

# Retirement Income: Which Accounts to Tap First

**Eric R. Bartok, CIMA, CRPC**  
**Managing Director - Investments**  
**Oppenheimer & Co. Inc.**

205 Town Center Drive  
Suite 260  
Virginia Beach, VA 23462

757-493-5374

Eric.Bartok@opco.com



–Elaine Floyd, CFP

**Many people assume that when retirement rolls around, they should draw cash from their taxable accounts first. Generally, this is a good idea; but not always.**

A basic tenet of tax planning is to put off paying taxes for as long as possible. By investing money rather than turning it over immediately to Uncle Sam, you can earn returns that are yours to keep; tax deferral becomes like a loan that actually pays interest to the borrower. This is why IRA rollovers are such a great idea—you can keep deferring the taxes on your retirement distributions and put that money to work in investments, rather than losing a chunk to current taxes.

For many people, in fact, the idea of tax deferral is so appealing that, when the time comes to start taking retirement income, they draw from taxable accounts first to keep tax-deferred accounts growing for as long as possible. But while this strategy may be appropriate for some, it's by no means a rule of thumb.

When deciding which retirement accounts you should tap first, you'll need to consider not just the character of the account itself—taxable, tax-deferred, or tax-free—but also the particular investments within each account. These investments, in turn, relate to your risk tolerance, time horizon, and income needs.

## Cash bucket

The first order of business is to create a cash bucket that contains anywhere from two to five years of living expenses in safe, liquid investments such as money market funds, Treasury bills, short-term bonds, or CDs. If you know where your next few years of mortgage payments and groceries are coming from, you are far better equipped to tolerate the volatility that can go along with a diversified portfolio.

Make sure you set aside whatever size cushion you think you need before laying the foundation for your retirement portfolio. With each passing year, you'll need to replenish that bucket. At that time, you'll need to decide which securities to liquidate and which accounts to draw from.

## The downside of tax deferral

The downside of tax deferral as it relates to IRAs, unfortunately, is that it can't go on forever. You must start taking required minimum distributions at age 70-1/2 and the larger the account, the larger the distributions—and the tax—will be. Prior to age 70-1/2, you can calibrate your withdrawals to strike an optimal balance between having enough income live on and not

paying an excessive amount of tax. After age 70-1/2, you may no longer have this control. If the account is very large, the required distribution could throw you into a higher tax bracket, forcing you to pay more tax than if you'd drawn down the account earlier and paid some of the tax sooner but at a lower rate.

For example, let's say you receive a lump sum distribution of \$800,000 at age 62 and roll it into an IRA. Over the next eight years, the account grows at a compound annual rate of 8% to \$1.5 million. When you turn 70-1/2, your first required distribution will be \$88,235. (We're assuming you are single for simplicity's sake.) This jump in income could force you into the 24% tax bracket, requiring you to pay more tax than if you'd started siphoning money out of the IRA earlier. If, between the ages of 62 and 70, you had taken voluntary distributions in an amount that just topped out the 12% tax bracket—say around \$30,000 per year—you might pay less total tax than if you'd let the money ride. It's a question of paying tax at the 12% rate now, or at the 24% rate later. By siphoning off money this way, you would have about \$1.25 million at age 70-1/2 and your first required distribution would be closer to \$65,000 than \$88,000.

## Investments matter

It is possible, of course, to achieve tax deferral in a taxable account. One way is to buy growth stocks and hold them. So if your risk tolerance can handle it, you could conceivably turn the taxable account into the tax-deferral vehicle and draw income from the IRA. If you have plenty of assets and won't need to sell the growth stocks during your lifetime, your heirs will be happy, since they will receive a step-up in basis and owe no capital gains tax on the appreciation earned during your lifetime.

If you are sitting on big gains in stocks you don't want to sell, this could be a powerful reason to take income from the IRA. Beneficiaries must pay income tax on inherited IRA assets, and if your children are successful in their own right, they may end up paying federal tax at the top rate. If your portfolio of stocks stands to be a more valuable legacy than a fat IRA, you may want to

draw from the IRA and pay taxes at the (presumably) lower tax bracket while saving low-basis stocks for last.

But let's say you are very risk-averse and you want mostly income-oriented investments, such as bonds and high-dividend-paying stocks. If you are already earning taxable income in the taxable account, you might as well use that for your retirement income in order to reduce or postpone taking taxable distributions from the IRA (as long as you are under 70-1/2 and have the choice, of course).

For example, let's say that, in addition to an \$800,000 IRA, you also have \$800,000 in a taxable account, all invested in securities yielding about 6%, or \$48,000 per year. Even if that income is reinvested, you will pay tax on it, so you might as well use it for your spending needs while letting the IRA assets ride. When investing for income in the taxable account, you will have to determine whether the income should be taxable or tax-free depending on your tax bracket and investment objectives.

## Save Roth for last

The argument in favor of siphoning money out of an IRA account early doesn't apply to the Roth IRA because of one very important feature: no required minimum distributions at age 70-1/2. Since you never have to pay the piper on Roth money, you'll definitely want to let it ride as long as possible, even into the next generation.

One of the most important areas of retirement counseling is deciding if you can or should convert to a Roth IRA. Once a Roth IRA has been established, the only real reason to take money out is if you need the income and have no other resources. You may also want to consult with a financial professional to assess all your options. The three-year window closes.

## Watch for legal and regulatory changes

Of course, you may have to make course corrections as new rules and legislation take effect. The main consideration, of course, is your individual situation.

There's no magic formula for planning retirement income. You must take into account your income needs, tax situation, risk tolerance, life expectancy, and estate planning needs, and continue to work throughout retirement to ensure all your needs are met.

(Note: the scenarios presented here are hypothetical and the rates of return used are not indicative of any actual investment, which will fluctuate and may lose value.)

---

*Elaine Floyd, CFP®, is the Director of Retirement and Life Planning, Horseshmouth, LLC., where she focuses on helping people understand the practical and technical aspects of retirement income planning.*