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Managing taxes with a "spending waterfall"

Modern retirement monthly

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- When it comes to raising funds for retirement spending, a common approach is to defer taxable income as long as possible. Deferring taxes tends to create "tax torpedoes" for later retirement years, forcing families into higher tax brackets and reducing after-tax growth potential.
- As we will show in this report, retirees can manage taxes by implementing a dynamic withdrawal strategy that spreads taxable income more evenly over time. This approach helps to defuse "tax torpedoes," filling up lower tax brackets in order to help avoid higher tax brackets.
- To help families raise cash while spreading taxable income over as many years as possible, we introduce a "spending waterfall" framework to streamline the decision-making process of how much to withdraw tax-efficiently from different account types.



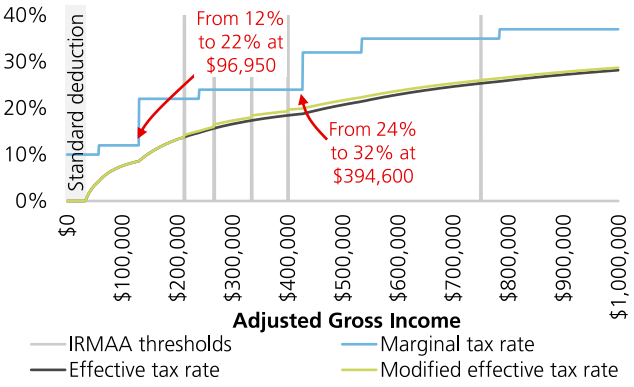
The order in which you draw from your retirement accounts can significantly impact your after-tax wealth and the longevity of your retirement plan.

One conventional approach is to spend taxable accounts first, then tax-deferred assets (e.g., Traditional IRAs and 401(k)s), and then tax-exempt assets (e.g., Roth IRAs, 401(k)s, and Health Savings Accounts). This simple strategy aims to maximize tax-advantaged growth and preserve tax-free assets for heirs, but it overlooks several opportunities that we will discuss in this report.

The benefit of smoothing taxable income

The US has a progressive income tax system, meaning that higher income in a given year is subject to higher marginal tax rates and a higher overall tax burden.

Fig. 1: Higher income triggers a higher tax rate
Marginal, effective, modified effective tax rates (including IRMAA surcharges), and IRMAA thresholds by adjusted gross income in 2025



Assumes a married couple filing jointly. Reflects 2025 federal income tax rates, does not include state income taxes. See the Appendix for more details on IRMAA income thresholds and amounts. Source: IRS, UBS.

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For example, a married couple filing jointly will pay about $322,000 in federal income taxes on $1 million of taxable income in a single year. If the couple can spread the $1 million of taxable income evenly over 10 years, their tax burden would be cut by more than 50% to $140,000, all things being equal.

In addition to federal income taxes, there are other costs that you will incur when you have a year of higher taxable income. For example, you will incur higher Medicare income-related monthly adjustment amounts (IRMAAs) on Medicare Part B and D premiums, reduce your access to health care subsidies under the Affordable Care Act, and trigger additional taxes such as the 3.8% Net Investment Income Tax.

Pushing taxable income into your later retirement years could also trigger the "widow's" penalty, where you face a higher income tax burden after your partner has passed away and you become a single tax filer.

In other words, "lumpy" income not only increases your marginal federal tax rate—it can also lead to a cascade of other costs and foregone benefits. For retirees, this underscores the importance of thinking strategically about how to withdraw from different types of accounts each year such that you smooth taxable income over time whenever possible.

Managing retirement account withdrawals

You can't defer taxes forever. You'll eventually need to take Required Minimum Distributions (RMDs) from your tax-deferred accounts, which are taxed as ordinary income.

The longer you delay tapping into your retirement accounts, the larger your RMDs will become, pushing you into higher tax brackets later in retirement. Therefore, it can be more effective to manage retirement account withdrawals and implement partial Roth conversions to keep your taxable income in a "Goldilocks" range over time—not too high, not too low.

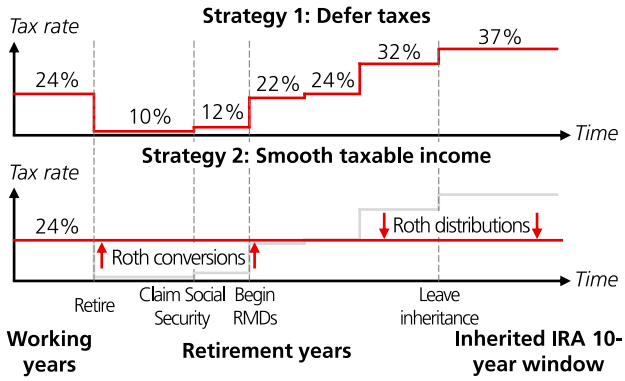
Every year that you have a lower taxable income is an opportunity to implement a partial Roth conversion at a lower tax cost. Roth conversions help to move assets from Traditional IRA/401(k) accounts to Roth IRA/401(k) accounts. Although the converted amount will be added to your taxable income for the year, future growth in the Roth accounts will be tax free.

By "filling up" lower tax brackets in years when you have lower taxable income, Roth conversions can help to reduce the tax impact of future RMDs.

With more Roth assets and smaller RMDs, it will be easier to stay out of higher tax brackets in years when you have higher taxable income from other sources.

Fig. 2: Spreading income over more tax years can help you to manage the tax burden

Comparison of two hypothetical retirees' marginal income tax brackets over time: one who defers taxable withdrawals as long as possible; and another who smooths withdrawals.



Assumes 2025 federal income tax rates only, no state income taxes.
Source: IRS, UBS

Introducing the "spending waterfall"

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.

To help you find an approach suited to your family's circumstances, we have developed a "spending waterfall" framework (see Figure 4, later in this report) that aims to help you minimize your average marginal tax rate throughout retirement and therefore boost your after-tax growth potential.

The spending waterfall framework works by informing how much of your cash flow needs should come from each account type, and then using other strategies—like partial Roth conversions—to fill up lower tax brackets, keep income out of higher brackets, and help improve the longevity of your retirement savings.

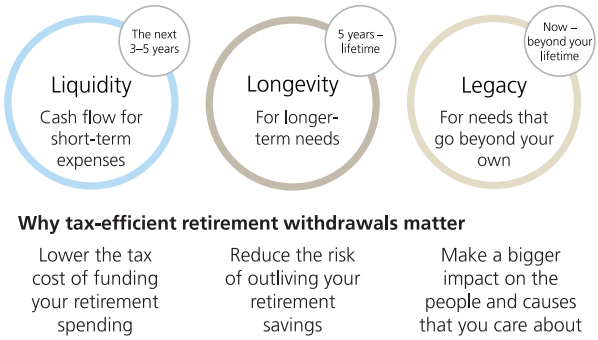
Implementing the spending waterfall

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.

Fig. 1: Managing retirement account taxes can help you achieve your goals

The Liquidity. Longevity. Legacy. framework



Source: UBS

Note: UBS Wealth Way is an approach incorporating Liquidity. Longevity. Legacy. strategies that UBS Financial Services Inc. and our Financial Advisors can use to assist clients in exploring and pursuing their wealth management needs and goals over different time frames. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved. All investments involve the risk of loss, including the risk of loss of the entire investment. Time frames may vary. Strategies are subject to individual client goals, objectives and suitability.

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.

#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. Figure 2, above, shows an example of what this process may look like.

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. The next page highlights some key considerations depending on where your spending needs (or, more specifically, the taxable income recognized when generating income for your spending needs) are relative to your targeted income tax bracket:

If your spending needs are **below** your target tax bracket, follow this list of priorities when meeting your spending needs while simultaneously filling up your target income tax bracket:

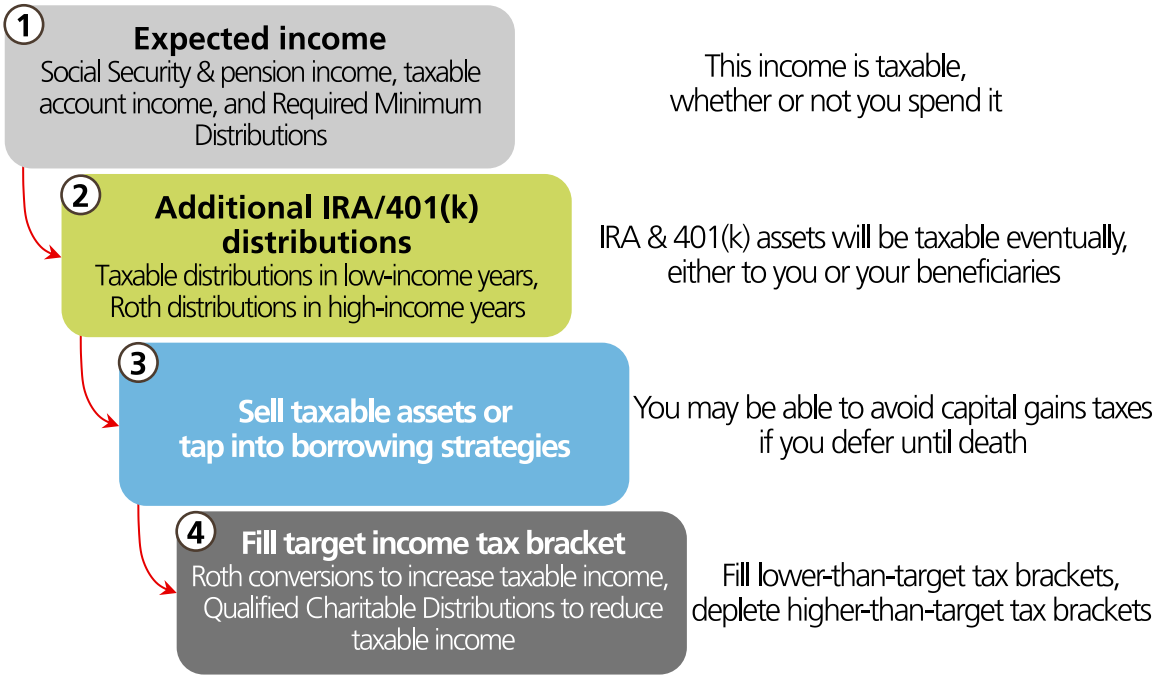
- First, take distributions from tax-deferred IRA and 401(k) accounts to fill up lower brackets.
- Next, look to tap into assets held in taxable accounts, prioritizing assets that can be sold without realizing gains.
- If you must realize gains, weigh the tax cost against the costs and risks of borrowing 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. See End note 1 for QCD rules and limitations.

Fig. 2: A "spending waterfall" can help you manage taxes

Suggested sequence of withdrawals to help improve tax efficiency



For illustration purposes. Source: UBS

Note: Be sure to use Health Savings Account (HSA) distributions to reimburse yourself in retirement for qualified health care costs. HSA distributions are tax-free when used for qualified medical expenses, but HSA funds inherited by a non-spouse beneficiary will usually lose their tax-exempt status.

#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.

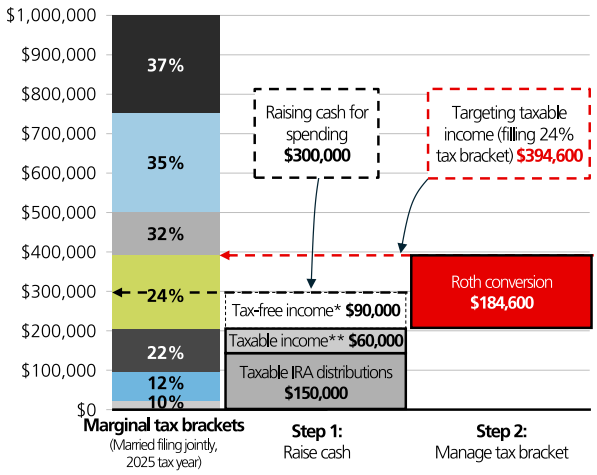
Case study

To illustrate how the spending waterfall and strategic withdrawals can help manage tax brackets in retirement, let's look at two hypothetical scenarios.

Scenario 1: Spending needs *below* the target tax bracket. Figure 5 illustrates how to coordinate different income sources—such as tax-free income (e.g., municipal bond interest), taxable income (like annuity income, interest, and non-qualified dividends), and taxable IRA distributions—to meet spending needs.

Fig. 3: The "spending waterfall" when you need to fill your target bracket

Example of raising funds while managing taxable income subject to ordinary income tax rates



For illustration purposes. *Income from municipal bonds and qualified dividends in taxable investment accounts. ** Income from interest and non-qualified dividends in taxable accounts. Source: UBS

Because these sources don't fully "fill" the target tax bracket, you have the opportunity to implement partial Roth conversions. By converting additional dollars up to the top of your target bracket, you pay taxes now at a lower rate, potentially reducing future RMDs and increasing your flexibility for tax-free income later in retirement.

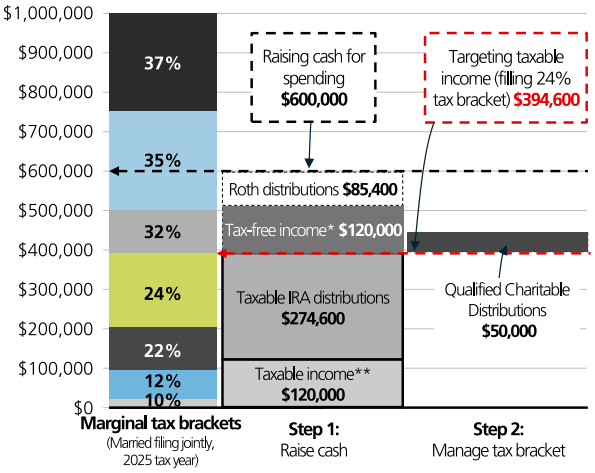
Scenario 2: Spending needs *above* the target tax bracket. Figure 6 shows income sources used for spending—taxable income, tax-free income, and taxable IRA distributions. In this scenario, the main challenge is avoiding higher tax brackets due to large withdrawals.

To manage this, you can use Roth distributions to fund spending needs without increasing taxable income.

Additionally, qualified charitable distributions (QCDs) from your IRA can be used to satisfy a portion of the RMDs while keeping your taxable income within the target tax bracket (Note: QCDs are excluded from taxable income; see End note 1 for QCD rules and limitations).

Fig. 4: The "spending waterfall" when you need to avoid higher brackets

Example of raising funds while managing taxable income subject to ordinary income tax rates



For illustration purposes. *Income from municipal bonds and qualified dividends in taxable investment accounts. ** Income from interest and non-qualified dividends in taxable accounts. Source: UBS

Note: A portion of your Social Security income may be taxable. For more details, please see the 2025 Tax fact sheet.

End notes

[1] There are some limitations for qualified charitable distributions (QCDs). For example, QCDs cannot be made to donor-advised funds or private foundations. In addition, QCDs are only an option if you are at least age 70½, can generally only be done with Traditional IRA assets, and cannot exceed $108,000 in 2025 (indexed for inflation). If you have a sizable IRA, you may not be able to use QCDs to fully eliminate your RMDs' tax costs. Additionally, if you are planning to make deductible contributions to your IRA during any tax year beginning with the year you turn age 70½, it's important to note that deductible contributions may reduce the portion of the QCDs that you're able to exclude from future taxes. The SECURE 2.0 Act expanded the IRA charitable distributions to allow for a one-time election of up to $54,000 (2025 limit, indexed for inflation) per individual to transfer via a qualified charitable distribution to a charitable gift annuity (CGA), charitable remainder unitrust (CRUT), or a charitable remainder annuity trust (CRAT). There are restrictions on the type of CRUTs and CRATs that can receive a QCD. For instance, they must be funded exclusively by the QCD.

Appendix

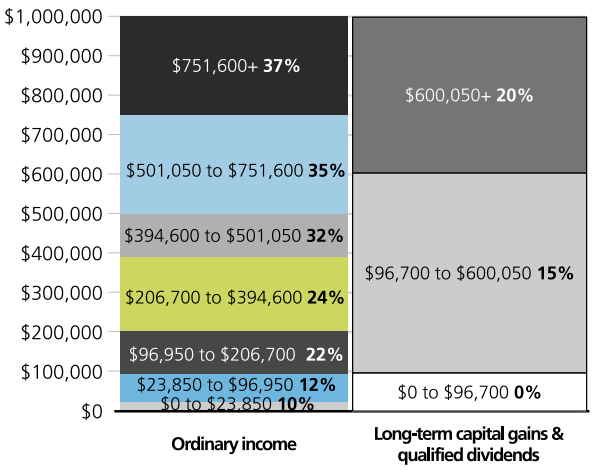
When planning retirement withdrawals, it's important to recognize that not all income is taxed the same way. **Ordinary income**—including wages, interest, pension payments, short-term capital gains, and withdrawals from traditional IRAs or 401(k)s—is taxed at your regular income tax rates, which increase as your total income rises.

In contrast, **qualified dividends** and **realized long-term capital gains**—profits from selling investments you've held for more than a year—are taxed at lower, preferential rates: typically 0%, 15%, or 20%, depending on your overall taxable income (Figure 7).

You may also have access to **tax-exempt income** from sources such as municipal bonds, return of capital distributions, cash value withdrawals from life insurance (generally tax-free up to basis), and proceeds from the sale of an investment's cost basis.

Fig. 5: Not all income is taxed the same way

2025 federal tax brackets and tax rates for ordinary income, long-term capital gains, and qualified dividends



Source: IRS, UBS

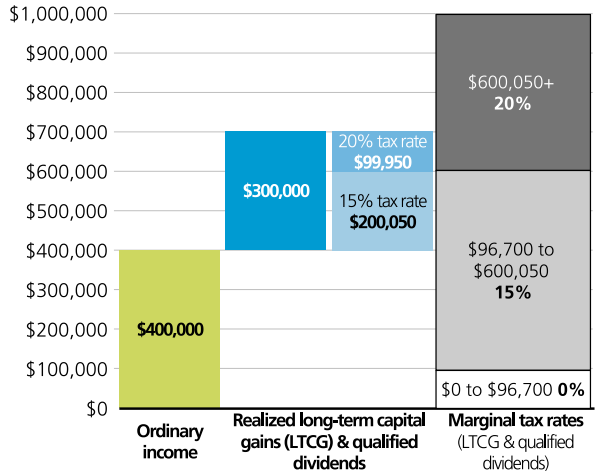
A key point to understand is that realized long-term capital gains and qualified dividends are "stacked" on top of your ordinary income when determining which capital gains tax rate applies. The IRS first fills up the ordinary income tax brackets, and then applies the long-term capital gains rates to any realized gains and qualified dividends above that level.

For example, as shown in Figure 8, if you are married filing jointly with $400,000 of ordinary income (after the standard deduction) and $300,000 in long-term capital gains, your ordinary income fills the lower tax brackets first. Your capital gains are then taxed starting at the point where your ordinary income ends—meaning you skip the 0% capital gains bracket and start at the 15% bracket.

The higher your ordinary income, the more likely your capital gains will be taxed at higher rates. While realizing more long-term capital gains increases your total taxable income, it does not push your ordinary income into a higher bracket. Understanding how these income types interact allows you to plan withdrawals more tax efficiently and keep more of your investment gains.

Fig. 6: Realized long-term capital gains and qualified dividends are taxed at preferential tax rates

Example of how a hypothetical investor's ordinary income, realized long-term capital gains (LTCG), and qualified dividends are taxed assuming 2025 federal tax rates



Source: IRS, UBS

The spending waterfall focuses on managing your ordinary income tax brackets, which is the priority for families with high levels of net worth and taxable income. For lower-income families (including those with significant savings in tax-exempt accounts), you may also want to consider "filling" lower capital gains tax brackets in lower income years, bearing in mind that LTCG and qualified dividends "stack" on top of ordinary income.

When weighing whether to realize capital gains, remember that it is possible to avoid some capital gains taxes altogether—for example, if you are able to defer capital gains until your heirs get a step-up in cost basis (or until you gift appreciated assets to a charity).

Fig. 7: Medicare Part B and D premium surcharges for individuals

Part B and D premiums (in $) and income-related monthly adjustment amounts (IRMAAs) according to your modified adjusted gross income (MAGI) from two years prior

Income in 2023 (2024 tax return)	2025 Part B premiums		2025 Part D premiums
Individual tax return	IRMAA	Total monthly premium	Your plan's monthly premium + IRMAA
0 – 106,000	0.00	185.00	your plan premium
106,000 – 133,000	74.00	259.00	+13.70
133,000 – 167,000	185.00	370.00	+35.30
167,000 – 200,000	295.80	480.80	+57.00
200,000 – 500,000	406.90	591.90	+78.60
>500,000	443.90	628.90	+85.80

Source: CMS, UBS

Fig. 8: Medicare Part B and D premium surcharges for married couples filing jointly

Part B and D premiums (in $) and income-related monthly adjustment amounts (IRMAAs) according to your modified adjusted gross income (MAGI) from two years prior. Both spouses will pay an IRMAA if they are both enrolled in Medicare and their combined income exceeds the thresholds.

Income in 2023 (2024 tax return)	2025 Part B premiums		2025 Part D premiums
Joint tax return	IRMAA	Total monthly premium	Your plan's monthly premium + IRMAA
0 – 212,000	0.00	185.00	your plan premium
212,000 – 266,000	74.00	259.00	+13.70
266,000 – 334,000	185.00	370.00	+35.30
334,000 – 400,000	295.80	480.80	+57.00
400,000 – 750,000	406.90	591.90	+78.60
>750,000	443.90	628.90	+85.80

Source: CMS, UBS

Appendix

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