

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 withdraw 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 withdraw. 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 | Alicia's Age | Consumption | Saving | Federal Income Taxes | Alicia'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.