

Tax Planning in Retirement: Strategies to Minimize Taxes When You Retire



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The transition from employment to retirement can be complex. For decades, you received either a regular paycheck or earnings from self-employment, and now that will slow or stop. To compound that, you'll be taking money *out* of all these accounts after putting so much effort into depositing money *in* them throughout your career.

Retirement-related behavioral and financial changes raise many tax planning questions and opportunities. In this article, we address the most common concerns for impending retirees and strategies to address those concerns. A trusted tax professional can help you effectively execute such strategies to help you minimize taxes in retirement, helping your money last longer and go further.

Common Concerns in Retirement

How much of your Social Security income will be taxable

How to plan for your annual taxable income and how to take advantage of “income timing” to accelerate or defer tax on income

How to plan for tax and income changes when you become a widow(er)

How to decide whether to convert Roth account savings (and how much to convert)

How to use deduction “bunching” to optimize tax savings by annually alternating itemized deductions with the standard deduction

Taxability of Social Security

How much of your Social Security income will be subject to tax is calculated based on half of your Social Security income, plus your income from other sources. We call this amount your “provisional income.”

Social Security benefits are taxed at one of three rates:

0% for provisional incomes under \$25,000 for individuals or \$32,000 for those married filing jointly (MFJ)

50% for provisional incomes of \$25,000 to \$34,000 individual or \$32,000 to \$44,000 MFJ

or 85% for provisional incomes greater than \$34,000 individual or \$44,000 MFJ

Social Security was designed as a safety net program that would *supplement* personal savings and possibly income from a pension. It was not intended to be most individuals' only source of retirement income. However, some people have not had or not taken the opportunity to save on their own, and guaranteed retirement pensions are fast becoming an endangered species, replaced by 401(k)-style plans.

Consequently, for many individuals, Social Security is their only source of income in retirement. If Social Security is your only source of retirement income in retirement, none or very little of it will be taxed.

If, however, you are expecting additional income in retirement – e.g., IRA or 401(k) distributions; interest, dividends, and capital gains from brokerage accounts; and/or pension income – either 50% or 85% of your Social Security income will be taxable. Note that this is the portion of your Social Security income that will be taxable – not the tax rate on the Social Security income.

To avoid owing taxes at filing time, you can withhold federal (but not state) income taxes from your monthly social security payments.

Without proper planning, retirees might also encounter the “tax torpedo.” The tax torpedo occurs when retirees realize additional income that increases the percentage of Social Security income that is taxable. This sometimes happens when you:

- Reach the age where you have to start taking required minimum distributions (RMDs) from your IRAs

- When your non-tax deferred brokerage accounts show significant capital gains

Or when you have to take a large unplanned distribution from a retirement account to pay for an unexpected expense (e.g., roof replacement, medical bills, etc.).

Annual tax planning with a year-round tax professional can help to both determine and plan for how much of your Social Security income will be taxable each year.

Can You Time How Much Income to Recognize Each Year?

Taxpayers encounter two types of income in retirement: fixed (Social Security, pensions, and annuities) and variable (investment accounts, traditional and Roth IRAs, 401(k) accounts).

The wonderful thing about fixed income is that it is a consistent income source; the downside is that it limits the available tax planning options.

Variable income, on the other hand, allows for income timing and tax planning opportunities such as:

Roth conversions

Qualified charitable distributions (QCDs)

Tax gain or tax-loss harvesting

Your tax professional can help you find the best strategy or strategies for your situation. The important thing is to plan for these strategies *before* the end of the year in which you

want to implement them. If you wait until tax season to talk to your tax professional about planning opportunities, the advantages will not be useful for your current return (the tax year you are filing) but for next year's return.

For most tax advisors, the ideal time for tax planning is in October or November, because that gives them good estimates of your income thus far for that year. It also gives them time to provide you with information, explanations and recommendations before the tax year ends.

If you have a small business that will continue into retirement, it's important to time your business income and expenses as allowed. For example, you can build extended payment due dates into your contract if you want the option to recognize business income in the following year.

Planning for Widowhood

While it may seem morbid and hard to consider (let alone discuss), planning for the loss of your spouse is important, because most married couples do not die together.

The U.S. Census Bureau reports that widowhood is more common among older women than among older men because of the differences in life expectancies. Among those 75 years and older, 54% of women were widowed at the time the research was conducted, versus 20% of men.

Planning for the transition from joint to single filing, while not pleasant, is usually beneficial, so you can avoid additional tax burdens. Most widows move up a tax bracket because accounts that were serving two people filing jointly are now serving one single filer, referred to as income consolidation. Losing a spouse is difficult enough without adding a large or unexpected tax bill on top of it.

A married couple who files jointly, for example, might be in the 12% or 22% tax bracket. When one spouse passes away, however – unless there is a corresponding reduction in income – the surviving spouse could jump at least one tax bracket because the income brackets are smaller for single individuals.

It may be possible to adjust variable income to reduce some of the additional tax burden as discussed above. Of course, adjusting income will also depend on expenses such as mortgages, property taxes, medical bills, food and utilities.

Though you might be tempted to avoid a difficult conversation, remember that forewarned is forearmed. When your spouse passes, you can and should plan to withhold more income taxes from retirement income sources if you know your taxes are going to go up. If you have large balances in traditional IRAs, with corresponding large RMDs, you can also consider using annual Roth conversions as a way of controlling your amount of annual income tax.

Benefits of Roth Conversions

The average taxpayer with some retirement savings has more money saved in traditional tax-deferred accounts than in Roth accounts. The theory behind this thinking is that you are typically in a higher tax bracket when you are working than in retirement, so you want the tax break in your higher-income, working years.

And that is good thinking – but exceptional savers with exceptional investments can find themselves in a higher tax bracket in retirement than they were when they were working, especially once the RMD requirement kicks in.

Properly calculated and timed, Roth conversions can help taxpayers with large balances in traditional tax-deferred accounts reduce their long-term taxes by paying a finite amount of

taxes in the short term.

A Roth conversion is when a taxpayer transfers a specified amount of money from a traditional tax-deferred retirement account into a Roth-style account. The taxpayer pays tax on the converted amount in the year of the conversion, because it is treated as a distribution from a tax-deferred account. Placing the money into a Roth account now allows that money to be taken out tax-free at any time after the conversion is made. Even better, it allows the earnings on that income to come out tax-free as long as certain rules, such as a mandatory holding period, are followed.

Consider a retired taxpayer with a large balance in a traditional IRA who is five years away from being subject to a rather large RMD. The taxpayer could work with their tax advisor to calculate how much could be converted to a Roth IRA without the income causing a bracket jump.

In other words, the tax professional helps calculate a Roth conversion that will keep the client close to the same tax rate. The overall amount of tax will increase, but their tax rate will stay the same. And then that income is no longer subject to tax, and the earnings on it will not be subject to tax when they are distributed as long as the Roth rules have been followed.