Beating Conventional Wisdom Using Roth IRAs

May 2017 • William Reichenstein, William Meyer

In our last article, we explained why tax-deferred accounts (TDAs), such as traditional IRAs are best viewed as partnerships with the government. The government effectively owns a percentage of your current principal—the marginal tax rate in the withdrawal year. Thus, a tax-efficient withdrawal strategy requires a retiree to time the withdrawals of her funds from tax-deferred accounts or time the conversions of her funds into tax-exempt Roth accounts so that she minimizes the average marginal tax rate on these accounts.

In contrast, the largest financial services firms and all financial planning software packages encourage retirees to withdraw funds in retirement by following the conventional wisdom: The retiree withdraws all funds from her taxable accounts until exhausted, then from her TDAs until exhausted, then from her tax-exempt Roths. A retiree following that strategy would generally be in relatively low tax brackets in the early years when funds are being withdrawn from the taxable account.

Withdrawals from taxable accounts are generally mostly, if not entirely, tax-free withdrawals of principal. But the retiree would be in relatively high tax brackets in the middle years when her funds are being withdrawn from TDAs. And finally, in her late years when all her funds are

being removed from Roths, this retiree would likely have an adjusted gross income (AGI) of $0.

We used an example from our article with a co-author that showed how a retiree of moderate wealth could add more than three years of longevity to her financial portfolio by moving TDA conversions and withdrawals from the high-tax-bracket middle years to the lower-bracket early and late years.

In that paper we wrote with Kirsten Cook, "Tax-Efficient Withdrawal Strategies," from the March/April 2015 issue of *Financial Analysts Journal*, we made several simplifying assumptions, including one that said the retiree's marginal tax rate was also her tax bracket. In reality, there are several reasons the marginal tax rate may exceed her tax bracket: 1) Her Social Security benefits are taxed. 2) She faces an increase in Medicare premiums as her income rises. 3) She must pay net investment income tax. 4) She must pay a Medicare surtax. 5) Her itemized deductions are eliminated and her personal exemption is phased out as her income rises.

For moderate and average-net-worth households, the largest factor is the taxation of Social Security benefits, while the largest factor for high-net-worth households is often the increase in Medicare premiums.

In this article, we explain how the taxation of Social Security benefits causes marginal tax rates to exceed the tax bracket. We then present an example that illustrates how the taxation of Social Security benefits can affect an average-wealth household.

Taxation of Social Security

The taxable portion of Social Security benefits depends on a household's provisional income (PI). For most retirees, this income includes everything in the adjusted gross income except the taxable portion of Social Security plus half of the Social Security benefits plus tax-exempt interest. For singles, no Social Security benefits are taxable if the provisional income is below $25,000. For most singles, if provisional income is above $25,000 then taxable benefits total the lesser of a) 50 cents for each dollar of PI between $25,000 and $34,000 plus 85 cents for each dollar above $34,000 or b) 85% of Social Security benefits. The formula for couples filing jointly is the same except the threshold amounts are $32,000 and $44,000.

We've noted in past papers that the taxation of Social Security benefits results in a substantial hump (a rise and then a fall) in the marginal tax rate as additional withdrawals are made from tax-deferred accounts. For many households, there is a wide range of income wherein every time a retiree withdraws an additional $1 from a TDA it causes an extra $0.50 or $0.85 of Social Security benefits to be taxed. Table 1 shows tax brackets and marginal tax rates for many single or married households.

Initially, this household is in the 15% tax bracket and its provisional income is below the first threshold amount. Thus, its marginal tax rate is also 15%. When PI rises above the first threshold, then each dollar withdrawn from the tax-deferred account causes another 50 cents of Social Security benefits to be taxable. Thus, taxable income rises by $1.50, and 15% of $1.50 is $0.225 for a 22.5% marginal tax rate. When the provisional income rises above the second threshold amount, each dollar withdrawal from a tax-deferred account causes an additional 85

cents of Social Security benefits to be taxed.
Thus, the taxable income rises to $1.85. The marginal tax rate is 27.75%, ($1.85 x 15%). When the tax bracket rises to 25%, the marginal tax rate rises to 46.25%, ($1.85 x 25%). Eventually, 85% of Social Security benefits are taxed, which is the maximum. At this point, the household's marginal tax rate falls to the tax bracket of 25%, because additional TDA withdrawals would not increase the taxable portion of Social Security benefits.

TABLE 1

TAX BRACKET	15%	15%	15%	25%	25%
Rise in taxable income	$1	$1.50	$1.85	$1.85	$1
Marginal tax rate	15%	22.5%	27.75%	46.25%	25%

TABLE 2

	LONGEVITY	TOTAL VALUE
Our Strategy	36	$2,735,924
Conventional Wisdom (taking Social Security benefits at 70)	30	$2,516,152
Conventional wisdom (taking Social Security benefits at 62)	30	$2,401,100

Case Study

Let's show how the taxation of Social Security benefits can affect a retiree's optimal withdrawal strategy. Peggy, a single, turns 62 on December 2, 2017. She has $400,000 in a taxable account (with a cost basis of $400,000) and $600,000 in a tax-deferred account. She will spend $6,200 per month and, for simplicity, we assume there is no inflation, so her tax brackets, standard deduction and personal exemption will not change. Her life expectancy is 100 and her primary insurance amount is $2,400. Also, for simplicity we assume she lives in Texas, where we can ignore state taxes (note, though, that state taxes are built into the software at www.incomesolver.com).

Table 2 summarizes the results from three combinations of Social Security claiming strategies and withdrawal strategies.

In one scenario, Peggy begins Social Security benefits at 62 and withdraws funds following the conventional wisdom (exhausting non-qualified money first, then tax-deferred accounts). The portfolio lasts 30 years. After her portfolio is exhausted, Peggy's spending is limited to her $21,360 in Social Security benefits.

In the second scenario, Peggy delays the start of Social Security benefits until 70 but otherwise withdraws funds following the conventional wisdom. Her portfolio lasts 30 years. After it is exhausted, her spending is limited to Social Security benefits of $37,632. This explains why this strategy's total value exceeds the first strategy's total value.

In the third strategy, however—the one we recommend—Peggy not only delays the start of Social Security benefits until 70 but also does something different with the tax-deferred

accounts. Until 2023, after which the taxable account is exhausted, she converts sufficient funds from the tax-deferred account into a Roth to take her taxable ordinary income to just under the top of the 15% tax bracket and then withdraws additional funds from her taxable account to meet her spending needs. (She receives some qualified dividends and long-term capital gains that take her taxable income above the top of the 15% bracket, but these amounts are taxed at the preferential rate of 15%.) Beginning in 2024, she starts to withdraw funds from the TDA—enough to take her taxable income to just below the top of the 15% tax bracket—then withdraws additional funds from her (tax-free) Roth. This portfolio lasts 36 years. After it is exhausted, her spending is limited to her Social Security benefits of $37,632.

This portfolio lasts an additional six years beyond the other strategies. How did it beat the second strategy, where the retiree put off Social Security benefits until 70 but otherwise followed the conventional wisdom? It's because in the latter, taxes are $0 through 2023 because interest, dividends and capital gains on assets held in taxable accounts are less than her standard deduction and personal exemption—but beginning in 2024, she has fallen into the 25% tax bracket. Moreover, from 2026 when required minimum distributions begin and she first receives 12 months of Social Security benefits and each year thereafter until her portfolio runs out, she has more than $30,500 of tax-deferred account withdrawals that are taxed at a 46.25% federal marginal tax rate (25% x 1.85). From 2026 until her portfolio runs out, 85% of her Social Security benefits are taxed.

In our strategy, Peggy never pays more than 15% on her income. From 2026—her first full year of Social Security benefits—until her portfolio is exhausted, she has slightly less than 50% of her Social Security benefits taxed. So, in these years, most of her TDA withdrawals are taxed at a marginal tax rate of 27.75%, (15% x $1.85), but she avoids the 46.25% marginal tax rate.

In the conventional wisdom strategy (taking Social Security benefits at age 70), from 2024 through 2047 Peggy is in the 25% tax bracket and from 2026 to 2046 she has more than $30,500 of her TDA withdrawals taxed at a 46.25% federal marginal tax rate.

In our strategy, by contrast, she converts funds each year through 2023 from her TDA to a Roth to essentially fill the 15% tax bracket. By doing this, she is able to reduce her required minimum distributions. This allows her to avoid having any tax-deferred account withdrawals taxed at higher than a marginal tax rate of 27.75%.

Conclusion

The good news is that financial advisors can use financial software to help add substantial value to their clients' accounts. The bad news is that, because of the complexities of the tax code and the need to take these complexities into account, we believe proper analysis requires specialized and detailed software if we are to find the best withdrawal strategy. In other words, it is far too difficult for you to determine the best withdrawal strategy by yourself or with existing software packages that only consider a few rules of thumb. Instead, we believe you will need to rely on software to help with your analysis to develop a good strategy.

It is clear that you can add a lot of value to baby boomers by helping them coordinate their

Social Security claiming strategy and their withdrawal strategy in retirement. But a conventional wisdom withdrawal strategy will almost always leave a lot of money on the table.

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