from in retirement.

In retirement, you can have assets in your own name, assets in a 401(k) or traditional individual retirement account, Roth IRAs and maybe even in a tax-deferred annuity. Where one takes the money needed each year is the key to extending the life of your retirement savings. Once this point was recognized, a rule of thumb developed based on the fact that the government was your partner in the accounts that were tax deferred. Why not wait to tap those assets last and keep the tax man away for as long as possible?

Traditional wisdom was to empty your taxable account first and your tax-deferred accounts last. It became quite clear during this conference that the traditional wisdom was far from optimal.

The goal of creating as little taxable income as possible sounds intriguing and might be correct if we did not have a progressive tax system or the ability to manage our withdrawals. If one waits to take income from tax-deferred vehicles last, there is a good possibility that some of the income will be taxed at the higher brackets.

It seems that what one should do is take money from a mix of asset locations in order to “fill up the lower tax buckets first” and only after that start to take money from the “more tax-friendly” locations. Having zero taxable income, surprisingly, is not optimum.

For those who want to delve further into this topic, I would suggest looking at the work of Stephen Horan (now at the CFA Institute) and William Reichenstein at Baylor University. Mr. Reichenstein's work concludes that a retiree could make their money last seven more years by optimizing income withdrawal strategies. This is not a simple exercise because of the interactions of Social Security and the potential for unusually large medical expenses.

Practitioners offering services utilizing these concepts include Robert Keebler's CPA firm in Green Bay, Wis., and Social Security Solution's software utilizing Mr. Reichenstein's work. Our home page (twenty-first.com) offers the 2008 conference's materials and more.

Robert N. Gordon (bob@twenty-first.com) is chief executive of Twenty-First Securities Corp. and an adjunct professor at New York University's Leonard N. Stern School of Business.