Lynn Toomey: Hello, there and welcome to this week's episode of the Walk, The Talk podcast. I am your host and founder of Her Retirement, Lynn Toomey. Welcome. And today I'm going to be talking about taxes in retirement, and my question is, do taxes in retirement matter? My answer, absolutely. Utilizing the proper tax planning strategy can potentially add five to 10 years to your retirement portfolio when withdrawing income. Let's talk about some eye-opening statistics. Number one, 37% of retirees admit they did not consider how taxes would impact their retirement income. As a result, Nationwide Retirement Institute says that they may have lost the opportunity to save six years worth of income in retirement. Number two, 60% of pre-retirees, 70% of recent retirees and 75% of those who have been retired for more than 10 years say they are only somewhat knowledgeable or not at all knowledgeable about tax planning.

Number three, 53% of pre-retirees and 47% of recent retirees wish they better understood how their income and retirement would be taxed. And number four, 46% of recent retirees wish they had better prepared for paying for taxes and retirement. And finally, 24% said that they have paid several thousand dollars more in taxes than they had expected. So very, very important to understand these statistics and make sure that you are not one of them. Before I get started into the real meat of this presentation, I want to talk about the national debt because it's very important to understand the debt and where tax rates might go. Our highest marginal tax rate today is about 37%. It's pretty close to historic lows where we're at today, but with our national debt approaching $30 Trillion, where do you think taxes have to go? Where do you think... There's probably no option for them to go lower, not with that kind of debt.

So it's very, very important that you prepare for the future tax rates because most experts and people agree that they are going to go up. And actually, there's a website and I will provide the URL in the notes for this podcast, but there is a website that talks about the published national debt being $30 Trillion, but there's actually a true national debt, which is closer to $135 Trillion. And the difference between the two is that the smaller number does not include total unfunded social security and Medicare promises. So look people, you don't have to be a statistic. Let's find out in this podcast how you can be tax smart and tax efficient. Tax risk is one of the important risks that you need to mitigate as part of your overall retirement plan. The issue is finding people that can help you mitigate tax risk.

A lot of CPAs don't do this. A lot of financial advisors, like those traditional advisors, who've focused on helping you grow your assets don't do it. [inaudible] certainly don't do it because they don't understand taxes. So really difficult to find someone. I can help point you in the direction of a retirement advisor who is well versed in tax planning. In fact, if you are meeting with a so-called retirement advisor and he or she does not talk about tax planning, don't walk, run away. Find a retirement advisor who is very well versed in tax planning. And I will give you a tax guide. At the end of this podcast, you'll get a link to a tax guide. You'll get a link to a tax questionnaire so that you can take it to your so-called advisors, make sure that they are able to do the tax planning that you need.

It's a no brainer. If you're not doing tax planning, you're leaving potential money on the table. So tax liability in retirement has an impact on your portfolio survivability rate. Future tax rate increases may be the biggest challenge retirees face. So some of those tax reduction strategies are Roth conversions, tax loss harvesting, annuities, whole life insurance, tax-free investments, tax-optimized withdrawals and asset location. Potential tax rate increases make tax planning more important and more beneficial than ever before. So I want to talk about seven tax strategies that can potentially save you a lot. Let's talk about strategy number one. Consider a health savings account or an HSA. Oftentimes it's available through your corporation as a benefit, as an HR benefit. For self-employed, you can find private HSAs. It does require you to have a high deductible health plan, okay? So important. You need a high deductible health plan in order to access an HSA.

However, the benefits, the tax benefits of an HSA make it the most valuable tax planning strategy in your retirement. It is triple tax free. So you can make tax deductible contributions, you'll have tax-free growth and you'll have tax-free withdrawals for qualified healthcare expenses, okay? Very, very valuable tax planning tool. According to fidelity health care cost estimates, an average retiree... An average retired couple age 65 in 2018 would need approximately $280,000 saved after tax to cover healthcare expenses in retirement. So the point is that you are going to need at least a few hundred thousand dollars in out-of-pocket healthcare costs in retirement. And for women, this is even more important because we tend to live longer therefore our healthcare costs tend to be higher. So prior to retirement, very important to try to access an HSA and save for these healthcare expenses because it is so tax advantaged.

Let's talk a minute about the contribution limits. So in 2021, an individual could contribute up to $3,600. There's a catch-up provision if you're over 55 of $1,000 bringing the total to $4,600. For a family it's 7,200. Over 55, it's $1,000 catch-up bringing it to $8,200. Any funds in an HSA account that is not used before the end of the year is rolled over and accumulates tax free. So an HSA is different than an FSA. FSAs are different vehicle, offered through your company, and those funds need to be used in the year that the money is accumulated. HSAs are a different products. Another benefit is the tax-free deductions or excuse me, tax-free distributions if they're used for qualified medical expenses. These distributions are not subject to provisional income. They're not subject to required minimum distributions or RMDs.

If you do use them for non-qualified expenses, they are taxable. So you're not losing the money if you're not using them for healthcare expenses, but you will pay tax on those distributions. But as long as you are using them for healthcare in retirement, they will be tax-free. So again, there's no other vehicle that's triple tax free. Let's talk about strategy number two, investments that come with tax advantages. So this three I want to talk about municipal bond funds.

They allow for tax deferred growth and tax free income on the dividends and the interest. The income, however, is included for provisional income calculations, but you don't have to pay RMDs. Then you have tax deferred annuities. Those allow for tax deferred accumulation, and they do have preferential tax treatment based upon something called the exclusion ratio. There is a percentage of the income included for provisional income calculations.

And again, these do not have any required minimum distributions. Then the third investment vehicle is a life insurance retirement plan or ALIRP. Those offer a tax-free death benefit, tax-deferred growth, tax-free income. They are not included in provisional income calculations, and there are no required minimum distributions. So make sure you talk to your retirement advisor about those three tax preferred or tax preferential investments. Let's talk a little bit about required minimum distributions or RMDs just for a moment. As of last year, the required minimum distribution age increased to age 72. And basically, RMDs are mandatory withdrawals that are based on age and IRS life expectancy table, and the value of your accounts each year. And these are distributions that must be taken starting at age 72 from qualified retirement accounts. Basically, the government wants its share of taxes that it allowed you to defer back when you were contributing to your retirement savings accounts.

So for all those years you were contributing money to your retirement accounts, you kind of had a business partner and now your business partner wants his share of your accounts and the way the government does this is through these required minimum distributions. And those are taken each year, and there's no exception basically. So you must take your first RMD by April 1st, following the year you turn age 72 and withdrawals must be taken by December 31st of each year after age 72. And if you miss an RMD, there's a 50% penalty and that's assessed on the amount that should have been distributed. It's actually the biggest penalty in the tax code. So note to self, do not miss your RMDs. And a little side note, RMDs were not required in 2020. Due to COVID-19 the government suspended those, but going forward, they are required and it's very important that you make those RMDs.

So one of the tricks of tax planning is to figure out how you can mitigate the amount of RMDs that you have to take each year in retirement. So just as a quick example, if you had a value of a retirement account of $500,000 on December 31st of 2021, by the end of December... By the end of 2022, December 31st, you would have to take $19,531 as an RMD. That's about a 3.9% withdrawal. So RMDs can really affect your retirement. So take that $500,000 at age 72, you're going to have to take $19,531 or 3.9%. at age 80 $500,000, you have to take $26,738. That's 5.35%. at age 90, it goes up to $43,850 or 8.77%. at age 100, $79,365, 15.87%. So RMDs are very important and definitely can impact your retirement income. Next strategy I want to talk about is a reverse mortgage.

Yes, a reverse mortgage. They offer tax-free income or a tax-free safety net, okay? Though reverse mortgages have long held a bad reputation, research and public policy in recent years is shedding a new light on this potential use in retirement. They'd been called the Swiss army knife of... Financial planning research has shown that coordinated use of a reverse mortgage starting earlier in retirement, outperforms waiting to open a reverse mortgage as a last resort option once all outs has failed. So there's a number of benefits to reverse mortgages using your debt asset of your home. Using the equity in your home in the form of a reverse mortgage can provide a very, very nice income buffer. It can also fund a long-term care incident, lots of things, but really important from a tax perspective is that a reverse mortgage offers tax-free income. Very important tax benefit.

So just a couple of things on a [inaudible] or reverse mortgage, can you tap into your home equity to support yourself in retirement? That's the question? The answer is absolutely, but you must be 62 years of age. You typically need 50% to 60% equity in your home to qualify. Owners must maintain the home as well as paying the property taxes. And again, the income is not subject to income tax and it's not subject to social security provisional income, okay? Tax strategy number four, moving right along, consider contributing to a Roth IRA or 401k. Benefits, after tax contributions, okay? Contributions must be made using after tax dollars. They offer tax deferred growth. Contributions and earnings compound tax-deferred. And third tax-free withdrawals. Contributions and earnings can be withdrawn tax-free, but it's subject to a five-year holding period plus an age restriction of 59 and a half. From a tax planning flexibility perspective, no RMDs are required and they're not subject to social security provisional income calculations, okay?

Roths are a very good tool to consider. Let's talk about the contribution limits on a Roth. Limits are $6,000 per year in 2021. People 50 and older can add $1,000 to those amounts for a total of $7,000. Roth IRA have income limits. In 2021, it's $140,000 of modified adjusted gross income or MAGI for singles, and $208,000 of MAGI for joint filers. A Roth 401k or a Roth 403B has limits of $19,500 for those under age 50, and $26,000 for age 50 plus. And just a quick note, both Roth IRA and Roth 401ks can be split with a traditional IRA and a traditional 401k, but they cannot exceed the maximum aggregate noted above. So you can split, but again, they can't be higher than the contribution limits that I mentioned.

So let's talk about an exception to the Roth income requirement rule. It is called the backdoor Roth. You can contribute to your traditional IRA and convert the nondeductible contribution to a Roth IRA in the same tax year. But you must pay tax on the conversion to the Roth IRA in the tax year that it was converted, okay? Taking money out of a Roth tax-free... Yeah. Taking money out of a Roth tax-free, let's talk about that. So, you must satisfy two triggering events. One, you must be aged 59 and a half, and you must've owned the Roth for five years, okay? There's a 10% penalty in tax on earnings for withdrawals before satisfying both triggering events, okay? You're allowed to take contributions at any time.

The exception allowed is a $10,000 withdrawal, including growth for the first time purchase of a home, okay?

Again, if you're missing any of these details, as I'm going through them, you will have access to a guide that goes along with this podcast recording, and you can certainly refer back to that guide for all of these numbers, okay? Let's talk about strategy number five, consider intelligent Roth conversions, okay? The question is to convert or not to convert and when to do it. Here's the trade-off you convert your traditional IRA to a Roth IRA. What's going to happen is you'll pay income taxes at your current tax rate on the conversion. You'll have tax-free growth, you'll have tax-free withdrawals during retirement, but again, you must satisfy those two triggering events, age 59 and a half and a five-year wait period on each conversion, okay? So a lot of people think, "Okay, so should I take those monies in my tax deferred account and convert them to a Roth?"

Well, the question is, it's all about timing. You have to consider what tax rate you're at in the year that you do the conversions. And again, the tax planning specialist, who's also a retirement advisor can help you make those decisions, okay? When you consider those intelligent Roth conversions, it's kind of like an all or nothing. If you convert a traditional IRA to a Roth IRA over the course of multiple years, you may pay less total tax than if you convert during a single year. Your future tax increases make conversion to Roth more advantageous. There's additional benefits when you pass Roth assets to heirs, it is done income tax-free, subject to some restrictions, and it's not subject to social security, provisional income calculation, and there are no RMDs, okay? Let's take a look at strategy number six, managing social security taxation. The question is, will your social security benefit be taxable?

And the answer is no unless your social security, provisional income exceeds certain limits. So what is provisional income? Well, it's a calculation. It's adjusted gross income, plus any non-taxable income from things like a municipal bond fund plus half of your social security benefit. So let's look at a hypothetical calculation. Let's assume you had an IRA withdrawal or an RMD of $45,000. From that you can deduct your standard marital deduction of $24,800 in this case, which equals a $20,200 AGI. You will add to that your municipal bond income of $10,000 and you'll add half of your $40,000 social security income benefit, which is $20,000. So the $20,200 plus the $10,000 [inaudible] bond income, plus half of your social security benefit of $20,000 and you arrive at total provisional income of $50,200. Now, let's look at the taxation on that.

Up to 85% of a benefit is taxable if your combined provisional income is over $44,000 and you file as married filing jointly. So in this case, up to 85% of your benefit would be taxed because your provisional income was $50,200 in this hypothetical case. So I'll go through a couple other scenarios. Up to 50% of your benefit may be taxable if your provisional income is between $25,000 and $34,000 and you file single or between $32,000 and $44,000 and you file married, filing jointly. And again, up to 85% is if you're over $44,000 and you file as married filing jointly over, $34,000 if you file single. So the name of the game is to try to lower your provisional income as much as possible so that you don't have those 50% and 85% taxes. So that's the name of the game with your social security strategy. Very, very important to make sure you meet with a retirement advisor who understands the impact of provisional income and the impact of taxes on your provisional income, and how can you get your provisional income as low as possible to avoid that taxation.

Let's talk about strategy, number seven, using cash value, life insurance, and in my next podcast next week, I'm going to be going into a lot more depth on using cash value, life insurance, as it relates to taxation or minimizing taxes in retirement. But for the purpose of today's podcast, I'm just going to mention that you have various cash value, life insurance as a tax strategy, whole life, universal life, variable life, okay? You're able to borrow or distribute cash value tax-free and it offers a tax-free transfer of wealth to your heirs. And if you'd like to learn a lot more about the value of cash value, life insurance as a tax strategy, make sure you tune in to next week's episode of the podcast. Strategy number eight, tax diversification. Very, very important to create what is called your tax buckets. There's a tax-free bucket, taxable bucket, a tax-deferred bucket. And I will add a fourth bucket, which is that triple tax free bucket and the only thing that's in that bucket is an HSA.

But let's talk about the tax-free taxable and tax-deferred. Tax diversification is all about having money in each of those buckets, okay? That's key to creating that tax efficient, income distribution strategy. Your strategy for withdrawing retirement assets is as important as your strategy for accumulating them, but it's much more complex. So you have monies in a tax deferred bucket, like a 401k, you have monies in a taxable bucket, and you might have monies in a tax-free bucket. The question becomes in retirement, which accounts money should be taken from and in what order, and then what opportunities exist for conversion to maximize your efficiency? I want to talk quickly about three draw down strategies to consider. One is pro-rata strategy. One is a sequential strategy, and one is sequential with a Roth conversion strategy. With the pro-rata, you withdraw from taxable tax deferred and tax-free accounts proportionately.

It's really not optimal in most cases. In a sequential strategy, you withdraw from taxable accounts first, then tax-deferred accounts and lastly, tax-free. This is the traditional approach, but not the most efficient in most cases. The sequential with Roth conversion strategy, you withdraw from taxable accounts first, then tax-deferred and lastly tax-free. Roth conversions are executed to take advantage of periods of lower tax brackets. And this is the most optimal in most cases. So in terms of tax efficient withdrawal or tax efficient retirement distribution, not all retirement savings assets are equal from a taxability standpoint. Important to know. Taxable, tax-deferred, tax-free. And an efficient retirement plan should illustrate which accounts money should be taken from, in what order and what conversion opportunities exist to maximize efficiency. And a customized tax efficient distribution strategy could save you significant value and extend the time horizon of your retirement assets, okay?

However, before you implement any strategy to reduce your tax liability, make sure it compliments your overall financial plan. And part of the guide that you're going to have access to will be a case study in which you're going to meet the Bradys. Mike and Amanda, they're married, their current ages of 56 and 54. Their target retirement age is 65 and their salaries are $200,000 for Amanda and $50,000 for Mike. They are planning to take social security at 70. Their monthly expenses in retirement are $9,000 and their invested assets are a million dollars in qualified and $100,000 in non-qualified. And basically what you're going to see and read in this case study is that tax brackets during retirement can be pretty surprising. So there's these troughs, if you will, where there's periods of low taxable income after retirement, before age 70.

And what you're going to see in the case of the Bradys is that RMDs and social security can drive up taxable income starting age 70 and result towards your mid 80s, in surprisingly high taxable income in these later years of retirement. And that large IRA distributions can drive up those tax brackets. So it's very important to, what we call, smooth out the tax liability. And in those earlier years to do intelligent Roth conversions, to do what's called filling up your tax bracket. And then later on in retirement, you have a less, less taxable income when your tax rates are higher. So what you'll see in the case study, by doing this efficient tax strategy in that strategy that I talked about sequential with Roth conversion strategy, which is the preferred strategy, you'll see that in this case with our friends, Mike and Amanda, implementing this tax strategy, they would have over $1.1 million more in their portfolio.

And this is a tax adjusted ending portfolio, rather than using a pro-rata withdrawal strategy without conversion, they would have $1.1 million. So not only are they being efficient, they are ending up with much more money as a result of being tax smart. Now, what I want you to understand is, by hiring a retirement advisor who understands these tax strategies, it can be worth its weight in gold. So taxes do matter in retirement. Some key takeaways, create your buckets, tax-deferred, tax-free and taxable. Make sure you pay attention to tax diversification. Utilize an HSA for those triple tax advantages. Implement tax efficient withdrawal sequencing coupled with Roth conversions. The result is you're going to minimize your RMDs, you're going to reduce your social security provisional income, you're also going to have reduced Medicare premiums because your income's going to be lower, and you'll reduce your taxes annually to increase your net-spendable income.

So I want to thank you very much for listening to this week's episode of taxes in retirement. And again, please, please access that tax guide and reach out to at lynnt@herretirement.com. I can connect you with one of those retirement advisors who can do a tax analysis for you. They do a quick assessment to find out if any of these strategies can put you in a better position, help you make your portfolio last longer. And remember, next week, I'm going to talk about cash value, life insurance, and how it can be a very intelligent strategy in retirement. Thank you. I'm Lynn Toomey. This is Walk The Talk podcast and I thank you very much for listening. And as I always say, go out and get her done.

In this case, I'm talking about taxes. Get her done, and you'll have much longer life to your portfolio. Thanks for listening. Have a great day.