



Ruminations on Tax-Efficient Spend-Down

Optimizing distributions from accounts can improve outcomes in two situations. The first issue is how to spend down a portfolio in retirement when the portfolio is comprised of Traditional IRA-type assets with little to no basis, Roth IRA-type assets, and assets in a taxable account. The second situation is when an individual is inheriting an IRA and needs to determine under what method to take the RMDs (Required Minimum Distributions). For simplicity throughout, “IRA” means any accounts with Traditional IRA-type tax treatment, “Roth” indicates accounts with tax-free withdrawals, and “Taxable” means, well, taxable accounts.

Optimal Spending Order for Accounts with Different Tax Treatments

What spending order is optimal for a retiree who is older than 59½ having three types of accounts: a taxable account, a Roth IRA, and a traditional IRA with no basis?

The default order is:

- 1) Taxable (preserves tax deferral in the other accounts)
- 2) IRA (no RMDs on the Roth, so this reduces future RMDs by taking the funds now)
- 3) Roth

In other words, the taxable account should be exhausted before drawing down the IRA which in turn should be exhausted before drawing upon the Roth. There are exceptions to the default order however:

- 1) If there is a taxable estate, spend the IRA first. The income taxes paid on the withdrawals are no longer in the gross estate to be estate taxed. Inheritors of IRD property (which this is) do get an income tax deduction for estate taxes attributable to the amount of the withdrawal. This is a deduction (not reduced by 2% of AGI, but still on the Schedule A), not a credit. Thus this helps mitigate the effect of paying estate taxes on the income taxes that will be paid in the future, but it does not make it equivalent. Short answer – it still makes sense to spend the IRA first if there is a taxable estate.
- 2) If the heirs are in a lower tax bracket, spend the Roth before the traditional IRA. It is better to have the heirs pay taxes on withdrawals at a lower rate.
- 3) If the income tax bracket is expected to decrease, spend the Roth first, leaving the IRA withdrawals for when they will be taxed less.
- 4) To the extent the assets in the taxable account have a low basis and/or the owner's life expectancy is short, it may be prudent to leave the assets untouched for a step-up in basis rather than sell them to live on.

Frequently, several of the exceptions may apply simultaneously giving conflicting recommendations. For example, if exceptions 1 and 2 both apply (taxable estate *and* heirs in a lower tax bracket), the decision must be worked out, and it is complicated. It depends on the degree of difference in the respective income tax rates, the probable withdrawal schedule, etc.

Optimal RMDs from Inherited Retirement Accounts

The table below shows three categories of heirs (the rows) and the distribution options available when the decedent has passed away either before or after their RBD (Required Beginning Date).

(Technical note: The RBD is generally April 1st of the year following the year in which the owner turns 70½, but there is an exception for someone who is still working, if they own less than 5% of the employer, and if the retirement plan is tax advantaged but not an IRA. In that case, RMDs may be delayed until actual retirement.)

Required Minimum Distributions		
Beneficiary	Before RBD	After RBD
Spouse	1, 3, 4, or 6	1, 3, or 5
Other Individual	2 or 4	2 or 5
Non-Individual	4	5
Distribution Options: <ol style="list-style-type: none"> 1. Rollover to beneficiary's own IRA 2. Take distributions over the non-recalculated life expectancy of beneficiary 3. Take distributions over the recalculated life expectancy of beneficiary 4. Distribute 100% within 5 years after year of death 5. Continue on decedent's existing payout schedule without recalculation of life expectancy 6. Take no distributions until the year the decedent would have attained 70.5 		

About 95% of the time (while I made up that statistic, it is approximately correct) the optimal solution is to roll over IRAs to the spouse's own IRA (option 1) or take distributions over the heir's life expectancy (option 2). This is so common that many times even financial advisors may not realize there are other options that are more advantageous. The defaults normally work because the heir is usually younger than the decedent and, if a spouse, older than 59½. Here are the exceptions:

- 1) If the decedent at the time of death was younger than the beneficiary spouse and had not yet reached the RBD, do option 6. Then, when the decedent would have been 70½, change to option 1.
- 2) If the beneficiary spouse needs funds from the IRA prior to reaching 59½, do option 3. Then, when the beneficiary spouse turns 59½, change to option 1.
- 3) If both the decedent *and* the beneficiary are beyond the RBD, and the beneficiary is older than the decedent, do option 5. The RMD under option 5 will be lower initially than under option 1. However, this will change eventually (the amounts of the RMDs cross at some point because one life expectancy is recalculating and the other is not), and at that crossover point, the beneficiary should switch to option 1.

Option 4 is the emergency bailout option when RMDs were missed the first few years. Given the 50% penalty for not taking RMDs, withdrawing everything prior to the end of the 5th year might make sense.

Notes:

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This report was originally written in July, 2009 and was last reviewed/updated in January, 2010.

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