

Which Assets Should I Spend First?

With retirement an individual moves into distribution mode—that is, beginning to spend one’s retirement savings. This is not to say that accumulation stops. Income and appreciation on the investments, Social Security funds, and any pension plan proceeds might still be exceeding your expenses.

You may be fortunate enough to find that your Social Security, pension, required distributions from your IRA (if any), and dividends and interest on your after-tax investments produce enough funds for your living expenses. Let’s assume, however, that isn’t the case, and you are required to either invade your after-tax funds (your nest egg) or make (additional) taxable withdrawals from your IRA or retirement account to make ends meet.

In general, it is preferable to spend principal from your after tax investments rather than taking taxable distributions from your IRA and/or retirement plan.

I’ve been in business for 27 years and most of my clients actually listen to me; but I’ve had quite a few who don’t. Instead of following my recommendations, some prefer to spend their IRAs first. It drives me crazy. When I review their tax return, I see it. You can’t hide it because it’s an IRA distribution and you have to pay taxes on it. With this one particular client, every year, when I delivered his tax return, I would include a personal note saying, “I really hate to see you pay income taxes on this.” I would also call him. He said his stockbroker wanted to maintain a balance between IRA and after-tax dollars. Now, I’m all for an appropriate and well-balanced portfolio. I agree that you don’t want to have all your eggs in one basket. But I’m not into this allocation between IRA and non-IRA dollars. Particularly if you’re past 59½, you don’t have to worry about having after-tax dollars because you can take money out of an IRA whenever you want without a penalty. I would much rather follow the “pay taxes later” rule.

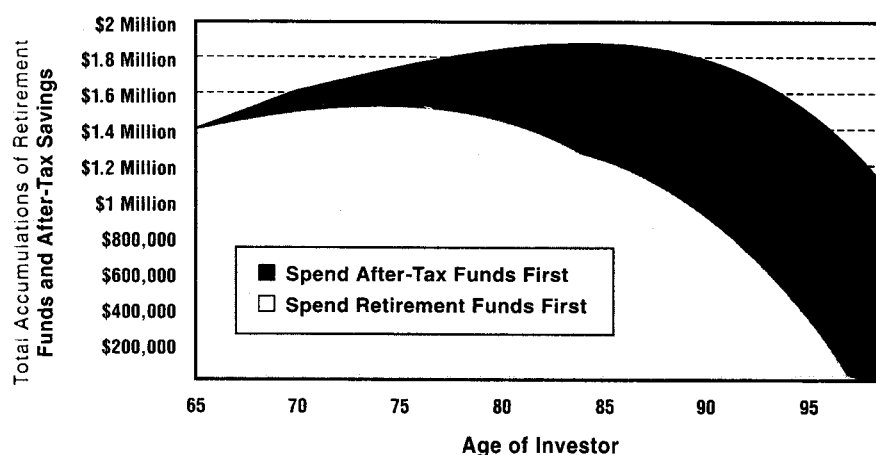
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Mini Case Study 3.1 and Figure 3.1 provide a graphic comparison of the benefits of spending after-tax savings before pre-tax accumulations.

MINI CASE STUDY 3.1 Spend Your After-Tax Money First

Figure 3.1

Benefits of Spending After-Tax Savings Before Tax-Deferred Retirement Accounts



Both Mr. Pay Taxes Now and Mr. Pay Taxes Later start from an identical position. They are both 66 years old and both have \$300,000 in after-tax funds, with a cost basis of \$255,000, and \$1,100,000 in retirement funds. They both receive \$25,000 per year in Social Security income. They want to spend \$8,000 per month, or \$96,000 per year after paying income taxes. Their investment return is 8%, consisting of 70% capital appreciation with a 15% portfolio turnover rate, 15% dividend income, and 15% interest income. Income-tax assumptions include the new lower rates on ordinary income and capital gains established by JGTRRA and subsequent tax laws. State income taxes are ignored.



The Big Picture

Mr. Pay Taxes Now does not spend any of his after-tax funds until all the retirement funds are depleted. By spending his retirement funds first, he triggers income taxes on the withdrawals, reducing the tax-deferral period, and his balance goes down. He also subjects a larger share of his after-tax funds to income taxes on the dividends, interest and potential capital gains. All income taxes due on the retirement funds and the after-tax funds cause a greater amount to be withdrawn from his retirement account. In 32 years, by paying taxes prematurely, he has sacrificed a fortune in tax-deferred growth. When he is 98 years old, Mr. Pay Tax Now is out of funds.

Mr. Pay Taxes Later first uses his after-tax funds to meet expenses. Only when the after-tax funds are depleted are withdrawals made from the retirement accounts. He fully uses the tax deferred features of the IRA. Mr. Pay Tax Later has over \$1,200,000, when he is 98. Both he and Mr. Pay Taxes Now enjoyed an identical lifestyle, investments, etc., but there was a \$1,200,000 difference in the

remaining amounts. In states like Pennsylvania that do not tax retirement income but do tax after-tax investment income, the benefits of spending the after-tax money first is even greater. The principle stands: don't pay taxes now—pay taxes later!

Please note that the conclusion would most likely be the same for any reasonable set of assumptions in terms of how much money there is and what interest rate you assume.

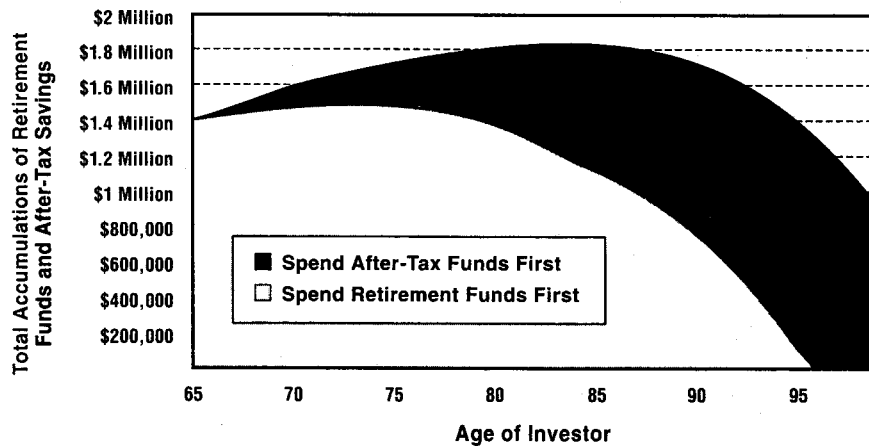
MINI CASE STUDY 3.2

A Note to Those Who Fear Capital Gains Tax

One of the primary reasons people think it may be better not to spend the after-tax money first is because of capital gains. For example, if instead of having a basis of \$255,000 on the \$300,000 of after-tax funds, let us assume the basis is zero. All spending of these after-tax funds will be taxed as capital gains. If we use the same assumptions as above, the graph now looks like: Figure 3.2.

Figure 3.2

Benefits of Spending After-Tax Savings With No Tax Cost Basis Before Tax-Deferred Accounts



You may have a hard time telling the difference. These results show that Mr. Pay Tax Now is out of funds at age 96 rather than age 98 as in Mini Case Study 3.1, while Mr. Pay Tax Later still has over \$1,300,000 left, which will last him another nine years. The bottom line is that spending after-tax money first is still wise, even when capital gains are involved. The step-up in basis rules, however, may provide planning scenarios that contradict this conclusion. The step-up in basis rule states that inherited property assumes a basis equivalent to its fair market value at the date of the decedent's death. It is referred to as a "step-up" because frequently the fair market value of the property at the date of death is greater than the decedent's basis—that is, its cost when it was first acquired.

For example, in estate situations where only a short remaining lifetime is anticipated or where the plan is to pass on the funds inside the estate, it may be advantageous to not spend highly appreciated investments. If you anticipate being in a situation like this, consult with a qualified advisor who will run some numbers for you. Most of the numbers we have run indicate that unless you are going to die in a few years, you are usually better off spending your after-tax dollars first, even if you will incur capital gains tax and give up your step-up in basis.

MINI CASE STUDY 3.3

The Optimal Order for Spending Classes of Assets

Phyllis Planner is 65 years old and widowed (though the conclusion would be basically the same for a married taxpayer). She is thinking ahead. She wants her money to provide her with a comfortable standard of living, and she also wants to leave some money to her three children. How should Phyllis evaluate which pool of money to spend first and which to save for as long as possible?

There are four general categories of money to support her retirement. They are ranked in order of how I recommend Phyllis spend her money, exhausting each asset category before breaking into the next asset category.

1. After-Tax Assets Generated by Income Sources

- Pension distributions

Determining a strategy for the distribution years is where the rubber meets the road. I've had clients who, while beginning their planning, get upset because they haven't accumulated as much as they could have, or for mistakes made along the way. That's water over the dam. If that's you, that's okay. Properly planning a strategy for the distribution years will help you make up for mistakes made during the accumulation years!

- Dividends, interest, and capital gains
- Earned income, not reinvested
- Social Security

Of course when Phyllis is 70½, she will be required to take minimum distributions from her IRA. Since she will have to pay income taxes on the distributions, the proceeds that remain after she pays taxes on the IRA distributions could also be spent before any of the following assets or sources of income.

2. After-Tax Assets (*Investments that are not part of a qualified pretax retirement plan that would generate income subject to taxes annually*):

- Investments that will either sell at a loss or break even
- Then, more highly appreciated investments

3. IRA and Retirement Plan Assets (*Assets subject to ordinary income tax*):

- IRA, 403(b), 401(k), etc., dollars over and above minimum required distributions

4. Roth IRA

- Roth IRA dollars

The assets in the income category should be spent first, since she has to pay tax on that money anyway. But let's assume that Phyllis's Social Security and the pension, dividends, and interest are not sufficient to meet her spending needs. Then the question becomes, "Which pool of money should be spent next?" If we

keep in mind the premise of “don’t pay taxes now—pay taxes later,” the answer is obvious: the after-tax dollars. If we spend our after-tax dollars, except to the extent that a capital gain is triggered on a sale, those dollars will not be subject to income taxes and the money in the IRA can keep growing tax-deferred. Then, when Phyllis has exhausted her “after-tax” funds, then she delves into her IRA or pre-tax funds.

Whenever you make a withdrawal from the IRA, you are going to have to pay income taxes. To get an equivalent amount of spending money from the IRA assets and the after-tax assets, you have to take the taxes into consideration. Assuming a 25% tax bracket, you need \$1.33 from the IRA assets to get \$1.00 of spending money (\$1.00 cash + \$0.33 to pay the taxes). We get .33 cents because $\$1.33 \times 25\% = .33$. On the other hand, the after-tax money is withdrawn tax-free, so to get \$1.00, you withdraw \$1.00 (with the exception of capital gains tax at 15% on the appreciation when you withdraw the money).

Finally, when she exhausts her IRA and pre-tax funds, she spends her Roth IRA. Why should she spend her traditional IRA before her Roth IRA? If tax-deferred growth is a good thing, then tax-free growth is even better. By spending taxable IRA money before Roth IRA money, she increases the time that the Roth IRA will provide income-tax-free growth.

If your plan is to leave money to your heirs, their tax situations should be considered as well. If the heirs to the Roth have tax deferral/avoidance as a goal, and their tax bracket is the same as yours or higher, then the Roth assets are the best to inherit. The opposite conclusion may be reached if the heirs plan on spending the money soon after they inherit it and are in a lower tax bracket. If that is the case, you could be better off spending the Roth IRA yourself. The facts of each case should be considered. In general, however, I would stick to what I recommended for Phyllis.

I had a client who came in to see me six or seven years ago, and at the time we thought this was going to be his last chance to make a Roth IRA conversion. I recommended that he make a \$500,000 Roth IRA conversion, which is much higher than I would normally recommend for anyone. When we were done with the conversion, he had three “pots” of money. He had after

tax dollars, his traditional IRA, and the \$500,000 Roth IRA.

The plan that we worked out for him (and by the way he has stuck to that plan) was for him to start out by using only his after tax dollars for spending purposes and for gifts to his children and grandchildren. He was planning to spend and give away all of his after tax dollars, so that within a couple of years he would have no after tax dollars left.

The next step of the plan was to eat up his IRA based on his spending pattern; it was going to take till he was 90 to exhaust his IRA. If he and his wife were still alive at age 90, then they would have the Roth IRA that, if it earned 7% interest, would be worth \$2,000,000 dollars. So, he wasn't likely to run out of money. More likely what is going to happen is that he is going to die, leaving the entire Roth IRA to his heirs.

That was a terrific plan. We calculated that this plan will literally save his family millions of dollars. Maybe your numbers aren't quite so high, but the concept is the same. The spending order is critical to both your financial good as well as your family's.

MINI CASE STUDY 3.4

Figuring the Tax Bracket Advantage into the Spending Order

One possible exception to spending after-tax dollars first is to "prematurely" make small IRA withdrawals if you are in a lower tax bracket now than you will be in the future when you have to start taking minimum required distributions. If you withdraw just enough to take you to the top of your current (low) tax bracket, then you get that money out at a lower tax rate than if you were to take the money out after you retire. But first, let me clarify a common misunderstanding about taxes and tax brackets.

What many people don't understand is that the first sliver of income is taxed at a lower bracket (income up to \$14,600 in 2005 is taxed at 10% for married filing jointly). Then the next layer of income is taxed at the next bracket (income from \$14,601 to \$59,400 is taxed at 15% for married filing jointly), then the next layer is taxed at the next bracket (income from \$59,401 to \$119,950 is taxed at

25%). (Rates are married filing jointly for 2005.) Some people are deathly afraid of getting one more dollar. They think, "Oh no! If I get one more dollar I'm going to be thrown into the 25% tax bracket and my taxes are going to explode." But that's not right. What happens is that just the one additional dollar would be at the 25% bracket.

Though Joe and Sally Retiree, aged 65, have an estate of \$1.5 million, their taxable income is only \$30,000. (Taxable income is ar-

One possible exception to spending after-tax dollars first is to "prematurely" make small IRA withdrawals to stay in a low tax bracket.

rived at after subtracting itemized deductions and personal exemptions and dependents.)

When Joe reaches age 70½, his minimum distribution will push his income well into the 25% tax bracket. Joe decides to make voluntary withdrawals from his IRA every year until he reaches his minimum required distribution date as follows:

The top of the 15% bracket for married filing jointly (using 2005 tables) is \$59,400.

Joe and Sally already have \$30,000 in taxable income before any IRA withdrawal. If Joe then makes an additional \$29,400 IRA withdrawal, he still pays tax at the 15% rate. If he waits, much of the later distributions will be taxed at 25%. Depending on the circumstances, this might be a reasonable strategy. Calculations reveal the higher distribution yields a slight long-term advantage, although not as much as you might think because of the simultaneous loss of some tax deferral.

For many clients, particularly frugal clients, I would prefer a variation of this strategy that provides better long-term benefits. Instead of making an IRA withdrawal of \$29,400, paying tax on the funds, and then being left with "after-tax" dollars that will generate taxable income, I would recommend Joe make a \$29,400 Roth IRA conversion. Many clients will resist this advice, but I urge you to at least consider it. This advice is perfectly consistent with Jonathan Clements's article in *The Wall Street Journal* dated February 23, 2005, in which Jonathan quoted me giving this identical analysis.

It is beyond the scope of this book to assess all the implications of Roth IRA conversions. Suffice it to say that I am a big fan of Roth IRA conversions and my wife and I have made a Roth IRA

conversion well into the six figures.

If Joe doesn't want to make a Roth IRA conversion, he should at least consider making "premature" IRA distributions based on tax brackets. Please note that adding income in the form of extra IRA distributions and/or Roth IRA conversions may have an impact on the taxability of Social Security benefits and other items as discussed in the previous chapter, which should be worked into the numbers for the amount to withdraw or convert.

A Key Lesson from This Chapter

Leaving money in the tax-deferred environment for as long as possible confers advantages that almost always outweigh concerns over paying capital gains on your after-tax assets.
