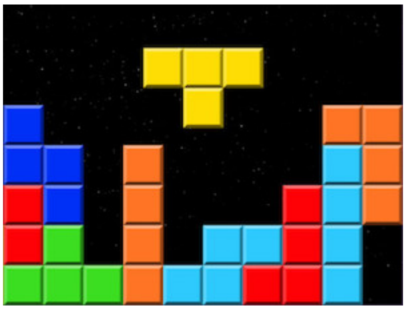
Tetris, Taxes and Retirement

By Kerry Pechter *Wed, Jan 29, 2020*

The tradition of withdrawing taxable, tax-deferred and finally tax-free assets in retirement may be obsolete. Matching retirees' tax brackets with the right account types may be better. It's like filling the rows in Tetris with blocks of different shapes.



Taxes are often a retiree's most vexing expense. That's especially true for people who are debt-free. If bills are minimal and there's no earned income, then property taxes, capital gains taxes, and taxes on superfluous IRA distributions loom larger in the retiree's mind.

That creates opportunities for financial advisers. If you're not currently a decumulation tax maven, there's no shortage of books, software and webinars that can make you one. Such advice can save your clients money and make your client-relationships "stickier." Tax-minimization is challenging, but it pays off.

Reichenstein

When clients have taxable, tax-deferred and tax-free (i.e., Roth) accounts, helping them take withdrawals in the most tax-efficient way is a good place to start. You've probably heard or read that spending from taxable, tax-deferred and tax-free (Roth) assets, in that order, works best.

But that tradition, like the 4% withdrawal rule, is being questioned. William Reichenstein, an academic known for his work with William Meyer on Social Security claiming strategies, suggests in a recent book (and companion software) that the conventional wisdom is often suboptimal. Different spending sequences, he says, especially those that take into account potential taxes on Social Security benefits, can result in subtle annual tax savings that lead to big savings in the long run.

In **“Income Strategies”** (Retire Inc., 2019), Reichenstein describes several strategies, from the simple to the complex; we’ll share two of the simpler illustrations below.

The goal of his book, Reichenstein writes, “is to demonstrate how coordinating 1) a smart Social Security claiming strategy with 2) a tax-efficient withdrawal strategy from the financial portfolio can either lengthen the longevity of a retiree’s financial portfolio or increase the after-tax value of the remaining portfolio for the retiree’s heirs.”

A game of tax ‘Tetris’

To show flaws in the conventional wisdom, Reichenstein hypothesizes a retiree in her mid-60s. She has three accounts to draw from: a taxable account worth $549,601, a tax-deferred account (TDA) worth $916,505 and a Roth IRA worth $234,928. She intends to spend $81,000 a year, or about 5% of her initial savings. She’s assumed to be invested 100% in bonds earning 4%. Social Security and inflation are left out for the sake of simplicity. Her tax brackets are fixed at 2013 levels.

If this retiree followed the conventional wisdom strategy, she would spend from her taxable account for the first seven years and a half years. Then she would spend from her TDA for 16 years. Lastly, she would spend from her Roth IRA. Her portfolio is projected to last until she’s about 98 years old.

Reichenstein notes that the traditional approach renders her tax rate at no more than 15% during the first period of retirement (because withdrawals will be mainly return of principal. It then concentrates her tax burden during years eight to 24, when withdrawals from her TDA will all be taxed as ordinary income at a marginal rate of 25%. In the last eight years, her Roth distributions aren’t taxed at all.

Alternately, he writes, the woman could have reduced her lifetime taxes and added up to two years and four months (or increased her legacy proportionately) by mixing some highly-taxed TDA distributions into the low-tax first seven years and last eight years. She could use her least-taxed years to convert TDA assets to Roth IRA assets.

The mixing strategy would, in effect, smooth the woman's tax burden over her retirement. Each year, she would distribute just enough of her highest-taxed assets to "fill" her lowest tax brackets, thus lowering the effective tax rates on those assets, and using the least-taxed assets to fill her higher brackets. Mentally, it's in the spirit of the computer game Tetris. But you're snugging blocks of assets into place instead of colored blocks.

All of this would be much more complex and labor intensive if each of the accounts held a different mix of asset classes, each class appreciating at a different rate, and if the adviser were trying to rebalance the portfolio back to a target asset allocation, or trying to harvest gains or losses. Also, on first reading, it's difficult to tell how much the tactic of "filling" tax brackets improves a client's overall average tax rate. Reichenstein's software presumably offers more definitive answers.

A pea and walnut shells

Later, Reichenstein addresses taxes on Social Security benefits. He hypothesizes the Smiths, a mass-affluent married couple filing jointly. Both are over age 65. They have $18,932 in taxable income and $55,000 in Social Security benefits.

To find out how much tax they'll owe on their Social Security benefits, they have to calculate their "Provisional Income," which is $18,932 plus half of Social Security ($27,500) or $46,432. (Pay close attention to what comes next. This is like following the path of a pea between three walnut shells.)

By statute, for the first $32,000 in Provisional Income, no Social Security benefits are taxable. For each dollar of PI between $32,000 and $44,000, $0.50 of Social Security benefits is taxable (0.5 x $12,000 = $6,000), and for each dollar of PI above $44,000, $0.85 of benefits is taxable (0.85 x $2,432 = $2,068), until 85% of benefits is taxable, which is the maximum. So, $8,068 of the Smiths' Social Security is taxable.

The Smith's adjusted gross income is therefore $18,932 plus $8,068 or $27,000. That happens to be the same as their household standard deduction under the Tax Cut and Jobs Act of 2017. So they owe no income tax for the year.

There's lots more in Reichenstein's book—about minimizing Medicare surcharges, converting traditional IRAs to Roth IRAs at opportune times, deciding whether a retiree or an heir should pay the taxes due on tax-deferred assets—than we can summarize here.

LifeYield and Keebler & Associates

To compare Reichenstein's methods with those of other practitioners in the field, *RIJ* talked with two senior executives at **LifeYield**, a software-as-a-service company that shows advisers how to make retirement distributions more tax-efficient.

Sharry

"We follow the conventional wisdom," said Jack Sharry, the chief marketing officer. "But we also maintain the client's asset allocation. Our software optimizes for asset location and makes recommendations consistent with overall theory."

"We hit the cash target each year and align the portfolio to the household allocation. We don't let the allocation drift," Tom Prior, executive vice president for Advisor Support, told *RIJ*.

"We quantify the tax benefit of each trade, looking at the most beneficial, then the next most beneficial. It's not a one-off process," he said. "Improvements are added each year, which makes the adviser-client relationship stickier. We also create a tax efficiency score for each household. The average is 53%."

As for converting traditional tax-deferred IRAs to tax-free Roth IRAs, Prior said, "We find that a lot of people talk about it but not a lot do it" after seeing the high initial tax cost of conversion. It's important to see tax decisions within the context of the whole household's finance, Sharry and Prior stressed.

Grant Keebler of **Keebler and Associates, LLC**, a tax advisory firm led by Robert Keebler, CPA, in Green Bay, WI, told *RIJ* that the conventional drawdown wisdom "is the easy and generally correct advice. However, we've proven mathematically that a mix of strategies can produce a better result."

In a recent **slide presentation**, the Keeblers demonstrated just how multi-dimensional the tax-minimization task can be. To find the best strategy in a given year, an adviser must consider at least four dimensions of every client: Age (under RMD age or older), wealth and income (low, middle, high or ultra-high), retirement accounts (taxable, tax-deferred and Roth), and tax brackets (10%, 12%, 22%, 24%, 32%, 35% and 37% for 2020).

That's preliminary to minimizing the impact of Medicare surcharges, to finding opportunities for Roth conversions, to considering risk tolerance, or to determining whether it's cheaper, tax-wise, for a retiree or her heirs to pay the tax on tax-deferred accounts. For the most complex cases, of course, guidance from a Certified Public Accountant (CPA) will probably be necessary.

After-Retirement – Top Annual Checklist Items

- Manage income tax brackets
- Select high-basis securities to sell first
- Manage taxation of Social Security benefits
- Aggressively harvest outside portfolio losses
- Monitor Asset Location
- Tax efficient use of annuities
- Target charitable gifts
- Monitor the 3.8% Medicare "surtax"

Source: Keebler & Associates, LLC.

The bottom line: Taxes irk retirees, perhaps even more than they irk younger people. The more money and the more types of accounts that a client has, it seems safe to say, the more he or she needs a tax-efficient drawdown strategy. All of which creates opportunities for advisers to do good and do well by helping retirees maximize not just their annual income but also their legacies.