

The Guide to Taxes and Your Retirement

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The good news is that many people are entering retirement with substantial monies in investment and retirement accounts to supplement Social Security. The bad news is that the rules about taking distributions from those accounts are complex, not well understood, and continually changing. As a result, retirees pay substantially more in taxes than they should, which is a shame, as most of these taxes could be avoided or reduced with proper planning.

If you have \$500,000 saved in a retirement account, that \$500,000 is more like \$390,000 if you are in the 32% tax bracket in retirement. Additionally, at age 73 you will have to take your required minimum distributions (RMDs) and pay income tax.

And this is not the only tax trap waiting for you when you retire. Any time you add additional income to your tax return—like withdrawals from retirement accounts—you are in danger of reducing certain benefits and increasing costs that are, in some way, tied to your income.

These tax traps have caught many off guard over the years, leading to needless taxation of their income and benefits. Don't let it happen to you. By looking ahead and planning now, you can take proactive steps to maximize the efficiency of your income in retirement and provide for beneficiaries, such as utilizing the Roth options in your 401(k) plan, exploring Roth IRA conversions, and engaging in retirement distribution optimization.

When and how you tap into your various accounts during your pre-retirement and retirement phases will dramatically affect the taxation of those accounts. There are four phases of your retirement to consider, each calling for different strategies and considerations.

1. Pre-retirement (40s and 50s)

In the decade or two prior to retirement, take advantage of tax deferral opportunities where appropriate and begin your retirement planning with a focus not just on accumulation, but also on managing taxes.

- ✓ Make the best possible use of retirement investment vehicles available to you through your employment with your long-term goals in mind
- ✓ Maximize your investments as the compounding effects of those monies will be substantial
- ✓ Understand what your tax picture will look like well before you retire so you can plan accordingly

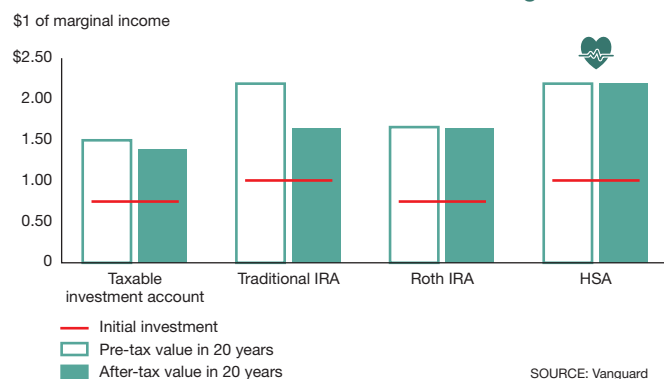
Create a plan. It is never too early to create a plan that takes into account future taxes and retirement distribution optimization. You and your financial advisor should project the growth of your account balances and consider the various account types (traditional IRA, Roth IRA, non-retirement account, etc.) to illustrate potential taxes in retirement. Start with the end in mind.

Consider the best use of employer retirement plans. Both a traditional and Roth 401(k) could have a place in your retirement nest egg and you need not choose between them. In fact, the best move may be to hedge your bets if your employer is one of the 50% of plan sponsors that offers both. With a Roth 401(k) you pay taxes up front—you contribute to your retirement account with after-tax monies. Once in the account, your money grows tax-deferred. Then at retirement, qualified withdrawals come out tax-free. Annual contributions are \$23,000 in 2024 plus \$7,500 more if you are 50 or over.

Roth IRAs and Roth conversions. A Roth IRA conversion allows an individual to transfer pre-tax dollars from a traditional IRA (or 401(k)) directly to a Roth IRA account. Anyone can perform a Roth conversion, regardless of income level. Taxes are paid on the converted dollars in the year of conversion, but thereafter, the assets grow tax-free and qualified distributions are tax-free. Equally important, there are no RMDs with a Roth IRA, thus helping to keep your income tax rates low and allowing the account to grow tax-free during your lifetime (and up to 10 years of your beneficiary's lifetime). For example, a 43-year-old gets a new job and decides to move \$150,000 from his 401(k) into a Roth IRA. He's in the 35% tax bracket, so he'll owe roughly \$47,500, which he'd be wise to pay with funds outside of the IRA. If he leaves the entire amount untouched in the Roth IRA and it grows at an annual rate of 7%, it will be worth \$1.14 million in 30 years (and it's all tax-free growth!).

Fund a health savings account for medical expenses in retirement. It's important to understand how to plan for medical costs, which are growing at 5% per year. Consider increasing contributions to your health savings accounts (HSAs), which enable tax-free spending on health care after age 65. An HSA's triple tax advantage—up-front tax deduction, tax-free growth, and tax-free withdrawals—makes it a top-notch way to save for retirement medical expenses. As the chart below indicates, the after-tax value of the HSA can be higher than all other retirement vehicles.

The favored tax status of HSAs can boost long-term savings



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You are able to contribute up to \$8,300 per year for a family if you are participating in a high-deductible medical plan, plus a \$1,000 catch up contribution if you are over 55. For individuals, the maximum is \$4,150 in 2024. You can use the money in the HSA for current health needs if you must, but letting it grow long term is the smarter choice. At age 65, the proceeds can be withdrawn tax-free for medical expenses, making it essentially a Roth IRA for medical expenses.

To qualify for an HSA, you must have a high-deductible health plan and no other health insurance. In addition, you are not allowed to fund an HSA if you are enrolled in Medicare, or if you can be claimed as a dependent on someone else's tax return. Therefore, plan to fund your HSA in these pre-retirement years.

Don't forget your long-term care insurance. First, you may find that long-term care premiums can be deductible at the federal and state levels. Second, payments from policies for reimbursement of LTC expenses are tax-free, so take advantage of that. Third, choosing where to take withdrawals for LTC costs from can have a big impact on your accounts, so consult with your financial advisor to avoid unnecessary complications. Finally, consider so-called hybrid policies (more on this later). All of these policies are tax advantaged and help to preserve assets.

Maximize your contributions to retirement plans to enjoy the compounding benefits later. Save early and often, the expression goes. In fact, investing an extra \$500 annually over 30 years with a 7% average annual rate of return would yield about \$47,000 in retirement savings. But, how to go about it, when all of the choices are dizzying? Consider a three-step approach. Contribute to your 401(k) up to the company match. Then fund your HSA to the maximum, if possible. Then, if you can afford it, contribute more to your 401(k), going to the maximum, including catch up contributions. If you have additional funds, consider funding a Roth IRA. And don't forget that some employer plans allow you to make additional after-tax 401(k) contributions up to a total of \$66,000, allowing even more opportunities to grow funds tax-free that can result in an expanded Roth nest egg in retirement.

Diversify your retirement savings. Now more than ever, consider tax diversification as a primary goal during these years leading up to retirement. Splitting your retirement savings among the following three accounts makes lots of sense. First, consider tax-deferred accounts such as 401(k)s or traditional IRAs where you make pre-tax contributions and are taxed on withdrawals in retirement. Second, consider tax-free retirement savings vehicles such as Roth 401(k)s, after-tax accounts and Roth IRAs where you contribute after tax dollars that can be withdrawn tax-free in retirement. Third, consider taxable accounts where you're taxed on interest, dividends and at the lower capital gains rate. Creating this type of tax diversification provides more flexibility regarding how much you withdraw in retirement and from where. Diverse savings are also essential if you plan to retire early, as monies can be withdrawn from those accounts without penalty and without paying taxes at your ordinary income tax rate.

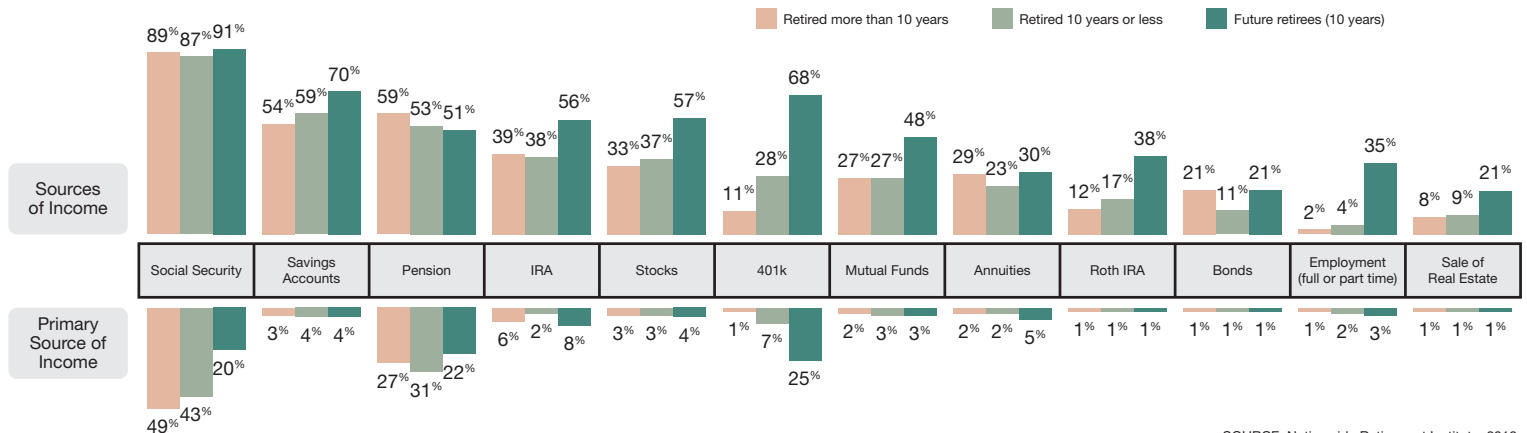
2. Early retirement (early 60s)

The early years of retirement present their own challenges. The important point here is that you have not started taking your RMDs and you may not be taking your Social Security yet, either. Therefore, your income is low, and you should be strategically approaching these years to maximize after-tax income.

Create a distribution optimization strategy. In retirement, you will probably have income from several sources, and that interplay can make withdrawals and your tax situation much more complicated. For example, withdrawing just a few dollars extra in any given year can trigger additional taxes on your Social Security and premium surcharges for Medicare, adding up to \$5,000 per year! This is the time to create a distribution optimization strategy with your financial advisor that analyzes your situation on a yearly basis and recommends a withdrawal strategy to maximize your income and minimize your taxes.

Social Security. Although it may be tempting to collect early benefits at age 62, there are lots of good reasons for most people to delay. Earnings after age 62 can still increase Social Security retirement benefits if they replace no- or low-earnings years. And, while you are working, you are likely not drawing down your assets.

Sources of income in retirement



SOURCE: Nationwide Retirement Institute, 2018.

Finally, your benefits will increase by 8% for each year you delay Social Security up to age 70 (prorated monthly). In most instances, it makes sense to delay the collection of Social Security until past full retirement age.

Health insurance options. With respect to health insurance, the optimal situation is continuing coverage offered by the employer with whom you or a spouse were last employed. While rare, some private employers and government entities do offer health insurance options to early retirees. For those who are unable to access their former employer's plan, in 2010 the Affordable Care Act (ACA) created the health insurance marketplace that is available to all regardless of pre-existing conditions. Yet the reality is that all of these options can be expensive, costing thousands of dollars annually until Medicare is available at age 65.

Roth conversions. Because your income is probably low, this is the time to consider partial Roth conversions. The idea here is to take advantage of the lower tax brackets, while “filling the tax bucket,” as discussed in the previous section. Partial Roth conversions during the pre-retirement years can set you up nicely with tax diversification that you will benefit from once you turn age 73, as you will not be required to take RMDs from these accounts.

Drawing down your retirement accounts. This is also the time to make crucial decisions regarding which accounts to draw down, particularly if you are delaying Social Security and require additional income. The traditional rule of thumb was to always protect the retirement accounts and draw down non-retirement accounts. However, after ten years of a bull market and people with retirement accounts worth \$1 million or more, the idea of drawing down non-retirement accounts will leave little flexibility at age 73 when it is time to take RMDs. Also, by drawing down the non-retirement accounts, the majority of future withdrawals will be from retirement accounts, triggering additional taxes and surcharges that are outside of your control. Working with your financial advisor and tax professional to create a distribution optimization strategy is absolutely critical during your 60s to prevent the higher tax bills that are otherwise sure to appear at age 73.

3. Middle retirement years (mid-60s through 73, when you start your IRA RMDs)

Many of the strategies discussed in the above section continue to make sense during your middle retirement years as well. In addition, as you get older, consider the following:

Medicare makes a difference. Medicare will likely become your primary payer when you turn age 65 (unless you are still working and covered by an employer group with over 20 employees). You must follow strict deadlines in order for Medicare and your supplemental insurance to take effect. And once you are enrolled in Medicare, your work does not stop there. You should periodically review your coverage and your supplemental plans to confirm that you have the coverage you need and are not paying too much in premiums. And remember, you need to keep saving for medical expenses in retirement, as Medicare does not cover a number of expenses, and also does not cover long-term care expenses.

Focus in on Social Security. When you have reached age 67, or full retirement age (FRA), it is time to consider taking Social Security. That is because you are now eligible to receive your full, unreduced primary insurance amount. If you delay the onset of benefits past FRA, you will earn delayed credits. In fact, by waiting until age 70 to apply, you can increase your benefit by up to \$1,000 per month. And don't forget that widowhood and divorce also affect the collection of benefits. The best way to determine the optimal time to collect Social Security is to have a complete analysis of you and your spouse's retirement income needs, which will show projected income streams based on the various claiming ages.

Continue practicing tax diversification. In a tax year where income is high, perhaps favor withdrawals from the Roth IRA to lessen taxable income. But, in years where income is low, perhaps favor withdrawals from traditional IRA accounts. In addition, by aggressively withdrawing from traditional IRA accounts in low tax years, fewer assets will be growing in those accounts and thus less money will be subject to dreaded RMDs down the road.

These strategies should all be discussed with your financial advisor and tax professional.

4. Later years in retirement (after age 73)

Once you reach age 73, you will be required to take withdrawals from your traditional IRA, annuities, and in most instances, your employer sponsored retirement plans. These are the RMDs, or required minimum distributions we have mentioned above. There are very few opportunities to reduce your RMDs, which typically require close to a 4% withdrawal in the first year and increase steadily after that.

Each year the percentage you must withdraw from your IRA increases, and with a growing account balance, that means your taxes will likely also increase as well. That is why it is so crucial to plan for this moment during the previous three phases of retirement. But there are still some strategies to employ during this later stage of retirement.

IRS Uniform Lifetime Table—Figure 1

RMD Age	Distribution Period	% of Balance	RMD Age	Distribution Period	% of Balance
73	26.5	3.78	82	18.5	5.41
74	25.5	3.93	83	17.7	5.65
75	24.6	4.07	84	16.8	5.96
76	23.7	4.22	85	16.0	6.25
77	22.9	4.37	86	15.2	6.58
78	22.0	4.55	87	14.4	6.95
79	21.1	4.74	88	13.7	7.30
80	20.2	4.96	89	12.9	7.76
81	19.4	5.16	90	12.2	8.20

Source: IRS

Tax-efficient charitable planning. The qualified charitable distribution (QCD) allows those age 70½ or older to donate money directly to charities from their IRAs in a tax-advantaged manner. Total annual QCDs from all IRAs cannot exceed \$105,000 (adjusted for inflation in 2024) for an individual. Making a QCD as opposed to

a normal charitable gift has two main advantages:

- ✓ A QCD counts toward satisfying the individual's required minimum distribution (RMD) for that year. (Note: The QCD must be done before the RMD is taken.)
- ✓ The distribution is excluded from the taxpayer's income, thus reducing the likelihood of other taxes being levied, such as on Social Security and Medicare premiums.

With very few individuals expected to itemize, the income tax deduction for contributions to charities will be lost for many people. However, you do not need to itemize to benefit from making a QCD, as you will still get a full exclusion of that money from taxes.

Step-up basis strategy. Consider locating assets to benefit from capital gains and capital losses. For example, let's consider a married couple: Phil and Mary. They have investments in a joint tenant account, positions with long-term capital gains of \$120,000, and positions with total capital losses of \$30,000. Unfortunately, Phil has been diagnosed with a terminal illness and will soon die. Phil and Mary have two options, the first being doing nothing. In this option, Phil dies and as a result there is a step-up in basis of \$60,000 (half of \$120,000 gain), tax on the remaining \$60,000 if sold, as well as step-down in the basis of \$15,000 (half of \$30,000 losses) which eliminates \$15,000 that could offset future gains.

The second option is to transfer assets to two individual accounts, one for Phil and one for Mary, assuming Phil lives for one year after the transfer. Phil's account will contain the positions with gains while Mary's account will contain the positions with the losses. After Phil dies, there would be a step-up in the basis of \$120,000 on gains which Mary can sell and pay no tax on, and Mary's \$30,000 of losses would help to offset future capital gains. When compared, option two is a far better option because it would save Mary over \$11,000 in taxes.

Beware the widow's penalty. Your tax filing status can hurt you, particularly after the death of a loved one. Consider the case of Jeff and Roberta, a happily married couple. In the year of 2022, they had taxable income of \$50,000 and a tax bill of around \$6,500. Unfortunately, Jeff dies on December 31, 2023 and Roberta files on her own in 2024. There are no changes in income, but because she can no longer file jointly, her tax bill will be higher, and in this case closer to \$8,000. Once survivors are required to use a single filing status, they are quickly faced with the possibilities of an increased

tax bracket, increases in Medicare premiums, increases in Medicare surcharges, and increased Social Security taxation, just to name a few. If you have a dependent child, the penalty may not kick in for two years after the spouse's death.

Consider how you will pay for long-term care. In recent years, non-traditional long-term care policies called "hybrids" that blend together some long-term care (LTC) insurance and life insurance have become popular. Often, the first inclination is to tap the policy to pay for long-term care costs, but that's often a tax mistake. Florence, a widowed woman who qualifies for long-term care benefits, has yearly care costs of \$60,000. She pays little to no income tax during her last 5 years because of such large unreimbursed medical expense deductions.

She could use the insurance money to pay \$300,000 of expenses, leaving behind a tax-free life insurance benefit of \$200,000 and \$400,000 in an IRA that will be fully taxable to her heirs. Alternatively, she could use the IRA money to pay LTC expenses and leave behind \$500,000 of tax-free life insurance money and \$100,000 of taxable IRA money. Discuss with your advisor the best way to leave an inheritance.

Develop a retirement distribution optimization strategy

You must have a retirement tax strategy that manages your assets for an "optimal drawdown" so you pay as few taxes as necessary. And this strategy should be revisited each year in retirement.

In order to minimize tax payments in retirement, it is a good idea to practice tax diversification, that is, maintaining accounts in the three major tax categories: taxable, tax-deferred and Roth. By maintaining accounts in all three categories, you can consider withdrawal sequencing on a year-by-year basis, staying flexible about where you draw income from, depending on your situation for the year.

As you can see, there is a lot more to retirement than simply collecting Social Security and taking a monthly distribution from your accounts. But, armed with knowledge and good professional advice, you can avoid high tax bills and preserve more of your hard-earned assets to enjoy for yourself and your family.