Strategic Tax Planning – Part Two

Last quarter we discussed the role tax planning can play in maximizing long-term spendable wealth, focusing primarily on tax-smart *contribution* strategies. This quarter we will continue the tax-planning theme and look at how various tax-smart *withdrawal* strategies can impact long-term spendable wealth.

The term "diversification" has become synonymous with investment portfolios, yet it is not always used in the same context. In fact, we believe that the general concept of diversification can be applied to three distinct phases of the investment & wealth management process:

1) **Reduce risk by spreading out a portfolio among many investments.** *This is a widely accepted norm and easily achieved in most retirement accounts. We rarely come across an investment portfolio that is not diversified in this manner.*

2) **Increase risk-adjusted returns by investing in asset classes with low or negative correlations to each other.** *This is a core component of Modern Portfolio Theory and almost universally accepted by the academic community. We typically see this form of diversification in professionally managed accounts, but rarely see this in retirement plans or accounts at Broker/Dealers.*

3) **Maximize after-tax wealth by using all three tax-account types to strategically align contributions and withdrawals with tax bracket cliffs**. *This often goes unaddressed because investment advisors and CPAs both assume that it is in the other's purview. We rarely come across an investment portfolio that has been purposefully diversified from a tax standpoint.*

A quick review of the three major account types:

1) **Traditional (pre-tax):** tax deduction at time of contribution, grows tax-free, and withdrawals are fully taxable as income.
2) **Roth:** no tax deduction at time of contribution, grows tax-free, and no taxable income at withdrawal.
3) **Taxable:** almost always generates a small annual taxable income and/or gains regardless of withdrawals. When withdrawals are taken the *growth* on the original investment is taxed at Capital Gains rates *(lower than Income Tax rates).*

To illustrate, suppose you invested $100,000 and it grew to $200,000, at which point you withdraw the full amount:

Account Type	Withdrawal	Tax Liability	Effective Tax Rate	Net Spendable Wealth
Traditional	$200,000	$34,800	17%	$165,200
Roth	$200,000	$0	0%	$200,000
Taxable	$200,000	$1,612	1%	$198,388

**Effective Tax Rate uses 2023 MFJ tax brackets and assumes no additional income*

And if the $100,000 investment grows to $500,000 and is then withdrawn:

Account Type	Withdrawal	Tax Liability	Effective Tax Rate	Net Spendable Wealth
Traditional	$500,000	$118,789	24%	$381,211
Roth	$500,000	$0	0%	$500,000
Taxable	$500,000	$52,313	10%	$447,688

**Effective Tax Rate uses 2023 MFJ tax brackets and assumes no additional income*

While the charts only show the tax impact of withdrawals (without factoring the tax treatment of *contributions)*, they demonstrate the wide gap in Net Spendable Wealth depending on the account type from which withdrawals are taken. Importantly, tax rates do not increase in a linear fashion; rather there are jumps that we refer to as tax "cliffs", as they represent steep inclines in the tax a person owes on their *last* dollar of taxable income.

These tax rate "cliffs" are inherent in the progressive tax systems found in most capitalist economies. When Congress periodically enacts changes to the tax code, they inevitably change the location and sometimes the severity of these tax "cliffs", but they are never eliminated. Here are the "cliffs" in federal income tax brackets from recent decades.

1980	1990	2000	2010	2023
14-18%	15%	15%	10%	10%
21-28%	28%	28%	15%	12%
32-37%		31%	25%	22%
43-49%		36%	28%	24%
54-59%		40%	33%	32%
64-68%			35%	35%
70%				37%

From a planning standpoint this creates an interesting conundrum regarding future withdrawals; we know there will be tax "cliffs" but we don't know where they'll be or what they will look like. Even if we make basic assumptions such as "taxes will be higher in the future" we cannot predict whether that will lean towards higher or lower incomes, earned income vs capital gains, etc.

This "known unknown" of future tax rates leads to one inevitable conclusion: when the time comes to take withdrawals from your portfolio we want flexibility. The size of these tax "cliffs" can have an enormous impact on long-term spendable wealth, so we need to be prepared to take retirement income in the most tax-efficient way that future tax brackets will allow. Unfortunately, we do not know what those future tax brackets will look like, and since Congress typically changes the tax code at least once a decade, we are likely to face different tax "cliffs" even *during* retirement.

This is why diversification is critical. A portfolio that is 100% pre-tax provides no flexibility to minimize taxes during retirement. Conversely, a portfolio entirely in Roth and/or Taxable accounts missed out on years of valuable tax deductions prior to retirement. But building up wealth in all three account types let's us have our cake and eat it too. Here is an updated chart demonstrating $200,000 of withdrawals taken from a combination of all three major account types:

Account Type	Withdrawal	Tax Liability	Effective Tax Rate	Net Spendable Wealth
Traditional	$89,450	$10,294	12%	$79,156
Roth	$55,550	$0	0%	$55,550
Taxable	$55,000	$4,125	8%	$50,875
Total	**$200,000**	**$14,419**	**7%**	**$185,581**

**Effective Tax Rate uses 2023 MFJ tax brackets and assumes no additional income*

In the above scenario we still rely heavily on withdrawals from the Traditional (pre-tax) account, but by aligning those withdrawals up to the tax bracket "cliff" we are able to keep our total effective tax rate extremely low. Mathematically, if we compare it to the previous $200,000 withdrawal example, we reduced our pre-tax withdrawal by 55% but reduced the taxes owed on that withdrawal by 70%.

Put simply, the goal is to make pre-tax contributions when we are in higher marginal tax brackets, and make Roth/Taxable contributions when we are in lower ones. This allows us to enjoy the most lucrative of the deductions over time, yet end up with a *tax-diversified portfolio* when we begin taking withdrawals. As the chart above demonstrates, being strategic in how to take withdrawals from the various accounts can have an enormous impact on the resulting spendable wealth.

On both the contribution & withdrawal side of the coin the critical element is *planning*. Income & tax brackets both change over time. The type of contribution or withdrawal that made sense five or ten years ago is not necessarily the optimal choice today, and what makes sense today likely will not be the optimal choice a few years from now.