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EDITORIAL & OPINION

Think your taxes will be lower in retirement?

Retirees lose many deductions; and what if tax rates increase?

WEALTH MANAGEMENT
BY MONTGOMERY TAYLOR

You may have bought into the myth that you would be in a lower tax bracket in retirement. Well, guess what? That doesn't just happen without some very special tax planning. Why? There are many things that will have contributed to lowering your tax bracket during your working years: dependent exemption credits, child care credits, education credits, retirement contributions, home mortgage deductions, etc. When you're retired those will have gone away, leaving you with sources of taxable income, but few tax deductions. And, do you think it's possible that tax rates just might go up anyway?

Could you end up paying higher taxes in retirement? Do you have a lot of money saved in a 401(k) or a traditional IRA? If so, you may be poised to receive significant retirement income. Those income distributions will be taxed. With federal and state governments hungry for revenue, you may see higher marginal tax rates in the near future. Planning is in order, so that you don't become a distressed taxpayer (hmmm… is that redundant or what?)

Retirees with meager savings may rely on Social Security as their prime income source. They may end up paying less income tax in retirement, as up to half of their Social Security benefits won't be counted as taxable income. On the other hand, those who have saved and invested well may retire to their current tax bracket or even a higher one.

Given this possibility, affluent investors would do well to study the tax efficiency of their portfolios. (Some investments are not particularly tax-efficient—REITs and small-cap funds, for example.) Both pre-tax and after-tax investments have potential advantages.

What's a pre-tax investment? Traditional IRAs and 401(k)s are classic examples of pre-tax investments. You can put off paying taxes on the contributions you make to these accounts and the earnings these accounts generate. When you take money out of these accounts come retirement, you will pay taxes on the withdrawal. Pre-tax investments are also called tax-deferred investments, as the invested assets can benefit from tax-deferred growth.

What's an after-tax investment? A Roth IRA is a prime after-tax investment example. (Certain types of cash value life insurance contracts are also superb tax-favored planning vehicles; a topic for another column.) When you put money into a Roth IRA during the accumulation phase, contributions aren't tax-deductible; as a trade-off, you don't pay taxes on the withdrawals from that Roth IRA (providing you have followed the IRS rules for the arrangement). These tax-free withdrawals lower your total taxable retirement income.

Since everyone would like to pay less income tax in retirement, the tax-free withdrawals from Roth IRAs are very attractive. As federal tax rates appear poised to climb, after-tax investments are starting to look even more attractive. Since anyone can now convert a traditional IRA to a Roth IRA, many affluent investors are considering making the move and paying taxes on the conversion today in order to get tax-free growth tomorrow.

Certain tax years can prove optimal for a Roth conversion: If a high-income taxpayer is laid off for most of a year, closes down a business or suffers net operating losses, sells rental property at a loss or claims major deductions and exemptions associated with charitable contributions, casualty losses or medical costs…that taxpayer might end up in the lowest bracket, or even with a negative taxable income. In circumstances like these, a Roth conversion may be a good idea.

Should you have both a traditional IRA and a Roth IRA? It may seem redundant or superfluous, but it could actually help you manage your marginal tax rate. If you have both kinds of IRAs, you have the option to vary the amount and source of your IRA distributions in light of whether income tax rates have increased or decreased.

Your marginal tax rate might be higher than you think. Consider that about 25 different federal tax deductions and credits are phased out as your income increases. Quite a few of these are related to education. For instance, if your children (or grandchildren) are out of school when you retire, you will no longer be claiming those deductions so your taxable income might be higher.

Smart moves can help you lower your taxable income and taxable estate. An emphasis on long-term capital gains may help, as long-term gains aren't taxed as severely as short-term gains or ordinary income. Tax loss harvesting—selling the "losers" in your portfolio to offset the "winners"—can bring immediate tax savings and possibly help to position you for better long-term after-tax returns.

Are you striving for greater tax efficiency? In retirement, tax efficiency is especially important—and worth a discussion. A few financial adjustments could help you lessen your tax liabilities.

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