Order of Withdrawal

Raising Your Living Standard

Roth and regular retirement accounts provide significant opportunities for saving taxes over your lifetime. But deciding how much to invest in each and which to withdrawal first is tricky without the right software.

With a regular 401(k), 403(b), or IRA, we are able to invest money we earn before having taxes taken out and watch that money compound tax-free until we start to withdrawal. Then we pay taxes at ordinary rates. With a Roth 401(k), 403(b), or IRA, we invest our earnings after taxes have been taken out. This money also compounds tax-free. But when we take the money out, it's tax free.

Our case study, "Beating the Tax Man," compares contributing to Roth and regular retirement accounts. Here we consider which account to tap first. There is no one answer that's right for everyone. A lot of interconnected factors come into play, including how much other taxable income you have, how much you have in the two accounts, the level and duration of your mortgage interest and other deductions, when you plan to take Social Security, and whether tax rates will be raised.

Fortunately, ESPlanner can calculate your living standard in seconds under different withdrawal choices and assumptions about Social Security and future tax rates. So you can quickly see what option leaves you with the highest living standard.

Consider Chris and Alicia Rother who live in Ann Arbor, Michigan. They are 65 and ready to retire. They have $500,000 each in their regular 401(k) and $250,000 each in their ROTH. They have regular joint savings of $200,000.

If they tap the Roth first, they will, according to ESPlanner, be able to spend $74,862 each year (valued in today's dollars) over and above their housing expenses, tax payments, and Medicare Part B premiums. If, instead, they tap their regular 401(k) first, they will enjoy a living standard of $75,693. That's a 1.11% increase in their living standard every year for the rest of their lives.

This finding depends, however, on the assumption that tax rates aren't raised. Suppose, instead, that federal and state income taxes are raised permanently by 30 percent starting when Chris and Alice are 75. In this case, their sustainable spending is $71,671 if they withdrawal from the Roth first and $74,475 (3.9% more) if they withdrawal from the regular 401(k) first. The reason is that paying taxes early avoids having the regular 401(k) withdrawals hit by the higher future tax rates.

ANNUAL RECOMMENDATIONS

Year	Chris's Age	Alica's Age	Consumption	Saving	Federal Income Taxes	Alica's Life Insurance	Living Standard Per Adult
2007	65	65	74,475	(5,718)	16,090	0	46,547
2008	66	66	74,475	(5,874)	15,989	0	46,547
2009	67	67	74,475	(5,943)	15,792	0	46,547
2010	68	68	74,475	(6,156)	15,727	0	46,547
2011	69	69	74,475	(6,297)	15,571	0	46,547
2012	70	70	74,475	(6,513)	15,479	0	46,547
2013	71	71	74,475	(6,737)	15,384	0	46,547
2014	72	72	74,475	(6,970)	15,286	0	46,547
2015	73	73	74,475	(7,213)	15,185	0	46,547
2016	74	74	74,475	(7,466)	15,080	0	46,547
2017	75	75	74,475	(12,221)	19,462	0	46,547
2018	76	76	74,475	(12,507)	19,231	0	46,547
2019	77	77	74,475	(12,804)	18,994	0	46,547
2020	78	78	74,475	(13,111)	18,752	0	46,547
2021	79	79	74,475	(13,430)	18,503	0	46,547
2022	80	80	74,475	(13,761)	18,249	0	46,547
2023	81	81	74,475	(14,104)	17,989	0	46,547
2024	82	82	74,475	(14,460)	17,722	0	46,547
2025	83	83	74,475	(14,829)	17,448	0	46,547
2026	84	84	74,475	(6,814)	8,769	0	46,547
2027	85	85	74,475	1,514	0	0	46,547
2028	86	86	74,475	1,305	0	0	46,547
2029	87	87	74,475	1,077	0	0	46,547
2030	88	88	74,475	831	0	0	46,547
2031	89	89	74,475	565	0	0	46,547
2032	90	90	74,475	277	0	0	46,547
2033	91	91	74,475	(32)	0	0	46,547

This data from the Rother report shows their lifetime living standard of $74,475, assuming there is a 30 percent federal and state income tax hike when they reach age 75.