Case example on withdrawal strategies – Illustrating how a smart and tax efficient strategy can add to portfolio longevity

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Example

The couple begins Year 1 with $284,000 in a 401(k) and $119,250 in a Roth IRA. For simplicity, we will assume returns are 0% for each year, but the same conclusion would prevail no matter what the rate of return was. Each year for each withdrawal strategy, they spend $119,250 after taxes.

In withdrawal Strategy 1, the couple withdraws all funds from the 401(k) until it is exhausted and then all funds from the Roth IRA. In Year 1, they withdraw $142,000 from the 401(k) and it provides $119,250 after taxes.[1] The 401(k) balance is $142,000 after Year 1. In Year 2, they withdraw the remaining $142,000 from the 401(k) and it provides the $119,250 after taxes for that year. The 401(k) is exhausted after two years. In Year 3, they withdraw the $119,250 from the Roth IRA and it provides all funding for the third year. With Strategy 1, their portfolio lasts 3 years.

In withdrawal Strategy 2, the couple withdraws $89,000 each year from the 401(k) and $39,750 from the Roth IRA to meet their $119,250 spending goal. The $89,000 withdrawal from the 401(k) provides $79,500 after taxes, while the withdrawal from the Roth IRA provides $39,750 after taxes for a combined $119,250 after taxes. This portfolio last three years and there is $17,000 remaining in the 401(k) for the fourth year, $284,000 - $89,000*3. This $17,000 would be tax free and provide spending needs for 0.143 of the next year, $17,000/$119,250. Strategy 2 provided all funds for 3.143 years. Strategy 2 extends the portfolio by 0.143 years in this example.

If we developed an example for a longer horizon such as 30 years as frequently assumed in financial planning, the additional longevity from this one tax play would be about 1.5 years. There are other tax strategies besides the idea illustrated in this example. Altogether, tax efficient withdrawal strategies can add from 2 to 7 years to a portfolio's longevity.

The excel spreadsheet on the next page presents this example. At the end of first year in Strategy 2, the 401(k) contains $195,000 = $284,000 - $89,000. After Years 2 and 3, it contains $106,000 and $17,000.

[1]The excel model assumes the first $20,000 of withdrawals are tax free, which is slightly less than the sum of their standard deduction, two personal exemptions, and two deductions for being 65 or over. The next $17,000 of income is taxed at 10%. The next $52,000 of income is taxed at 15% and additional income is taxed at 25%. The $17,000 and $52,000 amounts correspond to the 2011 tax brackets for couples.

After Years 1 through 3, the Roth IRA contains $79,500 (that is, $119,250 - $39,750), $39,750, and $0. Since the $17,000 remaining in the 401(k) would be tax free in year 4, this portfolio lasts 3.143 years (3 + (17,000/118,250)). In Strategy 1, the 401(k) is exhausted after two years, and the Roth provides all funds for the third year. So, in Strategy 1 the portfolio lasts exactly 3 years.

		Roth	401(k)						
Withdrawal		119250	284000	Year 1	After-tax	Year 2	After-tax	Year 3	After-tax
location	Tax rate	Withdrawal	After tax	WD	amount	WD	amount	WD	amount
401(k)	0%	20000	20000	20000	20000	20000	20000	20000	20000
401(k)	10%	17000	15300	17000	15300	17000	15300	17000	15300
401(k)	15%	52000	44200	52000	44200	52000	44200	52000	44200
Roth	25%	53000	39750	39750	39750	39750	39750	39750	39750
		142000	119250			128750	119250	128750	119250
			401(k) end yr 1	195000		106000		17000	
		284000	Roth end yr 1	79500		39750		0	