

Drawing down retirement money

Upcoming conference to consider tax-efficient ways to manage withdrawal of assets

By Robert N. Gordon

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Over the past six months, I have done extensive research on the best ways to draw down assets to create retirement income, including looking at the effect of taxes on that process.

This is an important issue, as several studies have found that managing the drawdown process correctly can add years to the longevity of a retiree's savings.

In fact, I have been working with New York University's Leonard N. Stern School of Business in creating a one-day conference on the issue. The conference, which will be held May 1, will bring together all those who have published or commented on this topic.

The goal of the conference is to establish an algorithm that can be put into the public domain and will allow individuals to ascertain their most effective withdrawal strategy. At the very least, we expect to identify all the issues that could affect the decision, and rank them according to priority for inclusion.

We invite anyone interested in this topic to attend and participate.

Mathematical models of withdrawals have been in existence for more than a decade.

The first, by Cliff Ragsdale in 1994, illustrates that most retirees would be well-served by taking money from their taxable accounts before withdrawing from their tax-deferred accounts. This is especially true for those in higher income brackets, where there are fewer complications.

But the analysis becomes more complicated when devising an optimal withdrawal strategy for a specific individual, particularly for those without much taxable income before any withdrawals occur.

As an example, Social Security becomes taxable when retirees have "too much" taxable income. The interaction between taxable income and Social Security has been called "the tax torpedo."

Avoiding the torpedo led to the notion that some retirees should wait until age 70 to start taking Social Security benefits and draw down tax-deferred accounts before that date. At 70, they would switch to lower-taxed sources.

Subsequent work pointed out the possible benefit to those in lower tax brackets of tapping a bigger mix of taxed assets each year. The goal would be to receive some taxable income each year in order to take advantage of the lower tax brackets available for modest incomes.

A few practitioners have pointed out that academic models tend to ignore what happens to an investor's asset allocation after withdrawing all taxable account assets first. Because many financial advisers have long advocated that growth stocks be held outside retirement accounts and that bonds belong in tax-deferred vehicles, the conventional wisdom of first cashing out all taxable assets leaves the investor with no stocks and a tax-deferred fixed-income portfolio.

That certainly isn't what most advisers would recommend.

Coming up with an optimal withdrawal strategy, therefore, is complex. State taxes, for example, belong in a thorough analysis but may prove too complicated to incorporate.

Factoring in the fact that capital gains taxes are forgiven at death adds more complexity. Whatever comes out of the conference, I think that lot-by-lot identification of holdings in a taxable account can add value. Established algorithms make blanket assumptions as to the cost bases of all stocks and bonds held in such accounts.

Yet withdrawing funds by selling losing positions can be the most effective source of cash because such sales not only create no current tax but also create capital losses. The losses can allow an investor to take a gain elsewhere in the portfolio without depleting available cash by paying a tax.

And what about real estate, an asset many advisers ignore altogether? If many baby boomers wind up house-rich and cash-poor, reverse mortgages may become "the" financial tool of the coming decade.

Proceeds from a reverse mortgage would prove very tax-friendly, as the money received would have been borrowed and wouldn't have created taxable income.

While one's primary residence theoretically may be the most efficient asset to tap for income, retirees steer clear of borrowing against their homes for fear of losing them. But the non-recourse nature of reverse mortgages may allay fears that accompany leveraging the home, leading to more use of the product.

Given the complexity and choice, it is obvious that there is indeed more to be done in the area of tax-efficient withdrawal strategies. May 1 should prove interesting.

Robert N. Gordon is chief executive of Twenty-First Securities Corp., a New York-based brokerage firm. He can be reached at bob@twenty-first.com.