Tax Efficiency in Retirement

How much attention do you pay to this factor?

Will you pay higher taxes in retirement?
Do you have a lot of money in a 401(k) or a Traditional IRA? If so, you may receive significant retirement income. Those income distributions, however, will be taxed at the usual rate. If you have saved and invested well, you may end up retiring at your current marginal tax rate or even a higher one. The jump in income alone resulting from a Required Minimum Distribution could push you into a higher tax bracket.

While retirees with lower incomes may rely on Social Security as their prime income source, they may pay comparatively less income tax than you will in retirement; some — or even all — of their Social Security benefits may not be counted as taxable income.[1]

Given these possibilities, affluent investors might do well to study the tax efficiency of their portfolios; not all investments will prove to be tax-efficient. 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, you are looking at taxes on the withdrawal. Pre-tax investments are also called tax-deferred investments, because the invested assets can benefit from tax-deferred growth.[2]

What's an after-tax investment?
A Roth IRA is a classic example. When you put money into a Roth IRA, the contribution is not tax deductible. As a trade-off, you don't pay taxes on the withdrawals from that Roth IRA (so long as you have had your Roth IRA at least five years, and you are at least 59½ years old). Thanks to these tax-free withdrawals, your total taxable retirement income is not as high as it would be otherwise.[2]

Should you have both a Traditional IRA and a Roth IRA?
It may seem redundant, but it could help you manage your marginal tax rate. It gives you an option to vary the amount and source of your IRA distributions considering whether tax rates have increased or decreased.

Smart moves can help you reduce your taxable income & taxable estate.
If you're making a charitable gift, giving appreciated securities that you have held for at least a year may be better than giving cash. In addition to a potential tax deduction for the fair market value of the asset in the year of the donation, the charity can sell the stock later without triggering capital gains for it or you.[3]

The annual gift tax exclusion gives you a way to remove assets from your taxable estate. In 2018, you may give up to $15,000 to as many individuals as you wish without paying federal gift tax, so long as your total gifts keep you within the lifetime estate and gift tax exemption. If you have 11 grandkids, you could give them $15,000 each — that's $165,000 out of your estate. The drawback is that you relinquish control over those dollars or assets.[4]

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

Contact us for help in financial planning.

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Citations.
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