RETIREMENT & TAXES

- IT'S A - MONEY THING® Golden Years

HOW LOW CAN YOUR TAX BILL GO DURING RETIREMENT?

Preparation is key in the years leading up to retirement. Rather than reacting to changes in your tax situation, proactive planning can ensure lifelong financial security.

Diversification isn't limited to your investment portfolio. If you're actively saving for retirement, consider diversifying how and when your savings will be taxed. This strategy helps navigate two uncertainties in retirement:

How much of your income will be taxable?

Beyond your retirement savings, you need to consider your Social Security benefits, pensions, non-retirement investments and other potential sources of income.

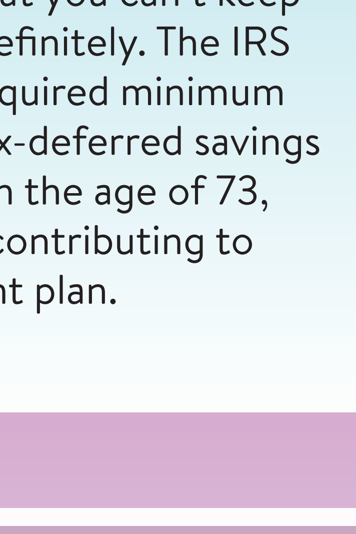
What will your tax rate be after you retire?

Today's tax rates are relatively low by historical standards, and it's possible that they could rise before or during your golden years.

Despite these uncertainties, planning for a favorable tax outcome is possible. One approach is to utilize a mix of accounts with different tax treatments to better manage taxable income in retirement.

You have four main account types at your disposal, each with its own unique tax advantages.

1 Tax-deferred accounts



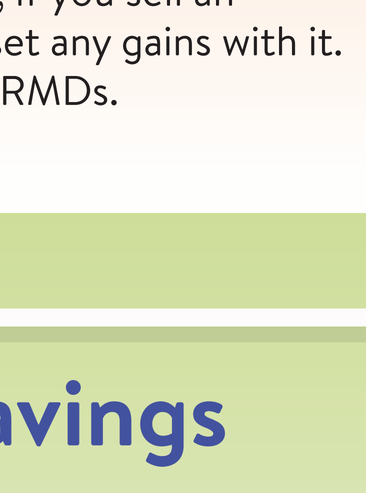
Contributions made to 401(k)s, 403(b)s and traditional IRAs typically result in a direct reduction of your taxable income for the year in which the contribution is made. Additionally, any pretax contributions and gains in these accounts are typically tax-deferred until retirement, at which point withdrawals are subject to ordinary income tax rates.

However, it's important to note that you can't keep your savings in these accounts indefinitely. The IRS mandates that you begin taking required minimum distributions (RMDs) from your tax-deferred savings accounts each year once you reach the age of 73, unless you are still employed and contributing to your current employer's retirement plan.

2 Roth accounts

Unlike tax-deferred accounts, contributions to Roth 401(k)s and Roth IRAs are funded with after-tax dollars, meaning they do not lower your current taxable income. However, upon retirement, withdrawals from these accounts, including appreciation, income or distributions, are tax-free. Both Roth 401(k)s and Roth IRAs are exempt from RMDs.

3 Taxable accounts



These traditional bank and brokerage accounts are funded with after-tax dollars. In brokerage accounts, you have the flexibility to trade securities and deposit or withdraw funds at your discretion without facing penalties. Taxable investment income is subject to taxation in the year it's earned, and profits from the sale of investments are subject to capital gains taxes. Conversely, if you sell an investment at a loss, you may offset any gains with it. These accounts are exempt from RMDs.

4 Health savings accounts

While not typically categorized as retirement accounts, health savings accounts (HSAs) can serve as a valuable savings tool if provided by your employer and you're enrolled in an eligible high-deductible health plan. Contributions to HSAs decrease your taxable income within annual limits, and investments within the account grow tax-free. Withdrawals for qualified medical expenses are tax-free as well. However, once you reach age 65, withdrawals for non-medical purposes are subject to ordinary income tax. HSAs are also exempt from RMDs.

TAX DIVERSIFICATION IN ACTION

Determining the optimal mix of retirement accounts depends on various factors, such as your current marginal tax rate, anticipated tax rate in retirement and desired flexibility in withdrawals. Nevertheless, there are fundamental principles to guide your decision-making process.

CAPTURE EMPLOYER MATCH 1

If your employer offers matching contributions, prioritize saving enough to receive the full match. This contribution essentially translates to free money, making it unwise to forgo.

EXPLORE AN HSA 2

Given the likelihood of increased medical expenses during retirement, leveraging tax-free dollars through an HSA can be advantageous. Maximize contributions to the allowable limit, especially if your employer offers matching contributions.

MAXIMIZE TAX-ADVANTAGED SAVINGS 3

Determine an appropriate allocation between tax-deferred and Roth accounts based on your current tax bracket.

Lower tax bracket: Consider maximizing contributions to Roth accounts, as your tax bracket in retirement may equal or exceed your current rate.

Middle tax bracket: Split your retirement savings between tax-deferred and Roth accounts to mitigate uncertainty regarding future tax rates.

Higher tax bracket: Prioritize maximizing contributions to tax-deferred accounts, assuming your retirement tax rate remains the same or decreases.

CONSIDER ROTH CONVERSION 4

If your income prevents Roth IRA contributions, explore the option of Roth conversion. This involves transferring funds from a traditional IRA to a Roth IRA, paying taxes on the converted amount in the year of conversion. Although this incurs additional taxes, it diversifies a predominantly tax-deferred portfolio. Careful planning is necessary to avoid nudging into a higher tax bracket, potentially spreading Roth conversions across multiple tax years.

While predicting future tax rates involves some uncertainty, leveraging different account types offers flexibility and control over future tax liabilities.

SEEK PROFESSIONAL ADVICE

Consulting a tax professional can provide valuable guidance in navigating these decisions effectively

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Sources: Charles Schwab, Internal Revenue Service, Investopia

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