Tax strategy important for retirees

**Colin Kelton:** Please comment on the recommended order in which one should spend from the portfolio.

**Colleen Jaconetti:** We get this question a lot actually and when it comes to taking withdrawals from a portfolio we would recommend starting with required minimum distribution, or RMDs. And the reason why these are the first portfolio source to meet income needs is because they are required by law. So any investor, who owns a tax deferred account and is over 70 and a half, has to take these distributions. So we would recommend those be the first moneys used for spending.

After that we would then say start looking at your taxable portfolio. Maybe spend the interest dividends and capital gains distributions when any assets that you hold are in a taxable account. So these are the next source because they’re really taxed to the investor whether they spend them or reinvest them.

But if you would reinvest them and then you just spend them in three to six months, you actually can incur higher taxes to meet the spending need. Typically these two areas actually cover a lot of retiree spending needs. If the retiree still needs more money, we would then start selling assets from a taxable account. Obviously the whole goal here is minimize taxes. So if you would sell something at a loss, sell something at no gain or small gain, until the portfolio would be depleted.

And then once the taxable portfolio has been depleted, you really have a decision to make. Are you going to spend—within your tax-advantaged accounts you could have tax-deferred accounts, 401K, traditional IRA, as well as tax-free accounts such as Roth. And the primary driver here—of which account to spend from first—is really your tax bracket.

So you want to spend from your tax-deferred account when you think your tax rate will be the lowest. A lot of people really don’t know when their tax rate will be the lowest, so that can, at times, be a little bit challenging. But if for some reason you know right when you retire, you’re still having part-time income or things like that, you may want to consider delaying spending from your tax-deferred account because your income could be higher at this time. Maybe spend from the tax-free account first.

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Maria Bruno: What Colleen is alluding to is essentially tax diversification—much like asset allocation—having assets spread across, in this situation, different account types. So it would be taxable, tax deferred, and Roth.

So if you are nearing retirement for instance, you might have an opportunity to potentially direct future savings into different account types which would then give you flexibility when you are drawing on an annual basis to perhaps pick and choose or be more judicious in order to be tax efficient.

Colin Kelton: How should I think about taxes in the future? Typically if I think they’re going to be higher, do I assume they’re going to be higher?

Colleen Jaconetti: So, it’s really hard to know whether taxes will be higher or lower, right? Which is kind of where we were coming up with this tax diversification idea of, if you really don’t know if your taxes will be higher in the future or not, it doesn’t hurt to consider maybe if most of your taxes are in a tax-deferred account kind of maybe doing a partial Roth conversion or something like that because we really don’t know.

To be honest, one of the single largest expenses retirees will have, if the majority of their assets are in tax-deferred accounts, could be taxes. Required minimum distributions could be high enough that it could actually put them in a relatively high tax bracket.

Maria Bruno: And the thing that retirees face too is, because I remember in years of working with clients, we’re programmed to defer, defer, defer, which is excellent, but as we talked about then, you have to take these distributions and they’re fully taxable in most situations. So, couple that with Social Security, it could also trigger taxation of Social Security benefits. It could potentially trigger what we have today in terms of the Medicare tax, in terms of net investment income. So these are the things that when you’re in retirement you may not think about, where you are today maybe in early retirement, but then later these flows start coming in and they’re taxable and they could trigger taxes that maybe you didn’t think about.

My suggestion would be if you’re someone who is newly-retired before you hit 70 and a half, get a sense of what these RMDs might look like, and Social Security as well, and see whether it makes sense. Roth conversions in retirement are also still an option. For many people, that window before RMD kicks in would be a good window to start looking at that. I’m not saying that everyone should go run out and do a Roth conversion, but certainly think about whether there’s an opportunity to be a little bit more strategic now to help than later.

Colin Kelton: What’s the best way to improve the tax efficiency of an existing taxable account invested in both equity and fixed income funds? Colleen, can you touch on that?

Colleen Jaconetti: Sure. So really, it depends on what you’re holding today and what your marginal tax bracket is. So, you know, we would normally recommend, according to our asset location methodology, would say “Okay, let’s put tax-efficient investments in your taxable account,” meaning try to minimize the amount of taxes you’re going to pay. And then try to put tax in efficient assets—say taxable bond funds or actively managed equity funds—in a tax-advantaged account, so shelter those investments that you think would generate the highest income.

If you’re currently within your taxable account, if you’re in a high tax bracket, you have index equity funds and municipal bond funds, you may not need to do anything to improve the tax efficiency. If, on the other hand, you’re holding actively managed equity funds, high dividend paying funds, in order to get increased income from the portfolio, taxable bond funds outside, you may want to consider maybe moving the bond funds to municipal bonds or moving them inside tax-advantaged accounts.
On the equity side, if you’re holding those higher yielding stock funds, you may want to consider moving those more toward index equity. I would take one thing into account when you’re doing this though, pay attention to the tax implications.

**Maria Bruno:** A couple of ways you could get there would be one to direct dividends to maybe more tax-efficient accounts or maybe stagger out the liquidations over a couple of years. So be tax smart as you move to a more tax-efficient portfolio.

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