(UBS)

How to manage taxes using a "spending waterfall"

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When raising funds for your retirement spending, it can be a challenge to decide which accounts to tap, and in which order, to raise cash without triggering higher taxes. The "Spending Waterfall" approach helps to streamline this process, empowering you to spread taxable income over time, smoothing out their tax burden throughout retirement. This approach can improve the after-tax growth potential and the longevity of your retirement plan.

A common approach retirees take to funding retirement spending is to defer taxable income as long as possible. This strategy aims to maximize tax-advantaged growth and preserve tax-free assets for heirs. Unfortunately, deferring taxes tends to create "tax torpedoes" for later retirement years, forcing families into higher tax brackets and reducing after-tax growth potential.

To help solve the challenge of tax-efficiently funding retirement spending, CIO has created a "Spending Waterfall" framework. This approach aims to streamline the decision-making process of withdrawing from different account types, with the goal of smoothing taxable income throughout retirement and thus improving after-tax growth potential. Using the spending waterfall, retirees aim to fill up lower tax brackets during low-tax years and stay out of higher tax brackets in high-tax years.

The optimal withdrawal sequence will vary for each retiree depending on spending needs, tax bracket, and the mix of taxable, tax-deferred, and tax-exempt assets. Below is a guide for implementation.

Implementing the spending waterfall

Your withdrawal choices affect both your retirement spending and the after-tax wealth you pass on to future generations. Therefore, it's important to align your withdrawal decisions with your financial goals, whether that's covering near-term expenses, ensuring long-term financial security, or leaving a legacy.

The Liquidity. Longevity. Legacy. framework can be a useful approach for balancing these different priorities and customizing the approach for your personal circumstances.

Here is a step-by-step process for implementing the spending waterfall. We recommend following these steps every year as you refill your Liquidity strategy (cash flow for short-term expenses).

1. Compare your planned spending to your expected income.
When refilling your Liquidity strategy each year, consider your cash flow needs for the next 3-5 years, including expected taxes, and compare these needs to your current Liquidity strategy funding.

Next, assess your expected income for the coming year. Start by totaling your guaranteed income sources such as Social Security, pensions, and annuities. To this figure, add the income you'll receive from required minimum distributions (RMDs) as well as interest and dividends in your taxable accounts. These cash flow sources are taxed whether you spend them or not, so they are a priority for covering your spending needs.

Take the amount of cash that you need to refill your Liquidity strategy and subtract the amount of your expected income. The difference will tell you how much cash you will need to raise from other sources, such as IRA withdrawals or selling taxable account investments.

2. Identify your "target" tax bracket
With your financial and tax advisors, estimate your taxable income in each of your remaining retirement years. Using this information, determine a target marginal income tax bracket that will help you spread your taxable income evenly over time. You may also want to factor in the risk that tax rates may increase in the future.

A financial plan can help guide this process and allow you to assess the potential value of different strategies such as partial Roth conversions to target this tax bracket each year.

Filling up your target tax bracket each year (and keeping taxable income out of the higher-than-target tax brackets) can help you smooth your tax liability and avoid costly spikes and "tax torpedoes"

3. Determine which assets to draw from next
If your spending needs are **below** your target income tax bracket, follow this list of priorities when meeting your spending needs while simultaneously filling up your target income tax bracket:

- First, take distributions from tax-deferred IRA and 401(k) accounts to fill up lower brackets.
- Next, look to tap into assets held in taxable accounts, prioritizing assets that can be sold without realizing gains.
- If you must realize gains, weigh the tax cost against the costs and risks of borrowing instead. When possible, avoid realizing short-term capital gains.
- If you still have room in your target bracket after covering spending, consider increasing your taxable income by implementing a partial Roth conversion.

If your spending needs are **above** your target tax bracket, consider these strategies to help avoid moving into higher brackets:

- Use tax-free Roth distributions to fund spending without pushing yourself into higher tax brackets.
- Use tax-free HSA distributions to cover qualified medical expenses.
- When selling taxable assets, avoid realizing short term capital gains, which are taxed as ordinary income.
- Harvest capital losses to offset gains; if losses exceed gains, up to $3,000 of the remaining losses can offset ordinary income if married filing jointly.

- Use qualified charitable distributions (QCDs) from your IRA to satisfy all or a portion of your RMDs without generating taxable income; no itemization required.

4. Review and adjust annually

Revisit your financial plan each year, especially if your spending needs or tax laws change.
There are many moving parts in the spending waterfall framework, but remember: The goal is not to optimize every dollar, just to smooth your income and tax rates over time. You do not need to fill your target tax bracket with precision each and every year. Don't let the pursuit of perfection get in the way of an effective, flexible strategy.

Conclusion

Being strategic about how you fund your retirement expenses can have a meaningful impact on your tax burden throughout retirement. Implementing a spending waterfall could help minimize your average marginal tax rate throughout retirement and therefore boost your after-tax growth potential. We recommend following these steps every year as you refill your short-term retirement funding strategy.

To learn more, read the latest Modern retirement monthly: Managing taxes with a "spending waterfall"

Also listen to this podcast: Top of the Morning: A "Spending waterfall" to fund your retirement lifestyle

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