7 Practical Tips to Creating Tax-Efficient Retirement Income

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Approaching the unchartered territory of retirement can be exciting, enlightening, or even a bit nerve-wracking for individuals. A future retiree's focus during the working years is to build up savings; once retirement is on the horizon, the focus shifts to not outliving it.

Risks that a retiree may face come in many forms:

- Financial risks, such as inflation, market fluctuations, potentially challenging retirement savings to cover necessary expenses;
- Health care risks, which can present in the form of rising health care costs or unanticipated health care needs during retirement;
- Public policy or tax risks through policy changes that could inflate taxes or modify laws to adversely impact retirement income; and
- Longevity risks, or the risk of outliving retirement savings.

Other post-retirement risks could include the death of a spouse, divorce, or having to care for a loved one. A recent study conducted by the Aegon Center for Longevity surveyed 16,000 American workers and retirees, and echoes prior study findings: a major concern for retirees is a fear of outliving their assets.[1] And, in fact, longevity risk is a multiplier of all the other risks. In other words, the longer someone lives, the more likely they are to experience many of the other risks.

Predictability is the antithesis of uncertainty. Unfortunately, the global pandemic has created a climate of uncertainty. The $2.4 trillion coronavirus relief package has likely led to conversations about the potential effects on future retirement strategies and, more specifically, the potential for a change in tax policy to adversely impact retirement income.

Helping your clients, along with their tax professionals, craft alternative strategies to mitigate tax risk and other post-retirement risks is a good place to start. Here are some practical tips for your clients to consider to potentially increase the tax-efficiency of their retirement income.

Tip #1: Don't Put All Your Eggs in One "Bucket"

This familiar saying applies to many facets of life. In the retirement strategy realm, it means the idea of diversifying retirement savings among various tax "buckets." Encouraging your clients to diversify their retirement savings, ideally while in their pre-retirement years, across accounts with different tax treatments—taxable, tax-deferred, and tax-free—can help prevent too much of a retiree's income being exposed to taxes. Tax diversification leads to the ability to pivot withdrawal strategies by tapping a tax-free bucket for income in a particularly high tax year, for example.

Tip #2: Consider Roth IRAs and Roth Conversions

For some individuals approaching retirement, their savings may consist largely of pre-tax retirement accounts—think 401(k), 403(b), TSP, or Traditional IRA. During the early stages of saving, the ability to deduct contributions from current income is particularly attractive to these arrangements because the deduction reduces overall tax liability. However, taxes on the contributions and

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tax-deferred growth must eventually be paid. In retirement, the assumption is generally that overall tax liability will be lower than in peak earning years. However, an alternative plan should be considered, should public policy cause tax rates to increase.

Roth IRAs can provide a way to mitigate tax exposure in retirement. Qualified Roth distributions, or those that are made after five years and a qualifying event, are tax-free. Roth IRAs, unlike their traditional counterparts, are also not subject to lifetime required minimum distributions (RMDs), permitting more flexibility in drawing down Roth IRA monies as needed and not as required.

Clients with sizable pre-tax retirement savings may consider converting small portions of pre-tax IRAs or retirement accounts over several years before retirement to shift more money into the tax-free bucket for retirement. While each conversion is taxable, this strategy could help ease the risk of tax creep on retirement income.

Tip #3: Consider Delaying Social Security and Tapping Retirement Accounts to Bridge Income

Encourage clients to consider bridging income in the early years of retirement with tax-deferred retirement savings and delay claiming Social Security benefits. Here's why. Waiting until a retiree's full retirement age (FRA), which ranges from ages 66 to 67, depending on their year of birth, means that they will collect 100% of their retirement benefit. But waiting beyond FRA, even by a year or two, up to a maximum of age 70, can produce an income benefit that is 8% higher per 12 months of delay, plus any cost of living adjustments. Larger monthly payments also result in ongoing larger annual COLA increases to benefits.

So, for example, a 66-year-old with an FRA benefit of $2,500 could collect as much as $3,300 by waiting to file at age 70 (8% increase per year, times four years). Using pre-tax retirement savings from IRAs or 401(k)s in the earlier years could require less to supplement a larger Social Security benefit in the later years. In addition, drawing down these retirement savings could reduce the impact income taxes may have on Social Security benefits down the road.

Income Taxes and Social Security

Determining whether a portion of Social Security benefits will be taxable is a two-step process and has a direct correlation with the other sources of funds supplementing retirement income. First, combined income needs to be determined.

To determine combined income:

Adjusted Gross Income
+ Nontaxable Interest
+ ½ of Your Social Security Benefits

= Combined Income

If you are single and your combined income is:	
< $25,000	none of your benefit is taxable
$25,000 - $34,000	as much as 50% is taxable
> $34,000	as much as 85% is taxable

If you are married and your combined income is:	
< $32,000	none of your benefit is taxable
$32,000 - $44,000	as much as 50% is taxable
> $44,000	as much as 85% is taxable

Once combined income is determined, thresholds based upon tax filing status are compared to combined income to determine taxation of a portion of the benefits. Continued earnings, pension distributions, capital gains, and even municipal

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bond interest can cause benefits to be taxable. Drawing pre-tax savings down prior to a claim may be a strategy to consider to not only secure a higher lifetime benefit but reduce future RMDs, creating a more tax-efficient drawdown plan.

Tip #4: Don't Forget to Plan for RMDs

The CARES Act temporarily suspended RMDs for 2020. But, in 2021 and all future years, RMDs will be required for those who reach age 72 and beyond on all qualified and traditional IRA accounts. Planning ahead, ideally long before RMDs must be distributed, can help reduce the risk of a ripple effect on other sources of retirement income. Higher taxable income and a potentially higher marginal tax bracket are only two potential consequences of RMDs.

RMDs can also cause as much as 85% of Social Security benefits to be taxable. And, in some cases, RMDs can cause a retiree to be pushed into a higher Medicare Part B premium than the standard 2020 premium of $144.60. Modified Adjusted Gross Income (MAGI) in excess of $87,000 for single filers and $174,000 for married filers in 2018 would cause these high-income Medicare beneficiaries to pay the standard Medicare Part B premium plus a Medicare surcharge of $57.80 per month, per person, if married. The surcharge can increase to as much as $347 for Medicare beneficiaries, depending upon MAGI.[2] Additional surcharges may also apply to Part D premiums.

Medicare premiums for 2020 are based upon income two years prior (2018), so planning for spikes in income once an individual reaches age 63, two years before typical eligibility year of 65, is important to the planning process.

Tip #5: Use Qualified Charitable Distributions (QCDs) for Giving at Age 70 ½ and Beyond

RMDs from Traditional IRAs of up to $100,000 may be tax-free, provided the distribution is made payable to a qualified charity. Further, QCDs may begin as early as age 70 ½, even though RMDs are no longer required until age 72, per the SECURE Act.

If you are working with clients who plan to donate to their favorite charity, a QCD not only allows the RMD to be satisfied up to $100,000 annually, but the distribution is tax-free to the IRA owner. QCDs are only permitted from IRAs and not other retirement accounts, like 401(k)s, but are a cost-efficient way to reduce taxable income for charitable giving.

Tip #6: Use Health Savings Accounts (HSAs) to Save for Retirement Health Care Costs

An HSA is a great way to save for future health care expenses, while reducing current taxable income. An individual must be enrolled in a high-deductible health insurance plan to be eligible. In 2020, an individual with a self-only plan may contribute, on a pre-tax basis, up to $3,550 and a family plan permits a $7,100 maximum.

Another benefit of an HSA is that unused balances are carried over from year-to-year, unlike its similar counterpart, the Flexible Spending Account. Encourage eligible clients to take advantage of max-funding HSAs and earmark the monies for use on health care expenses in retirement, rather than using the funds while still actively employed. Allowing the funds to grow tax-deferred may help offset the risk of health care costs in retirement eating away at retirement income.

Keep in mind that HSA contributions must stop once an individual enrolls in Medicare.

Tip #7: Cash Value Life Insurance Can Provide More than a Death Benefit

Cash value life insurance may provide more than just a tax-free death benefit to loved ones.

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Just like converting a Traditional IRA to a Roth IRA moves money from a pre-tax bucket to a tax-free bucket, the same concept applies to moving pre-tax money to a cash value life insurance policy. Taxes must be paid if the premium is paid from pre-tax retirement savings to fund the life insurance policy, but the resulting tax diversification may help offset the tax risk in retirement, while also providing protection in the form of a death benefit for loved ones.

Lifetime withdrawals from a cash value policy may provide needed funds on a tax-free basis through loans or withdrawals.

In addition, some policies may provide living benefits if the policy owner experiences certain conditions, such as critical illness, nursing home confinement, or long-term care. These are valuable lifetime benefits, in addition to the death benefit and the ability to pull tax-free income during retirement. Keep in mind, these benefits may be available at an additional cost.

Beginning conversations with your clients in the five to 10 years leading up to retirement is ideal, as it allows for more time to employ strategies such as these.

Sources:

[1]https://www.aarp.org/retirement/planning-for-retirement/info-2019/retirees-fear-losing-money.html

[2]www.medicare.gov; 2020 Medicare Costs https://www.medicare.gov/Pubs/pdf/11579-medicare-costs.pdf

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