Retirement Tax Planning: Common Rules Are Meant to Be Broken

When it comes to tax planning for retirement income, following the "rule of thumb" isn't always in the best interest of your clients.

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Now that most 2022 individual income tax returns have been filed, it's time for busy season's next phase—tax planning season. I think most CPAs and personal financial planners recognize now that tax planning is a year-round exercise for bringing added value to clients. Those of you who choose to formally offer tax planning by preparing deliverables to clients might agree with me that the market for tax planning is underserved and ripe for growth. The complexities of both variable compensation (including ordinary income and gains from equity compensation, as well as business owner income) and offsets (like deductions, exclusions, and credits) are too much for most clients to understand. This is especially true for retirement income tax planning. Admittedly, this is one of the most sought-after services my clients pursue, and because of the emotional and complex nature of the topic, it's one of the more meaningful ways I get to add value to my client relationships.

For more than a generation, it's been clear that some form of retirement income tax planning is appropriate for most taxpayers. That's because for at least that long, taxpayers' retirement income has been largely based on self-directed defined contribution plans, like IRAs and 401k plans, which feature more complicated withdrawal options than the traditional defined benefit pension plans of prior generations (thus, more tax planning opportunities). It's more complicated for at least three reasons.

1. These plans come in both tax-free (Roth) and tax-deferred (traditional) varieties.
2. There's investment volatility in these accounts.
3. There's a wide range of variability in withdrawal rates from these plans.

Of course, retirees must contend with annual required minimum distributions (RMDs) from most of these accounts, but there are no required maximum withdrawal rules.

In this environment, the common retirement income tax planning advice given has been something to the following effect: Take out the RMD, pay the income taxes, leave the balance in the tax-deferred account invested to provide growth, and spend after-tax investments to meet any remaining living expenses (net of pensions and Social Security) for the year.

In this example, the retiree pays a minimum amount of income taxes—at least in the earliest years of retirement—with the hope of growing the tax-deferred assets. This common rule may also result in an accelerated depletion of after-tax investments.

The issue I have with this common rule is that each client's situation is different. It's our duty as CPAs and financial planners to consider the hopes, expectations, and finances of our clients before giving any recommendations, because, like any rule of thumb, the common rule may break down under multiple scenarios.

For example, in an environment where individual income taxes are expected to rise on account of either higher marginal tax rates or smaller taxable income ranges, or both, then future larger IRA account balances will generate much larger income tax bills. Perhaps it might be more prudent to draw down more rather than less IRA money sooner, even paying more income taxes sooner, but at a lower marginal rate.

Likewise, if married spouses are following this common rule in the early years of their retirement and one of them later passes, the survivor will be thrown into an effectively higher tax bracket as a single filer (assuming no future marriages). They'd therefore pay meaningfully higher income taxes even if marginal tax rates remain the same.

Similarly, if a client was open to considering their children's finances in the decision-making process, especially when leaving a legacy of a generational inheritance, perhaps the client would prefer to pay more in taxes in order to leave as much tax-free wealth to their children as possible.

These are a few examples of how following the common rule in retirement income tax planning produces a less-than-optimal solution for clients.

In my own practice, I advise clients with what I think of as a "modified common rule" to retirement income planning: Take out the RMD plus as much additional distribution as will "fill" the taxpayers' marginal income tax bracket (or the next one or two, based on the taxpayers' anticipated future income tax rate), then pay the income taxes, etc. The benefit of this strategy is that it takes better advantage of clients' current income tax rates than the common rule strategy. Though, one cost of this strategy is that it potentially places clients who are on Medicare into a higher income bracket where the income-related monthly adjustment amount means their monthly Medicare premiums will increase for the year.

In academia, there's been a growing interest in identifying and quantifying the amount of income taxes saved by a taxpayer, or taxpayer and family, when CPAs and other advisors recommend tax planning strategies other than the common rule strategy. In 2022, James DiLellio of Pepperdine University and Andreas Simon of the University of Southern California described this process as "tax alpha" in an award-winning research paper, "Seeking Tax Alpha in Retirement Income." Through their findings, DiLellio and Simon concluded:

- Tax alpha can increase annual portfolio returns and/or extend portfolio life meaningfully.
- The larger the taxpayer's portfolio, the more the capture of tax alpha is relevant.
- A taxpayer looking to establish a relatively larger legacy for heirs should consider not just their marginal tax rate but the highest marginal tax rate of the heirs when determining how much, if any, taxable withdrawal to take from a traditional tax-deferred account in lieu of after-tax assets.
- A primary determinant in producing tax alpha is avoiding large taxable income spikes, which can occur when withdrawing only required distributions.

Fortunately, DiLellio and Simon recognize that income calculators should be employed by CPAs and financial planners. To that point, the authors have created a retirement income calculator that determines an optimal strategy for retirement income tax planning, taking into account some of the factors discussed above (e.g., spouses, ages, heirs, tax rates, etc.). Of course, there are other calculators like this in the marketplace. However, calculators offered by some of the larger financial firms, like Fidelity or Vanguard, fall short because they're based on the common rule strategy with little flexibility.

As you can see, there are multiple factors involved when advising clients on retirement income tax planning beyond the IRA or 401k RMD. From my perspective, it's too important to rely on some simple rules of thumb. My advice is to invest in the right software to increase the quality of your client advice. After all, aren't rules meant to be broken?