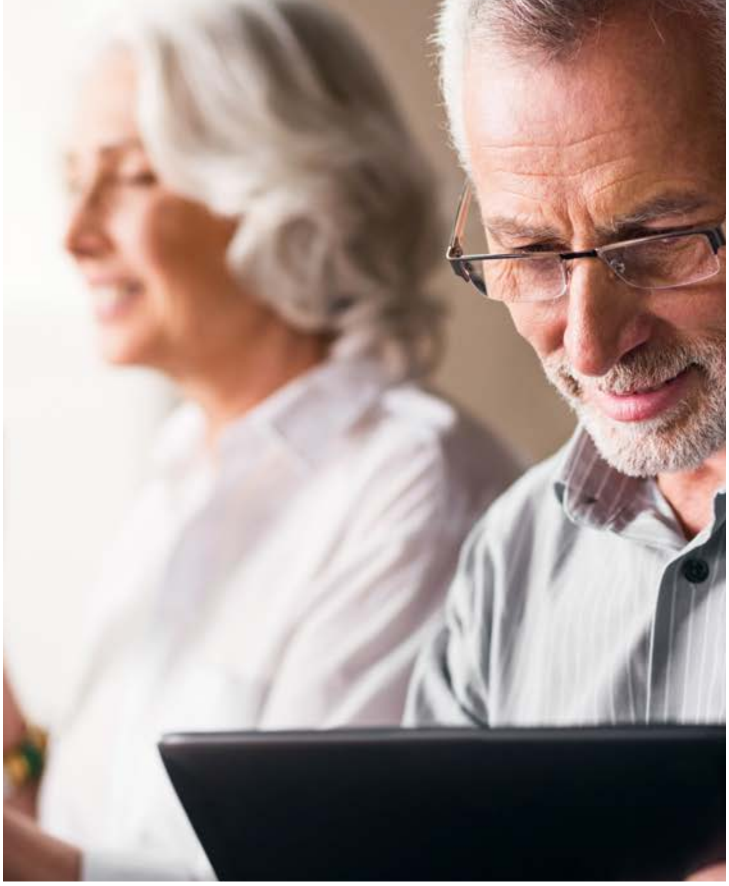

How to Enjoy Your Wealth in Retirement Without Spending it All on Taxes

How to Enjoy Your Wealth in Retirement

Without Spending It All on Taxes

It has been said that you don't know how much you have to be thankful for until you have to pay taxes on it. After a lifetime of hard work, no truer statement can be said about the wealth you've accumulated for retirement. So when you get ready to enjoy the fruits of your labor—seven day weekends, travel, golf, and grandkids—you want to make sure that you're keeping as much of your hard earned money as possible.

The key is to be proactive and maintain a long-term perspective. Taxes are inevitable—they fund our military, infrastructure, and other basic functions of the government. But working with an experienced financial advisor with a deep understanding of the tax code can make those checks to Uncle Sam much, much lower during retirement.

2020 Tax Brackets

Rate	Single	Joint Filing Married
10%	0 – 9,875	0 – 19,750
12%	9,875– 40,125	19,750 – 80,250
22%	40,125– 85,525	80,250 – 171,050
24%	85,525– 163,300	171,050 – 326,600
32%	163,300– 207,350	326,600– 414,700
35%	207,350– 518,400	414,700 – 622,050
37%	518,400 and over	622,050 and over

As you can see, higher income means higher tax rates. However, one thing many taxpayers fail to realize is that you don't pay the same percentage on all your income. We have a progressive tax system, which means that you progress through the brackets as you earn more income.

So even if you and your spouse are in the highest 37% tax bracket, you still only pay 10% on your first $19,750 of taxable income. Otherwise, earning one additional dollar over a given bracket would create dramatic swings in your tax liability and make tax planning nearly impossible.

Example: You and your spouse have $650,000 of taxable income.

Here's how your income tax liability is calculated:
$19,750- $0 = $ 19,750 x 10% = $1,975
$80,250 - $19,750 = $60,500 x 12% = $7,260
$171,050 - $80,250 = $90,800 x 22% = $19,976
$326,600 - $171,050 = $155,550 x 24% = $37,332
$414,700- $326,600 = $88,100 x 32% = $28,192
$622,050 - $414,700 = $207,350 x 35% = $72,572.50
$650,000 - $622,050 = $27,950 x 37% = $10,341.50
Total Tax $177,649

- You "only" pay 37% on the last $27,950 of taxable income.
- There are larger rate jumps between the 12% and 22% brackets, as well as the 24% and 32% brackets, which is particularly important for tax planning.

Retirement Income Sources and Taxability

Income sources throughout retirement vary widely among retirees. It depends on several factors throughout your working years: type of employers, number of employers, positions within each employer, tenure within each employer, states in which you worked, outside investments made, etc.

However, retirement income sources fall broadly into just a few categories:

Retirement Plan Accounts

This retirement income source includes the bulk of retirement savings accounts: 401(k), 403(b) ("TSA"), deferred compensation, 457, traditional IRA, Roth IRA, SEP-IRA, etc.

Typically, these accounts allow for tax-deductible contributions, which means you have to pay taxes on them when you make withdrawals. However, the most notable exception is the Roth IRA—there is no tax deduction for contributions, but distributions are tax-free. The same is true of the employee portion of Roth 401(k)s.

Investments

Many retirees have also put a significant amount of money into brokerage accounts, real estate investments, or interests in operational businesses. These investments produce dividends, rents, and business income that are taxed as earned.

As a result, it often makes sense to draw from these income sources first, delaying withdrawals from retirement plan accounts and allowing them to continue tax-free growth. However, income and/or distributions from these sources may be inconsistent, and the investments themselves may be less liquid.

Social Security

You pay into the social security program for your entire working life so that you can receive benefits in retirement. Full retirement age is between 66 and 67, depending on when you were born. You can choose to start reduced benefits early at 62, or you can choose to delay payments until 70 for increased benefits.

Taxability of social security benefits depends on your total income. If social security is your only source of income in retirement, then those benefits will probably not be taxable. Or you can choose to delay payments until 70 for an 8% increase in benefits each year.

Pensions

Although they are less common within the private sector, many federal and state employers offer some type of retirement benefit based on years of service and salary earned. Often there is a vesting period to create eligibility, but pensions can be a significant source of income for those with many years of service. Pension benefits are generally taxed as paid in retirement.

Tax Strategies in Retirement

Asset Location

Since investments grow tax-free within retirement accounts, it is more efficient from a tax perspective to keep income-producing investments (e.g. dividend-paying stocks and taxable bonds) in these tax deferred accounts, leaving growth stocks and other investments less likely to produce annual income in taxable accounts.

Example: You have a portfolio made up of a $500k IRA and $500k brokerage account with an asset allocation of 60% stocks and 40% bonds. Assume the stock positions are non-dividend paying and the bonds pay annual interest of 5%.

If each account has the same allocation as the overall portfolio (60/40), then it would produce taxable income of $10k ($200k bonds in the brokerage account x 5%), which would create a tax liability of $3,700 at the highest rates

IRA: $300k stocks, $200k bonds
Brokerage Account: $300k stocks, $200k bonds
Total Portfolio: $600k stocks, $400k bonds

However, if the entire bond allocation is located in the IRA, then the portfolio would produce no taxable income, saving $3,700 in taxes while maintaining the same overall portfolio allocation

IRA: $100k stocks, $400 bonds
Brokerage Account: $500k stocks
Total Portfolio: $600k stocks, $400k bonds

Tax Loss Harvesting

Each year, taxpayers can deduct up to $3,000 in capital losses from ordinary income on their tax return. However, this deduction cap represents a net number, so any capital gains can be offset with capital losses plus an additional $3,000.

As a result, it often makes sense to sell a loss position even when it still fits within your long-term investment strategy because you can re-purchase a similar security to fill that void in your portfolio. Wash-sale tax laws prevent you from selling and immediately repurchasing the exact same security, but the same effect can still be achieved.

Example: You sold a stock you inherited for a $25,000 capital gain, but you also have a position in SPY (State Street S&P 500 ETF) currently trading at a $28,000 loss. If you sell your position in SPY, realize the loss, and repurchase IVV (BlackRock S&P 500 ETF), you will completely eliminate the $25,000 gain, receive a current-year $3,000 capital loss, save $6,985 in taxes at the highest rates, and still maintain your long-term portfolio allocation.

Qualified Charitable Distributions

Once you reach the age of 70 ½ (increased to 72 under the SECURE Act), you must take required minimum distributions (RMDs) from most retirement plan accounts. The amount is based on your age and the balance of your account, but this requirement forces some retirees to withdraw funds before they are needed and prevents continued tax-free growth within the account.

However, often retirees in this position are also very charitable. So instead of taking the RMD and then making a charitable contribution, which would still count as an itemized deduction and lower taxable income, these retirees should make a qualified charitable distribution (QCD), which sends the distribution directly to the charity. This option fulfills the RMD obligation while keeping the distribution amount out of adjusted gross income calculation (AGI), which determines how much social security is taxable.

Example: You need to take a $50,000 RMD and plan on contributing $50,000 over the course of the year to your church. You and your spouse also have $34,000 in social security income.

- If you take a normal RMD and then contribute the money to your church, $25,550 of your $34,000 total social security benefits would be taxable.
- Instead, if you make a QCD directly to your church, none of your social security benefits would be taxable, saving about $5,500 in taxes.

Roth Conversions

Many retirees will have an income dip between their last working year and the first year of their RMDs, which provides a good opportunity to convert a traditional IRA to Roth. Since traditional IRA distributions are taxable and Roth distributions are not, the idea is to “fill in” lower tax brackets with Roth conversions during lower income years, reducing the overall tax liability throughout retirement.

Example: Before retirement, you and your spouse had taxable income of $400,000, and you do not project your income to reach that level again until RMDs start in five years. During that five-year period, you project your taxable income to be $300,000.

- Without Roth conversions, your RMDs will push you up to the 35% tax bracket.
- But if you implement Roth conversions, you can fill in the 24% bracket during those five lower income years with an extra $25,000, save $10,000 in taxes, and reduce future RMDs.

Other Considerations

- Deferral of first year RMD: You can defer your first year RMD as long as you double up in year two. However, if you are still employed at a high salary for most of that first year, you may save taxes by deferring your first distribution until year two when your total income will be much lower.
- Continued IRA contributions: The CARES Act removed maximum age for IRA contributions, so if you have earned income, you can continue to make contributions and take the tax deduction past age 70.5.
- Utilize Exchange Traded Funds (ETFs): Many investors prefer mutual funds because they have been around longer. But because of the way they are constructed, ETFs are more tax efficient by producing fewer capital gains distributions.
- Rethink Municipal Bonds: You always want to keep taxes in mind, but don't let the tax tail wag the investment dog. Many investors over-estimate the advantage of tax-free interest from muni bonds, so make sure they fit into your overall strategic investment allocation. If not, you may get a greater after-tax return on your money elsewhere.
- Self-Employed Pre-Retirees: When you are self-employed, there is greater flexibility with your retirement options. As a result, you can put away a significant amount of money in tax-advantaged accounts, which is especially advantageous if you are on the verge of retirement but still a higher earner. SEP and solo 401k contributions may allow you to push income out of high bracket working years and into low bracket retirement years.

Start Planning Now

When the tax bill comes, it will be too late. You'll wish you had put a plan in place to reduce taxes and allow you to keep more of your income in retirement.

So start now by scheduling a retirement income analysis meeting with your financial advisor—He or she can work with you to develop a custom tax strategy for your individual situation. And if your financial advisor does not have a deep knowledge of the tax code, make sure he or she works closely with your CPA and attorney.