Confused About Withdrawing Retirement Savings?

A withdrawal hierarchy may help you achieve key goals

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As a retiree, you know that a successful retirement income plan requires a well-conceived investment strategy to help you meet your living costs and ensure that your savings last at least as long as you do. You also may understand the importance of settling on a withdrawal rate to support current expenses without drawing down your savings too quickly.

Another component of a retirement income plan, however, is also important: developing a strategy for tapping your retirement savings accounts and investments in the most efficient way possible. It's what professional advisers call a "retirement withdrawal hierarchy"—that is, a plan to help you decide from which accounts to take money first.

A retirement withdrawal hierarchy will help you achieve a key goal: By minimizing taxes and eliminating penalties on withdrawals over the course of your lifetime, you'll help to maximize the amount of money that's available to support you and perhaps your spouse for the rest of your lives.

During the past several months, a team of Fidelity tax and retirement experts has devoted hundreds of hours of research and statistical analysis to developing a retirement withdrawal hierarchy. What follows are savings withdrawal guidelines, backed by Fidelity expertise and research, to try to help you draw down your retirement savings in the most tax-efficient manner possible.

"When we looked closely at this issue, some relatively predictable patterns emerged," says Stephen D. Fisher, a tax attorney who is vice president and associate general counsel at Fidelity Management & Research Company, and who took the lead role in developing the guidelines. "You may end up with a good deal more money over your lifetime if your withdrawal choices reflect those patterns."

MAKING MINDFUL WITHDRAWAL DECISIONS
It's critical to enter each withdrawal transaction with your eyes wide open to the potential pitfalls as well as to the benefits that will accrue if you make the right moves.

You can avoid penalties for failing to meet minimum withdrawal requirements
Investors age 70 1/2 and older need to make sure that they take any minimum required distributions (MRDs) from their tax-advantaged accounts. Withdrawals are based on IRS life expectancy tables, and deductible (or pretax) contributions and

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any earnings that are distributed should be subject to income taxes. Failure to take MRDs by the applicable deadlines may result in a tax penalty of 50% of the amount not taken.

You'll help your remaining retirement savings last longer
Your withdrawal decisions can have a crucial impact on your portfolio's long-term prospects. "Maximizing the after-tax proceeds from all of your accounts does not necessarily mean that you should start by liquidating those assets that will generate the smallest tax liability," Fisher points out. "In some situations, that goal might require you to look beyond short-term factors such as your immediate tax bill to include factors such as the future after-tax returns in various accounts."

You might help your heirs
Investors who intend to leave behind sizable estates should consider how estate or other transfer taxes might affect their choices. "In some cases, estate planning considerations may outweigh other considerations and may lead you to formulate different withdrawal strategies," notes Hunter A. Payne, assistant general counsel at Fidelity Management & Research Company, who helped develop Fidelity's withdrawal guidelines.

You will preserve your investment strategy
Some withdrawals may have an impact on the balance of investments in your portfolio, so you should consider tailoring them to help maintain or restore that balance, which is crucial to your long-term financial security. In other cases, liquidations and withdrawals may skew your investment balances, leaving you with the need to rebalance afterward. "It's rarely worth sacrificing your asset allocation strategy to reduce your taxes," Payne says.

GUIDELINES FOR RETIREMENT WITHDRAWALS
Fidelity has developed a set of five guidelines to help you create and maintain your personal withdrawal hierarchy. Bear in mind that these are only rules of thumb, since there is no single order that is appropriate for all investors. Your ultimate decisions should reflect your personal circumstances and take into account any tradeoffs that may be necessary.

For now, reviewing the guidelines is a strong first step toward creating a strategy that makes sense for you. However, you may want to consult with a tax adviser to take into account your specific situation when formulating your own withdrawal strategy.

1. Take your minimum required distributions (MRDs). Make sure you know which accounts are due for such distributions and how large those distributions need to be, then meet the deadlines to avoid penalties.

2. Liquidate loss positions in taxable accounts. Some investments in your taxable accounts may be worth less than their tax basis (generally the amount you paid to acquire them). In addition to offsetting (netting) realized losses against realized gains, at the federal level you can usually use up to $3,000 ($1,500 for married couples filing separately) of net losses each year to offset ordinary income such as interest, salaries, and wages. What's more, you can carry over any excess losses for use in future years.

3. Sell assets in taxable accounts that will generate neither capital gains nor capital losses. Such assets might include money market funds or other cash-equivalent investments. You can withdraw just enough money to meet your income needs without needing to take out additional sums for taxes, therefore leaving more money in your account.

There are two caveats: First, be sure to leave a rainy-day fund of liquid investments intact so that you can meet short-term financial emergencies. Second, try to ensure that you can rebalance your portfolio to your target asset mix without generating capital gains. For example, you might achieve that by selling some growth investments in your tax-advantaged accounts and not generating an immediate tax liability.

"Rebalancing is a potential issue regardless of from which tier in the hierarchy you are taking retirement withdrawals," Fisher says. "But it's especially important when you target withdrawals from a particular asset class such as cash-equivalent investments."

4. Withdraw money from taxable accounts *or* tax-deferred accounts and investments funded with at least some non-deductible (or after-tax) contributions, such as variable annuities and traditional IRAs. Conventional wisdom calls for making withdrawals from taxable accounts before you tap any tax-deferred accounts. Fidelity's research has found that the choice depends on the circumstances, and in some cases, it might make more sense to tap the tax-deferred account first. Assuming there is a significant difference in the basis-to-value ratio of the assets to be liquidated in two accounts (in other words, the tax basis of the assets divided by their current value), the best tactic for choosing between these two types of withdrawals is often to liquidate the assets with the higher ratio. That is, the assets that have generated the smallest gain or the largest loss. If the basis-to-value ratio of the assets to be liquidated in each account is relatively low, such as in the case of significant investment gains, it often will be preferable to liquidate the assets in the taxable account. Conversely, if the basis-to-value ratio of the assets to be liquidated in each account is relatively high, such as in the case of immaterial gains, it may be preferable to liquidate assets in the tax-deferred account.

Note: Tax-deferred accounts are generally subject to certain aggregation requirements when allocating basis. Consult with your tax adviser for additional details.

When it comes time to withdraw from the taxable account, some other guidelines may be helpful. It usually makes sense to sell assets with long-term capital gains first, since they should be taxed at lower rates than short-term gains are. In addition, consider liquidating assets that are likely to generate smaller taxable gains.

Investors whose primary concern is estate planning might not be well served by this fourth guideline. In particular, such investors may want to avoid selling taxable assets that have risen significantly in value. Under current federal tax law, the cost basis (the adjusted purchase price of an asset assumed for calculating gains or losses) of taxable assets your heirs inherit usually equals the assets' market value when you die. That means they shouldn't have to pay taxes on gains that accrued during your lifetime, so selling such assets now might expose you, your estate, and/or your heirs to unnecessary tax liabilities.

Of course, you also should consult with your tax adviser for specific tax rules and tradeoffs for making withdrawals among these accounts.

5. Withdraw money from tax-deferred accounts funded with deductible (or pretax) contributions or tax-exempt accounts. The typical advice is to withdraw money from tax-deferred accounts funded with fully deductible (or pretax) contributions, such as a 401(k), before you touch the balance in a Roth IRA. That's because withdrawals from the Roth are tax-free at the federal level, provided certain requirements are met, so that you earn a higher after-tax return on that account.

In fact, it may not make much difference which account you tap first within this category, assuming all withdrawals from any tax-deferred accounts funded with fully deductible (or pretax) contributions are taxed at the same rate. When you withdraw money from the tax-deferred account funded with fully deductible (or pretax) contributions, you'll have to take out enough to cover taxes, which means you'll have less money continuing to grow on your behalf than if you had withdrawn a smaller sum from the potentially tax-exempt Roth.

Suppose you were in the 35% federal ordinary income tax bracket, wanted to obtain $60,000 of proceeds after the payment of federal income taxes, and had two accounts-one a tax-deferred traditional IRA valued at $92,308 and one a Roth IRA valued at $60,000. You could withdraw either $92,308 from the tax-deferred account funded with fully deductible contributions or $60,000 from the Roth. If you took the former approach, you would leave less money in your accounts ($60,000 in the Roth), but it would earn a (potentially) tax-free rate of return (for example, 8%). If you took the latter approach, you would leave more money in your accounts ($92,308 in the tax-deferred account), but it would earn a lower after-tax rate of return (5.2%-that is, the 8% pretax rate of return reduced by the 35% tax rate applicable to distributions).

That said, if you believe that, among other things, there will be significant future changes in tax rates, tax brackets, or your income, you may be better off liquidating one type of account within category No. 5 before another. For example, you might be more inclined to leave your Roth account intact if you thought your ordinary income tax rate was likely to rise in later years, increasing the value of the Roth's tax exemption.

Fidelity's retirement withdrawal guidelines won't always lead to the perfect withdrawal sequence for your retirement assets. "But the important thing is to be aware of the issues that arise when you make withdrawals," Fidelity's Fisher says. "Chances are, you'll end up much better off if you bear in mind these guidelines." Nonetheless, you should consider consulting with a tax adviser to formulate your own withdrawal strategy.

The Elements of Your Withdrawal Plan
Here are the different types of accounts that might play a role in your withdrawal plan:

- **Taxable accounts (conventional brokerage or mutual fund accounts, CDs, and savings and checking accounts).** Taxable accounts are funded with after-tax savings. Any interest, capital gains, dividends, and other earnings should be taxed in the year you realize them at either ordinary income or long-term capital gains rates.
- **Tax-deferred accounts funded with non-deductible (or after-tax) contributions (traditional IRAs and tax-deferred annuities).** This category includes certain retirement accounts that are funded with non-deductible (or after-tax) contributions but which should allow savers to defer taxes on their investment earnings.
- **Tax-deferred accounts funded with deductible (or pretax) contributions (401(k) and 403(b) plans, traditional IRAs, SEP-IRAs, and SIMPLE IRAs).** This category includes accounts funded with deductible (or pretax) contributions. Contributions and earnings should be taxed at ordinary income tax rates only when they are withdrawn from the account.
- **Tax-exempt accounts (Roth IRAs and, starting in 2006, Roth 401(k)s).** These accounts are funded with after-tax dollars. Withdrawals should be tax-free at the federal level provided certain conditions are met. Tax rules related to withdrawals vary at the state level.

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