How to create tax-efficient income in retirement

Robert Powell, Special to USA TODAY | April 13, 2015

It's not what you earn, but — as the old adage goes — what you keep.

And that's an especially important phrase to live by in retirement. During your golden years, when income might be scarce, you ought to draw money from your various investment accounts in the most tax-efficient manner possible. Otherwise, you risk spending less on your lifestyle and more on taxes for Uncle Sam.

"I think 'tax alpha' is one of the most overlooked aspects of investing," says David Blanchett, the head of retirement research for Morningstar Investment Management in Chicago and co-author of *Alpha, Beta, and Now…Gamma.* "Too many investors focus on picking great funds without understanding how tax-efficient the fund really is, or how to generate income in a tax-efficient manner in retirement."

So what's the best way to go about creating tax-efficient income in retirement?

Experts say there are several rules of thumb. But before you blindly follow this or that rule, you ought to become familiar with how different types of assets and accounts are taxed and at what rate.

First, interest income, non-qualified dividends, short-term capital gains, rents and royalty income, income from qualified retirement plans (your defined benefit pension and 401(k) plan), income from non-qualified deferred annuities, and income from IRAs will be taxed as ordinary income at rates ranging from 10% to 39.6% in 2015. Earned income from wages and/or self-employment and, in some cases, Social Security will also be taxed as ordinary income.

Second, qualified dividends and long-term capital gains will be taxed as long-term capital gains at rates ranging from 0% to 20%.

And third, tax-exempt interest income, life insurance, income from certain qualified retirement plans — the Roth IRA and Roth 401(k) — are generally not taxed at all.

The general rule of thumb. In terms of order, the most oft-cited rule of thumb would have you fill up your tax brackets with money from taxable accounts (dividends and capital gains, for instance) first, then income from traditional retirement accounts (distributions from a 401(k) plan and/or IRA), and finally income from Roth IRAs and Roth 401(k)s.

"The idea being that you should hold onto your most tax-efficient assets to minimize 'tax drag,' which is the reduction in the realized return of an investment if you have to pay gains on the taxes annually," Blanchett says.

Exceptions to the rule. Truth be told, the order in which you actually draw down assets ultimately depends on whether you've got earned income or not, and whether you're taking Social Security and, if so, whether you're younger or older than full retirement age.

For instance, if you're at full retirement age and older, and you file a joint return, and you and your spouse have a combined income (from earned income, interest, dividends and other taxable income — say, a distribution from an IRA) that is $32,000 to $44,000, you may have to pay income tax on up to 50% of your benefits and if more than $44,000, up to 85% of your benefits may be taxable.

So, to avoid what Blanchett calls the tax torpedo, it might make sense to withdraw money from a Roth IRA or other tax-free accounts instead of your taxable or tax-deferred accounts to minimize the potential taxation on Social Security benefits.

For his part, William Raabe, a professor at the University of Wisconsin in Whitewater, says another way to avoid the tax torpedo is to delay taking Social Security until age 70 and withdraw money from your taxable and tax-deferred accounts to make up whatever income you would have received from Social Security.

The benefit of doing this: You increase your Social Security benefit by 8% per year, and you'll likely reduce the tax bill on your required minimum distributions after age 70½, Raabe says. This could be an especially useful tactic if you have a large IRA where the required distributions starting at age 70½ would push you into a higher tax bracket than in prior years.

Diversify your accounts. The best order for taking funds from your accounts will also depend on whether you have all the accounts – taxable, tax-deferred and tax-free accounts, such as a Roth IRA – in place to create the most tax-efficient stream of income in retirement.

"People need a diversity of accounts to accomplish this," Raabe says.

So, if you don't have a Roth IRA or taxable accounts, do so now.

Robert Keebler, a partner with Keebler & Associates in Green Bay, Wis., recommends converting some of your traditional IRA into a Roth IRA from ages 50 and 62 – depending on what you're trying to accomplish – before claiming Social Security.

The reason: You want the option of being able to withdraw money from whatever account makes the most tax-sense, especially when you're collecting Social Security and might also have earned income. "Though this has to be balanced with all the typical parameters, restrictions and cautions, on Roth conversions," Keebler says.

You could also establish, if you don't have any, taxable accounts during retirement. Raabe, for instance, recommends taking earlier-than-required withdrawals from your IRA while you're in a lower tax bracket than you might be later in retirement and putting the money into a taxable account for use later.

Locate your assets in the right accounts. Blanchett also recommends putting your assets that make the most sense, tax-wise. "Asset location is just recognizing that different assets vary in their tax efficiency, as do different types of accounts," he says. "For example, bonds are usually less tax-efficient than stocks, and so you should try and hold more bonds in your tax-advantaged accounts and more stocks in your taxable accounts."

Again, this is just a general rule, and there are obvious exceptions, Blanchett says. For instance, if you're holding a stock fund with a lot of turnover that could generate more taxes that you anticipate.

"When thinking about asset location, it's important to remember that your desired level of risk should drive your allocation," Blanchett says. "Not taxes. Taxes are important to think about from a realized return perspective, but you shouldn't take on more or less risk than you're comfortable with to avoid paying taxes."

Run what-if tax scenarios. To get a handle on all the moving parts and possible tax rates, project — perhaps with the help of a qualified professional — likely tax rates and tax bills for different spans of time: your pre-Social Security tax rate, your post-Social Security to age 70½ tax rate, your age 70½ to age 80 tax rate and then your age 80-plus tax rate.

"The critical thing is to establish a base case, and then you layer other alternatives on top of that," Keebler says.

By the way, don't worry if general rules of thumb don't apply to you and you need to create a customized retirement-income plan.

"On the drawdown, there's no doubt that there's a correlation between tax planning and Social Security planning," Keebler says. "However, it's so specific on a (person-by-person) basis we have not been able to come up with broad rules of thumb. … If there were these great rules of thumb, we would know that, and we would implement those."

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