Tax Strategies for Retirement

Buckets Create Tax Choices

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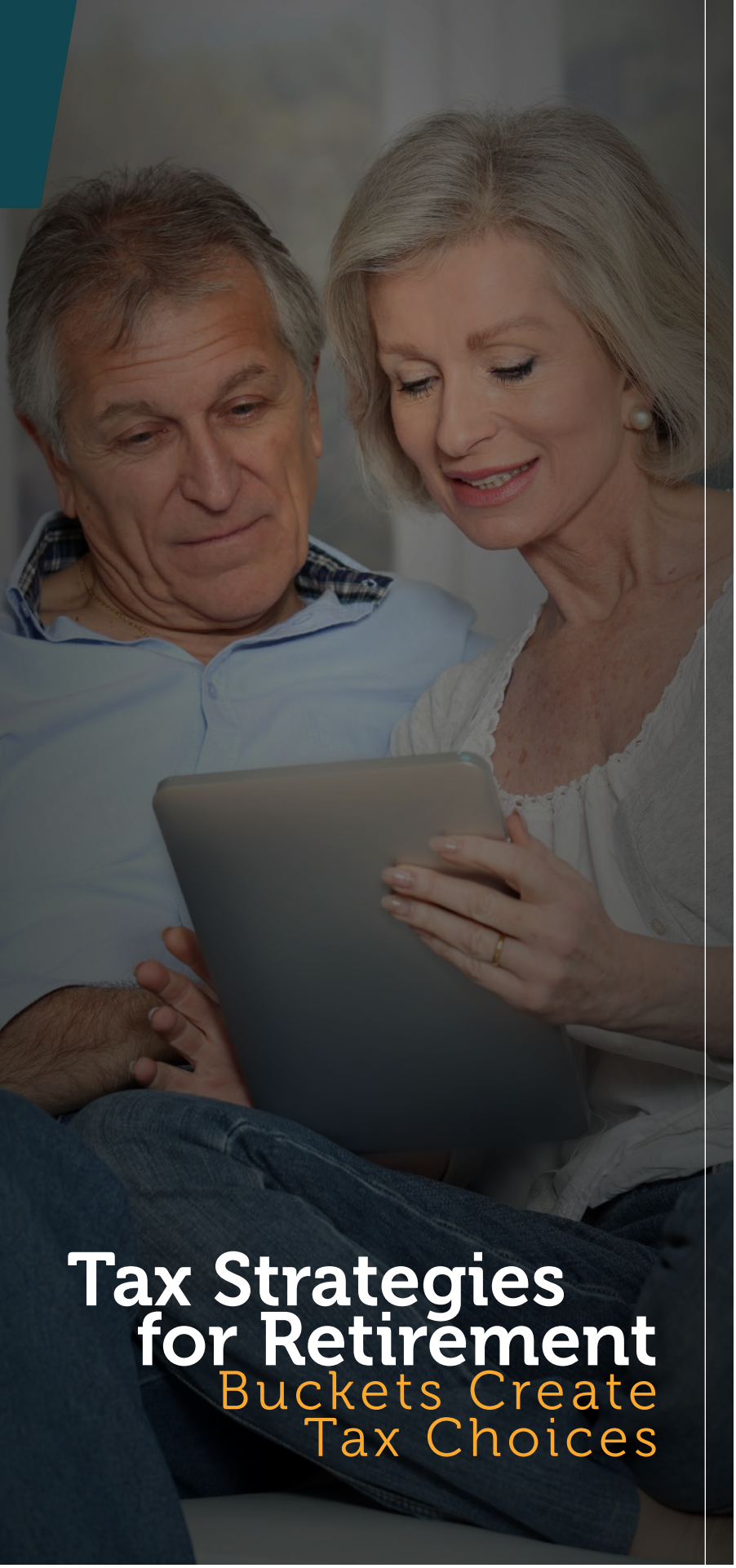


Tax Strategies for Retirement

Buckets Create Tax Choices

While designed to provide valuable information, this brochure is not intended to offer specific tax advice. Your unique situation will dictate whether any financial product or strategy described in this guide is right for you. Individuals are encouraged to consult with a qualified professional before making any decisions about their personal situation.

Retirees can be affected by a variety of taxes — state income taxes, estate taxes and Social Security taxes, to name a few. But the most common tax — the one that all retirees will deal with — is the federal income tax. For this reason, we'll focus primarily on the federal income tax and its effect on individuals planning for retirement, but be aware that all potential taxes need to be understood and planned for by those who hope to have a financially comfortable retirement.

The Importance of Tax Efficiency

You've probably been advised by more than one source that contributing money before tax into an IRA or a 401(k) plan (a qualified account) is one of the best ways to save effectively for retirement. When contributing money into an employer-sponsored retirement plan while still working, you are usually able to exclude contributions from your taxable income — such contributions are sometimes referred to as "pre-tax" dollars. Your untaxed contributions will grow tax-deferred over time because the growth in qualified retirement plan accounts is not subject to federal income taxes either.

When do you pay income taxes on a qualified account? Later on, when you make withdrawals from the account — typically during retirement when you might expect to be in a lower income tax bracket. At that time, withdrawals are subject to your ordinary income tax rate. It is this subsequent federal income tax liability on the distributions that should be considered when evaluating tax strategies for a future retirement.

For example, imagine that you are 35 years old. If your otherwise taxable income this year is $50,000 and you contributed $3,000 of pre-tax money to a qualified account, you would pay federal income tax on only $47,000 of your income. Then, say in 30 years, when you retire, if your taxable income is $40,000 and you withdraw $4,000 from the qualified account, your taxable income would be bumped up to $44,000. Even though you may be in a lower tax bracket, the taxable distribution from the qualified plan would still effectively increase your taxable income.

Tax Deferral of Qualified Accounts is not Forever

One of the challenges with a qualified retirement plan is that the federal government does not allow people to put off taking distributions forever. The tax code now requires most people to start taking required minimum distributions (RMDs) beginning with the year a person turns 72 — even if they already have plenty of income to live on at the time. This can be particularly problematic because as people are living longer, many are working longer as well. If you must take an RMD while still earning income from a job, for example, it could bump you into a higher income tax bracket.

RMD Penalty Tax

The penalty for not withdrawing the RMD from your employer-sponsored or other qualified retirement plan is 50% of the amount not withdrawn. For example, if your RMD is $20,000 and you do not withdraw anything from your retirement plan, you will be assessed a tax penalty of $10,000 (50% of $20,000). And, you will still owe regular income tax on the money when you take it out of the plan.[1]

[1] *IRS. June 26, 2021. "Retirement Plan and IRA Required Minimum Distributions FAQs." https://www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-required-minimum-distributions. Accessed Jan. 10, 2022.*

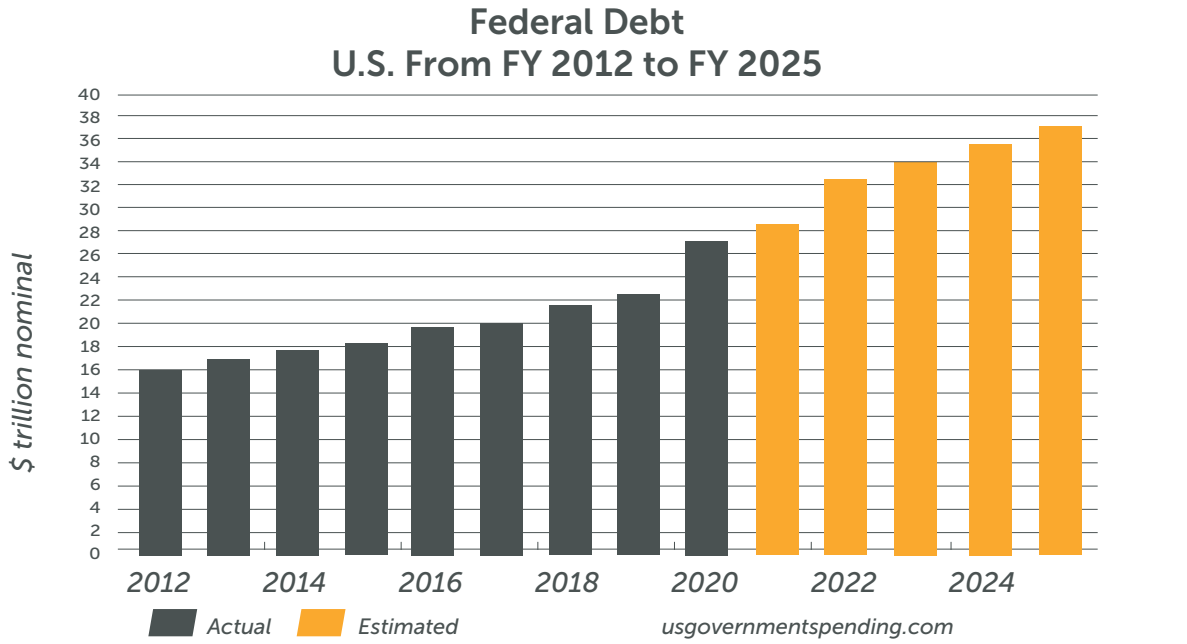
Will Taxes be Lower in the Future?

If you actually are in a lower tax bracket during retirement compared to when working, qualified plans are highly tax-effective.

Conventional wisdom suggests that your income will decline in retirement. What you may not realize is that for many, taxable income does not actually decrease. Why? Some people lose some valuable tax deductions and credits as they age and, as a result, end up with a higher taxable income in retirement. Others work longer than they expect, and still others have more taxable investment income than they planned for.

Future retirees are also facing a whole new set of variables that could impact both income tax rates and their level of income in retirement:

- Projected increases in the national debt,[2] which may lead to increased taxes
- Slower growth in the labor force paying into the income tax system,[3] which could also result in higher payroll tax rates
- Projected Social Security shortfalls in the future,[4] which could lower monthly Social Security retirement benefit payments
- Likelihood of increased Medicare/health care expenses with aging population[5]
- Likelihood of increased Medicaid/long-term care expenses with aging population[6]



[2] *USGovernmentSpending.com. "Gross Public Debt." https://usgovernmentspending.com/spending_chart_2012_2025USr_23s2li111mcny_H0f. Accessed Jan. 10, 2022.*
[3] *Social Security Administration. "Status of the Social Security and Medicare Programs: A Summary of the 2021 Annual Reports." https://www.ssa.gov/OACT/TRSUM/index.html. Accessed Jan. 10, 2022.*
[4] *Ibid.*
[5] *Congressional Budget Office. September 2020. "An Update to the Budget Outlook: 2020 to 2030." https://www.cbo.gov/system/files/2020-09/56517-Budget-Outlook.pdf. Accessed Jan. 10, 2022.*
[6] *Ibid.*

Will Your Social Security Benefits be Taxable?

Recognize that the more retirement income you receive from tax-deferred qualified plans, the higher your taxable income will be in retirement. And the higher your income, the more likely your Social Security benefits will be taxed.

Whether your Social Security benefits are taxable depends on your total taxable income, your Social Security benefits and your marital status. Generally speaking, if Social Security retirement benefits are your only income, your benefits will not be taxable and you may not even have to file a federal income tax return. However, if you receive income from other sources, your modified adjusted gross income must be below the base amount for your filing status to avoid federal income taxes on your Social Security benefits.

Base amounts (2022):[7]

- $32,000 for married couples filing jointly
- $25,000 for single, head of household, qualifying widow/widower with a dependent child or married individuals filing separately who did not live with their spouses at any time during the year
- $0 for married persons filing separately who lived together during the year

To determine if some of your Social Security benefits may be taxable, add one-half of your total Social Security benefits to all of your other income, including any tax-exempt interest. If this total is more than the allowed base amount for your filing status, some of your Social Security benefits may be taxable. The IRS provides an online tool for taxpayers to estimate the taxable portion of their Social Security benefits.[8]

As you can see, depending on your particular situation, the strategy of deferring taxes while you are working only to pay them when you're retired may not always be to your advantage.

[7] Social Security Administration. "Income Taxes and Your Social Security Benefit." https://www.ssa.gov/benefits/retirement/planner/taxes.html. Accessed Jan. 10, 2022.
[8] IRS. Aug. 20, 2021. "Are My Social Security or Railroad Retirement Tier I Benefits Taxable?" https://www.irs.gov/help/ita/are-my-social-security-or-railroad-retirement-tier-i-benefits-taxable. Accessed Jan. 10, 2022.

Four Buckets: The Tax Continuum

A simple way to visualize the impact of taxes on your money is to divide your assets into four buckets.



1 The Taxable Bucket represents accounts for which you typically receive a Form 1099 each year. Here are some examples:

- Interest from certificates of deposit (CDs)
- Dividends and taxable distributions from mutual funds held in nonqualified accounts
- Dividends and capital gains from stocks
- Interest and capital gains from bonds
- Reinvested dividends

2 The Tax-Deferred Bucket may include:

- Traditional IRAs
- 401(k), 403(b), 457(b) plans
- Qualified and nonqualified annuities
- Appreciation of unsold mutual funds and securities
- Savings bonds

3 The Income Tax Free / Estate Taxable Bucket includes:

- Roth IRAs
- Municipal bonds
- Appreciation of capital assets held until death
- Life insurance (if properly structured)

4 The Income Tax Free / Estate Tax Free Bucket includes items found in Bucket 3 used to fund:

- Irrevocable life insurance trusts (ILIT)
- Charitable trusts



Tax Strategies

To help minimize taxes in the future, you should consider taking action today. In fact, the more wealth you have, the more advantageous it might be to move assets from left to right on the tax bucket continuum. When the goal is to reduce the total amount of taxes you will pay in a future retirement, you may have to take on a greater income tax bill today — by strategically repositioning assets from Buckets 1 and 2 to Buckets 3 and 4.

Tax Diversification

If all of your retirement assets are in qualified plans, you may have a significant tax liability on distributions when you retire. But, if all of your accounts incur tax liabilities for you before retirement, the erosion of your assets due to taxes may limit the growth potential of those assets throughout your career. Tax diversification is the strategy of spreading your assets across a mix of taxable, tax-deferred and tax-free accounts, in order to avoid both of these scenarios.

For Example

Consider adding up to $7,000 ($6,000 if you're younger than 50) in a Roth IRA (if you are eligible) to your existing mix of retirement accounts. You will not receive an immediate income tax deduction for your contributions to a Roth IRA, but your money will have the opportunity to grow tax-free and you may withdraw contributions you made to your Roth IRA tax-free at any time. After age 59 ½ and after the account has been open for at least five years, withdrawals — including earnings — will not be taxed at all. In fact, the Roth IRA can be an ideal complement to an employer-sponsored retirement plan, because participation in a pension plan at work may preclude tax-deductible contributions to a traditional IRA.[9]

[9] IRS. Nov. 27, 2021. "Retirement Topics - IRA Contribution Limits." https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-ira-contribution-limits. Accessed Jan. 10, 2022.



Roth IRA Conversion

You can reposition traditional IRA and qualified plan assets from Bucket 2 (tax-deferred) to Bucket 3 (tax free) by converting them to a Roth IRA. Conversions are considered distributions for tax purposes, so you'll have to pay income taxes on the amount converted in the year of conversion. Note also that if you pay taxes on a Roth IRA conversion with proceeds from the qualified plan, the money used to pay the taxes is deemed an additional distribution and is subject to taxes and any additional IRS penalties for premature distributions. Therefore, it's usually recommended that you pay the taxes due upon Roth conversion from other assets.

While the taxes you pay on a Roth IRA conversion could put a dent in your current retirement savings, if you think your income tax rates will be higher in the future than they are now, it's still a strategy you should consider.

Because converting a traditional IRA or other qualified assets to a Roth IRA is a taxable event and could result in additional impact to your personal tax situation, including (but not limited to) a need for additional tax withholding or estimated tax payments, the loss of certain tax deductions and credits, higher taxes on Social Security benefits and higher Medicare premiums, you should be sure to consult with a qualified tax advisor before making any decisions regarding a potential Roth conversion.

Converting qualified account balances to a Roth IRA is not an all-or-nothing proposition. You can strategically convert limited amounts each year to control your income tax result. As you convert assets each year, you'll pay only the taxes on the amount converted, in addition to your regular income taxes. This way, you might be able to pay the additional tax liability associated with conversion using income earned from other sources, such as your job.

What if You're not Allowed to Contribute to a Roth IRA?

Single or head of household taxpayers who earn more than $144,000 a year ($214,000 for married spouses filing jointly or qualifying widowers) may not currently contribute to a Roth IRA.[10] However, what they may be able to do is contribute to a traditional IRA each year and then convert their IRA to a Roth IRA. There is currently no income limit on taxpayers who wish to convert traditional IRA balances to Roth IRAs.

Please remember, however, that converting your traditional IRA or other qualified assets to a Roth IRA is a taxable event and could result in additional impacts to your personal tax situation as described in the prior section on Roth conversions.

[10] IRS. Nov. 5, 2021. "Amount of Roth IRA Contributions That You Can Make For 2022." https://www.irs.gov/retirement-plans/plan-participant-employee/amount-of-roth-ira-contributions-that-you-can-make-for-2022. Accessed Jan. 10, 2022.

Advantages of a Roth IRA

The following are some potential advantages of converting employer-sponsored retirement plan assets to a Roth IRA:

- Tax-free Roth IRA withdrawals do not impact the taxable status of your Social Security benefits.
- Employer-sponsored retirement plan investment options may be more limited than those offered by Roth IRAs.
- Roth IRAs have no RMD obligations during the taxpayer's lifetime.

Be aware that any money in a Roth IRA will be considered part of your estate for estate tax purposes — placing it firmly in Bucket 3.



Reliable Income with Partial Taxation

There is also a strategy to reposition taxable assets from Bucket 1 (taxable) to Bucket 2 for tax-deferred growth opportunity and partially taxable distributions. One example of that strategy is to use a taxable investment, such as a CD, to purchase a nonqualified annuity. This is another way to deploy a tax diversification strategy to help avoid having all of your income be taxable during the run-up to retirement.

An annuity is a contract between you and an insurance company under which you make a lump-sum payment or a series of deposits into the contract and, in return, the insurer agrees to pay interest on the deposits and make periodic payments to you immediately or at some point in the future. Annuities offer tax-deferred growth potential, a death benefit during the accumulation phase and, when you're ready, income payout options that are backed by the financial strength and claims-paying ability of the issuing insurance company.

Most annuities have provisions that allow you to withdraw a percentage of the value of the contract each year, up to a certain limit, without any contractual penalty. Of course, withdrawals will reduce the contract value and the value of any protection benefits. Withdrawals above the contract's limit typically incur early withdrawal penalties (referred to as surrender charges). The length of



time surrender charges apply varies by contract. Because annuities are designed as long-term retirement vehicles, annuity withdrawals are subject to ordinary income tax. Federal tax law says that withdrawals are taxed based on the gain in the contract first, and, if taken before age 59 ½, taxable distributions are subject to an additional 10% federal tax.

Fully Taxable — But Reliable Income

Although buying an annuity probably won't reduce your tax bill at retirement, it can help secure a reliable income stream. By rolling over assets from a 401(k) or other qualified retirement plan to an annuity-based IRA, you can create guaranteed income options.* Reliable lifetime income is becoming increasingly more important because retirees are living longer, and they need their retirement income streams to likewise last longer. Some annuities will also allow their owners to reduce their overall market risk.

4 Estate Planning – Using Bucket 4

For the purposes of estate planning, federal gift taxes and estate taxes are now integrated into one unified tax credit, which means that any gift tax exemptions you use during your lifetime will reduce the estate tax exemption available upon your death. The top estate tax rate is 40% on assets over $12.06 million in 2022, before taking into account the necessary inflation adjustment. Currently, you may make a gift of up to $16,000 to an individual family member each year without triggering gift tax consequences.[11]

ILIT Trust Strategy

An irrevocable life insurance trust (ILIT) can be used to reposition assets from Bucket 1 (taxable) to Bucket 4 (income and estate tax free). As part of your annual gift exclusion, you can transfer assets to the ILIT that will be used to pay the premiums for a life insurance policy. If structured

[11] *IRS. Nov. 15, 2021. "What's New - Estate and Gift Tax." https://www.irs.gov/businesses/small-businesses-self-employed/whats-new-estate-and-gift-tax. Accessed Jan. 10, 2022.*

properly, the life insurance death proceeds will be both income and estate tax free. Proper use of an ILIT and gifting would allow you to leverage annual $16,000 gifts to generate substantial estate tax free proceeds for your beneficiaries upon your death.

With an ILIT, the trust is the owner of the insurance policy, thus excluding the life insurance policy's cash values and death benefits from your taxable estate. If the trust is drafted and funded properly, your loved ones should receive all of your life insurance proceeds undiminished by both income and estate taxes. Because an ILIT must be irrevocable, once you sign the trust agreement, you can't end the trust or change its terms. You must give up control of the ILIT assets, as you must choose someone other than yourself as a trustee, and you cannot be a beneficiary of the trust. Your spouse and your children may be (and usually are) beneficiaries of an ILIT. Contributions to the ILIT represent gifts that you cannot get back. Because you cannot reclaim your contributions or receive any benefit from the trust, it would be inappropriate to have the trust own policies the cash value of which you had planned to use for retirement income.

It's especially advisable to consult with a qualified estate planning attorney, as well as an insurance professional, when considering the implementation of an ILIT.

Conclusion

Different investments have different tax characteristics. The tax characteristics of certain financial products may make a big difference in determining whether such investments fit your specific circumstances.

In general, the more taxes you are required to pay in retirement, the more income you'll need to generate in order to both pay those taxes and live comfortably. Making financial plans early for retirement, and considering diversifying your tax buckets so that you can optimize tax results both during the accumulation phase of your life and again after retirement, can help you pursue the retirement you desire.

It's important to work with an experienced financial professional and your tax advisor to help you develop and implement a tax strategy for retirement that is appropriate for your financial situation.



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* Annuities are long-term, tax-deferred insurance products intended for retirement purposes. Any withdrawals may be subject to income taxes and, prior to age 59 1/2, a 10% federal penalty tax and state penalty taxes may apply to the taxable amount. Withdrawals from annuities will affect both the cash value and the death benefit.

Investing involves risk, including the potential loss of principal. Any references to protection benefits or lifetime income generally refer to fixed insurance products, never securities or investment products. Insurance and annuity product guarantees are backed by the financial strength and claims-paying ability of the issuing insurance company.

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