Tax-Efficient Retirement Income Strategies

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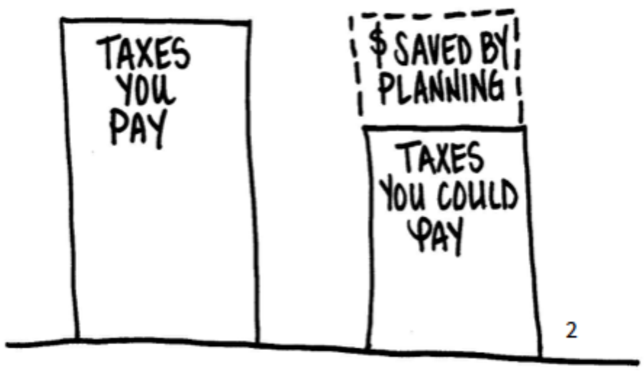
A tax-efficient retirement income strategy is crucial to maximizing an investor's probability of success in retirement. But what exactly is a tax-efficient retirement income strategy? Why is it important? Below we will tackle these questions and more. This review can also serve as a jumping-off point for a broader tax planning conversation for 2018 and beyond.

Why is a Tax-Efficient Retirement Income Strategy Important?

Minimizing the detrimental impact taxes can have on the accumulation and growth of your portfolio is crucial to putting yourself in the best financial position to retire.

An important but often overlooked next step is efficiently managing the *drag* of income taxes when you approach or are in the retirement stage of your life.[1]



[2]

Not implementing a specific plan to efficiently manage income taxes in the later stages of your life can be devastating to your chances of success in retirement. And while executing a tax-efficient retirement income strategy can often be complex, it is very achievable with prudent planning, diligent execution, and professional help. Investment accounts generally fall into one of three tax classification categories:

Tax Classification of Investment Accounts

- **Taxable (Taxed always):** Investment earnings, such as interest and dividends, are taxed when earned. Capital gains, or profits from the sale of an investment, are taxed when realized. Because all investment earnings are taxed when earned, and capital gains are taxed when realized, the act of a *withdrawal* from a taxable account does not create a taxable event. Also, contributions or deposits to taxable accounts are made on an *after-tax* basis. [3]

  Examples include: checking, savings, joint brokerage or revocable trust accounts.

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[1] At this stage, retirees often begin to withdraw funds from their portfolio (typically by liquidating portions of their investment accounts) to supplement any additional income sources, such as annuities, pensions, or rental income.

[2] GBS Group, June 13, 2016, Taxes Saved By Planning, digital image, GBS Group, accessed April 24, 2018, http://gbsgroup.net/blog_detail_insight/2014/11/blog/9-clever-year-end-tax-planning-strategies/.

[3] After-tax = an investor has previously paid taxes on these contributions.

- **Tax-deferred (Taxed later):** Investment earnings are not taxed when held "in the shelter" of a tax-deferred account. However, distributions from these accounts, including all accumulated investment earnings, are generally subject to ordinary income taxes. Contributions to certain tax-deferred accounts (401(k)s, 403(b)s, 457(b)s, etc.) may be made on a *pre-tax* basis,[4] and contributions to other tax-deferred accounts (traditional IRAs, SEP-IRAs, etc.) may afford an income tax deduction on an investor's tax return.

  Examples include: traditional IRAs, SEP-IRAs, and traditional 401(k), 403(b), and 457(b) accounts. Annuities also fall into this category.

- **Tax-free (Taxed never):** Investment earnings accumulate tax-free and all distributions occur on a tax-free basis. Like taxable accounts, the contributions to tax-free accounts are made on an *after-tax* basis.

  Examples include: Roth IRAs and Roth 401(k), 403(b), and 457(b) accounts.

Tax Classification Account Summary

Taxable	Tax-Deferred	Tax-Free
Checking Savings Brokerage Revocable Trust	Traditional… IRA SEP-IRA 401(k) 403(b) 457(b) Annuity	Roth... IRA 401(k) 403(b) 457(b)

In general, while an investor is better off by maximizing funding to tax-deferred and tax-free accounts from a long-term tax optimization perspective, there are annual contribution limits for both types of accounts.

What is the Most Tax-Efficient Way to Fund Retirement Needs?

The classic approach from a tax optimization perspective is to fund retirement needs by taking distributions from accounts in this order: **First taxable, then tax-deferred, and finally tax-free**.

The logic follows that withdrawing from taxable accounts maximizes growth in the tax-deferred and tax-free accounts held in an investor's portfolio. The same logic is then applied to withdrawing funds from tax-deferred accounts before tax-free.

[4] *Pre-tax = an investor has not previously paid taxes on these contributions.*

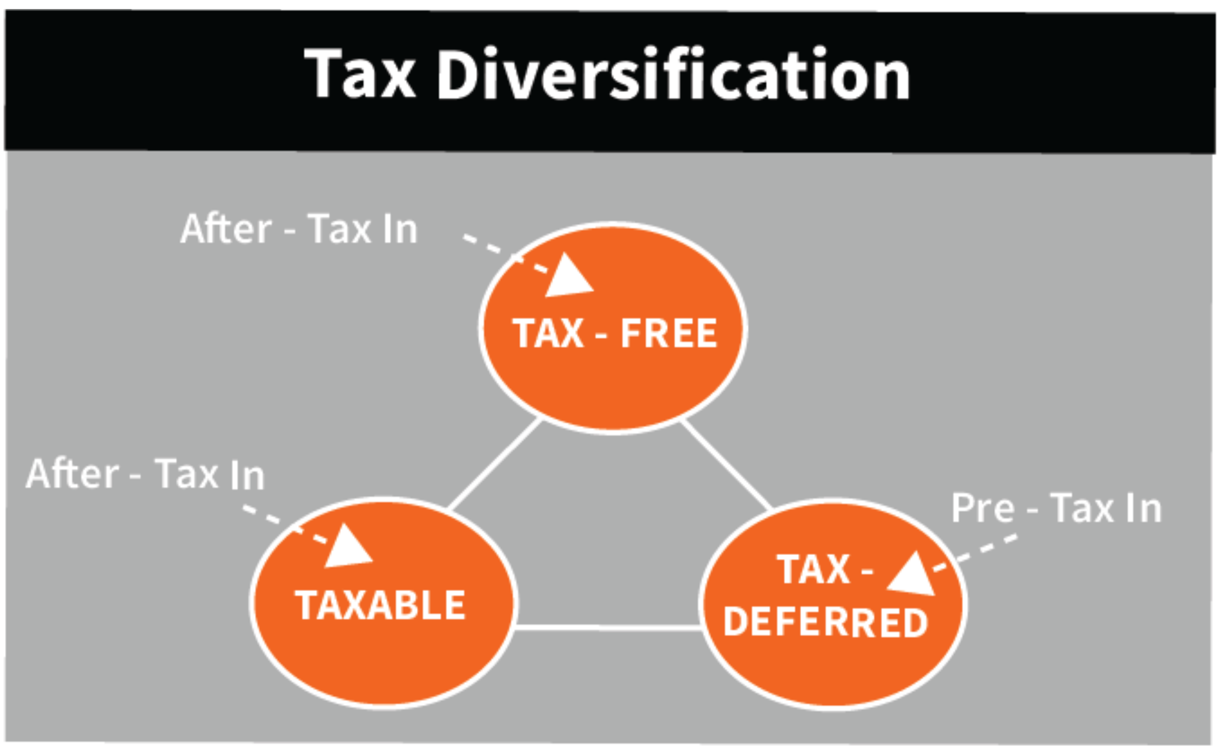
This ordering approach, while intuitive, is too simplistic when planning to optimize the minimization of income taxes on account distributions for most retirees. Every retiree has a unique financial profile, requiring a customized, and often complex, comprehensive tax retirement analysis and income plan.

Note: even if these ordering rules serve as a helpful rule of thumb, they are often impossible to follow universally because of the federal rules governing retirement plans.[5]

What is Tax Diversification and Why is it Critical to Executing a Tax-Efficient Retirement Income Strategy?

One of Towerpoint Wealth's fundamental core investment principles is the importance of diversification (the old adage "don't put your eggs in one basket") within an investor's portfolio. We believe this principle should also rightly be applied to an investor spreading assets across taxable, tax-deferred, and tax-free accounts. **We call this concept tax diversification.**

Tax diversification is a key foundation for a tax-efficient retirement strategy. It allows for better control of both the amount a retiree pays in taxes, and when a retiree pays this amount.



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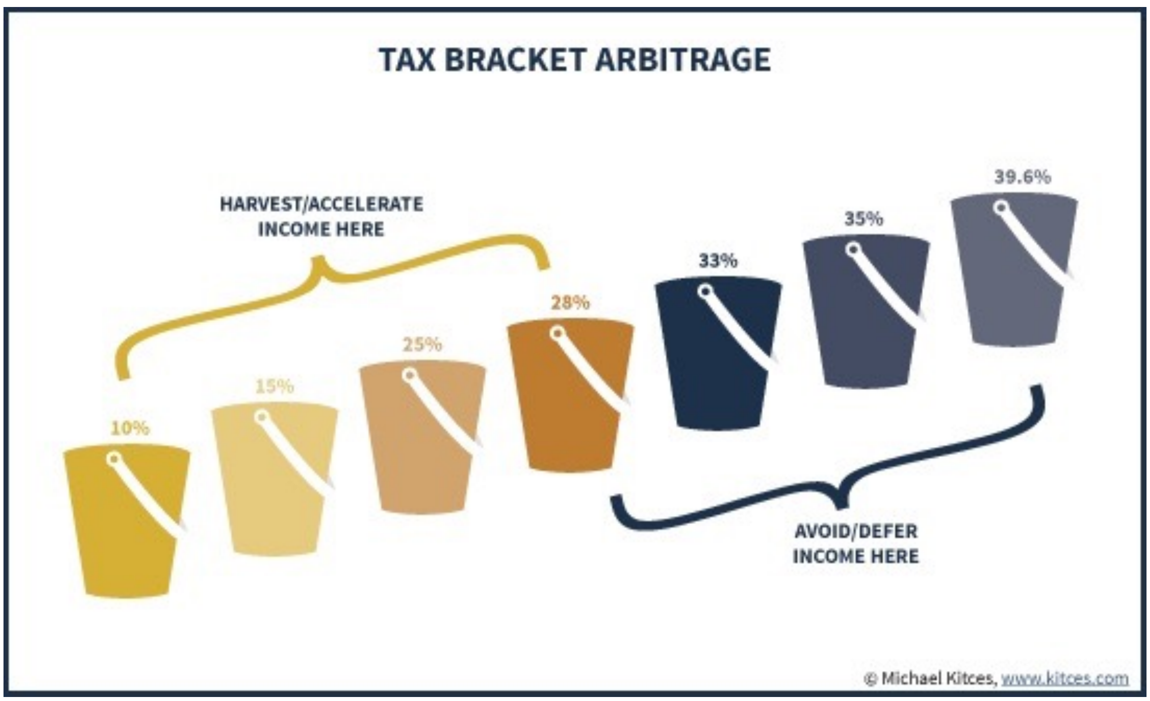
[5] *For example, pending an exception to the rule, an individual is required to withdraw a minimum amount annually from tax-deferred retirement accounts once they attain a certain age. These minimum amounts are known as required minimum distributions (RMDs). The most common age an individual is subject to RMDs is 70 ½.*

[6] *Pure Financial Advisors, November 22, 2016, Tax Diversification, digital image, Pure Financial Advisors, accessed April 24, 2018, https://purefinancial.com/ymyw/episodes/how-your-taxes-could-change-under-trump-special-episode/.*

With proper planning, tax diversification can provide an opportunity to minimize the detrimental impact income taxes can have on one's retirement success. Below are some specific examples of how tax diversification can allow for a tax-efficient retirement strategy:

- **A retiree can draw income from different tax sources as they gradually transition from lower to higher income brackets to control their marginal tax rate.**[7]
    - A retiree can draw enough from tax-deferred sources to reach the limit of an income tax bracket, then the retiree can draw from a taxable account to avoid jumping up to the next tax bracket.
    - A retiree can draw from tax-deferred accounts before being subject to Required Minimum Distributions (RMDs). For a client with a large traditional IRA, making distributions from this account in advance of being subject to RMDs can keep future RMDs from pushing them into a higher tax bracket.

- **In an unusually low tax year,**[8] **a taxpayer may be able to convert a portion of their tax-deferred retirement accounts to tax-free accounts (known as a Roth conversion), effectively accelerating income, for little or even zero tax impact.**
    - This provides an opportunity for tax arbitrage as these assets are then able to grow completely free of any future income tax.
    - Because they were originally tax-deferred contributions, they may have been made on a *pre-tax* basis or the retiree may have received a deduction for them on their tax return. A true "win-win" from an income tax perspective.



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[7] *The marginal tax rate is the amount of tax imposed on every last dollar of income. The U.S. is a progressive tax system, meaning the marginal tax rate increases as taxable income increases.*

[8] *The period of time after an investor's retirement and before they begin receiving social security payments can be one of relatively low taxable income.*

- **An older retiree with appreciated positions in a taxable account, and consequently, unrealized capital gains,[9] can withdraw funds from tax-deferred accounts before having to liquidate these positions.**
    - ➢ The retiree avoids any taxes owed on realizing the capital gains.
    - ➢ When the retiree dies, the assets receive a "step-up" in basis.[10]
    - ➢ The heirs will then inherit the assets with little to no unrealized capital gains.

- **Historically, the public sentiment tends to believe that individual income tax rates will continue to rise. This would make tax-free assets attractive relative to tax-deferred assets.**

    - ➢ As is often the case, public sentiment has been proven wrong.
    - ➢ The Tax Cuts and Jobs Act (TCJA) of 2017 lowered individual income tax rates for many taxpayers.
    - ➢ This increased the relative value of tax-deferred accounts, as retirees may now be paying lower than expected ordinary income tax rates on distributions from these accounts.

How Can We Help?

We understand that "talking taxes" is not everyone's ideal topic of conversation. We are here to work directly with you to formulate a tax-efficient retirement income strategy particularly in the context of overall tax planning for 2018 and beyond. If you would like to speak further regarding tax-efficient retirement income planning, I encourage you to call, **916-405-9166**, or email **spitchford@towerpointwealth.com**.

[9] *A profitable position that has yet to be sold. For example, holding a stock that is worth more than what was paid for it.*

[10] *The basis (the cost of one's investment for tax purposes) of the assets are updated from their original to the market value at date of death.*