A TAX WISE RETIREMENT E-BOOK

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James A. Crow is the President and Founder of Wealth Planners, LLC. He holds a Bachelor of Science Degree with a Major in Business and a Minor in Economics as well as a Master of Business Administration Degree with an emphasis in finance. His firm focuses on retirement planning and assisting people approaching retirement.

BE TAX WISE ABOUT YOUR RETIREMENT INCOME

It's not how much income you have, but how much you have left to spend.

All tax-related information contained herein is based on the author's current understanding of federal tax laws as they relate to Roth IRAs, life insurance or other subject matter discussed. These laws are subject to change in the future. Neither the author nor publisher offer legal or tax advice. You should consult your tax professional on any tax matters. Being "tax-wise" is no longer a concern for only the wealthy.

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Many people fear that increasing tax rates might be looming on the horizon. And, considering our country's spending and growing addiction to debt, this fear may be well-founded.

> *When you retire, you leave behind many things—the daily grind, commuting, maybe your old home—but one thing you keep is a tax bill. In fact, income taxes can be your single largest expense in retirement.* (Source: www.finra.org)

Perhaps you believe that your future tax rates won't be so high because the amount of your income during retirement will be less. Maybe you are right, but then again, what if you are wrong?

To raise the revenue our country will certainly need to pay its future bills, will Congress start targeting retirees with $80,000 or $60,000 or less in annual income? Will these people ultimately be considered affluent enough to justify extracting higher taxes from?

No one knows the answer to if or how high future tax rates might climb, and exactly who will be impacted if they do climb. But from a risk management perspective, what can and should be done anytime we face unknowns is to diversify our exposure to the risk.

Developing a "tax-wise" retirement income strategy starts with understanding the principle of tax diversification.

Different Income is Taxed Differently

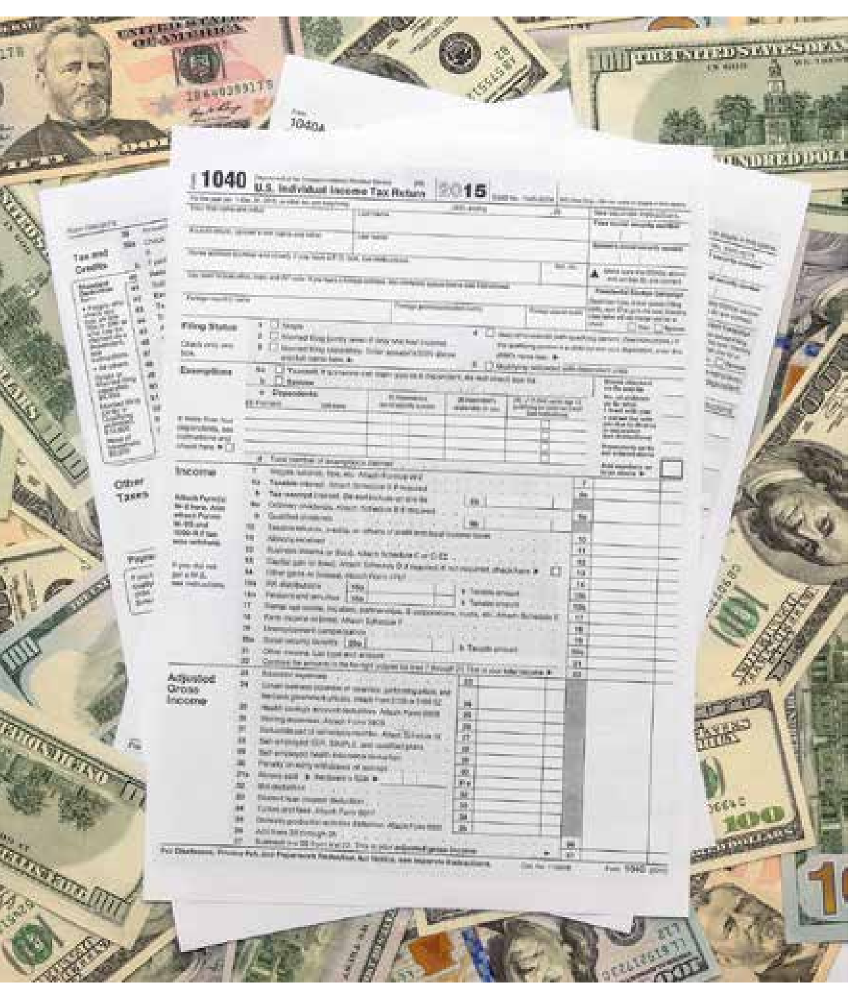
If we had a simpler tax system in this country, there would likely be no value to gain from tax diversification. Unfortunately, our tax system is extremely complicated and because it is, the potential benefits of tax diversification should not be ignored by anyone who is currently retired or approaching retirement.

To begin to understand the potential value of tax diversification, you don't need to look any further than the first page of your tax return.

Notice that there is not one single line on which you enter all of your income. Instead, there are more than a dozen different lines on the 1040 form where income is entered based on the source of that income. The reason for these different lines is that your income will be treated much differently for tax purposes depending on where it comes from.

This difference in tax treatment is potentially profound. It can range from being 100 percent taxable, as is the case with:

- **Wages**
- **Interest earnings from bank CDs**
- **Distributions from IRAs**



and all the way to the other extreme of being potentially 100 percent tax-free, as is the case with:

- **Interest from Municipal Bonds**
- **Qualified Distributions from Roth IRAs**

Between these extremes, there is income that is treated more or less favorably depending on its source.

- **Dividends**
- **Capital Gains**
- **Social Security Income**

AND, IT'S POSSIBLE TO RECEIVE MONEY FROM OTHER SOURCES THAT LEGALLY MAY NEVER EVEN APPEAR ON YOUR TAX RETURN.

- **Proceeds from a Reverse Mortgage**
- **Withdrawals of Basis and Loans from Permanent Life Insurance**

If your income can range from being 100 percent taxable to 100 percent tax-free, or anything in between, then the amount of taxes you pay can have every bit as much to do with the source of your income as it can with the total amount of that income.

KEY INCOME SOURCES

Two different people could each have the same $100,000 of annual income, but the taxes they pay and subsequently the amount they have remaining after taxes to spend can be markedly different depending on the sources of their income. And, just because one person has less income, you can't necessarily conclude that he will pay less tax than another person with has more income. To a certain degree, the amount of tax that each will be required to pay has a great deal to do with the sources of their income.

For example, assuming both have the same expenses, who is able to enjoy a higher standard of living, George, with $120,000 of income, or Bill with $95,000? You can't know the answer until you know the source of their income. If George's income is all from a traditional IRA that is 100 percent taxable and Bill's income is all from a Roth IRA that is 100 percent tax-free, they might have the same after-tax income, or Bill might even have more spendable income.

Or, consider a situation in which both Nancy and Judy have total retirement incomes of $5,000 per month. And of this amount, assume that each receives $2,000 from her Social Security retirement benefit. Assuming that they both have identical expenses, who might have more money to spend on travel and buying gifts for her grandchildren? The answer to this question could depend largely on who will pay the least amount in income taxes. And that might depend principally on the source of the remaining $3,000 of income that they each receive.

If Nancy's other $3,000 comes from a pension, 100 percent of that will be taxable, plus it could cause a large portion of her $2,000 Social Security benefit to be taxed as well. With so much of her income subject to taxation, what remains after taxes might not be much more than what she might need just to pay her basic essential living expenses. Nancy may not have any money to spare on travel or the other fun things she wants to do.

On the other hand, if Judy's $3,000 comes from the proceeds of a reverse mortgage, none of it will be taxed and none of her Social Security benefit would be taxed as well. With a reduced tax bill, Judy might have more to spend on the fun things she wants to do.

CAPITAL GAINS TAX

Years ago, Bill and Pete were each fortunate enough to buy the same high-flying stock that resulted in the same $250,000 gain. Who will have more left after taxes to buy the boat or vacation home they each desire? The answer could have everything to do with the type of account in which they each had chosen to hold the stock. If Bill held his stock in an IRA, the entire amount is taxable, at his ordinary tax rates. If Pete held his in a brokerage account, the gain would be taxable but only at his long-term capital gains rate. Plus, if Pete happened to have owned any other stocks that resulted in a loss, he could offset some of the gains from his winning stock with some of the losses from his losing stock, and reduce his taxes even more. Bill doesn't have this option with any losing stocks in his IRA.

Do these examples mean that you should use a reverse mortgage for income, start a Roth IRA or switch your retirement savings to some other type of financial instrument? Or does it mean that you should only hold volatile investments in brokerage accounts instead of IRAs?

Not necessarily. Instead, the point is that it can be important to understand that not all sources of retirement income are treated the same for tax purposes. And that there might be reasons for considering if any benefit might be gained by diversifying your future income sources.

TAX “CATCH 22”

Considering all the different possible sources of retirement income and the many different ways that taxes can be applied depending on the source, you might expect to see a wide variety of financial instruments used by people for accumulating and storing retirement funds. And while such a variety could result in some “tax-wise” income strategies, most people aren’t tax-diversified. Many end up reaching retirement with a disproportionate amount of their income coming from Social Security and traditional 401(k)s, IRAs and other tax-postponed retirement plans.

It is not unusual to find a person who reaches retirement with 95 percent or more of his total savings in a 401(k) or IRA. This one-trick pony approach to retirement savings is understandable, considering that we are rewarded with a postponement of taxation every time we make a contribution to a traditional 401(k) or to the other retirement plans that are commonly offered at the workplace today.

Deferring Taxes

It’s easy to forget that these taxes are only postponed, and that after we retire and start taking withdrawals, 100 percent of this money will be subject to taxation.

Traditional retirement planning has said it is OK to postpone taxes because you will probably be in a lower tax bracket after you retire. But what if this assumption proves to be wrong, and instead our tax rates are the same or possibly even higher in the future?

Many people have two principle tax deductions during their working years that often they don’t have after they retire. One deduction is from those contributions we made to our 401(k)s and IRAs.

Once retired, we stop contributing to these plans, so the tax deduction we use to get on these contributions stops. The second deduction that is our interest write-off on our home mortgage payments is often lost during retirement. Many people are in such a hurry to get their mortgage paid off that they reach retirement with little or no remaining tax deduction.

Combine the loss of these two major tax deductions with the potential for any possible increases in tax rates that might be looming on the horizon, and it may be wise to rethink the logic of over relying on 401(k)s, IRAs and other tax-postponed retirement plans.

PROGRESSIVE TAXES

The problem the progressive nature of our tax system creates for many retirees is that the more successful they are at accumulating large balances in their 401(k)s and IRAs, the more likely that the withdrawals from these accounts will nudge them from a lower bracket to a higher bracket. When the majority of a person's retirement savings is in a 401(k), IRA or other tax-postponed retirement plan, and he finds himself creeping up the tax brackets, a vicious cycle is often set in motion.

TAX DIVERSIFICATION

To see the value of flexibility that tax diversification can provide, we will use the example of two friends we will call Frank and Beans. Both are age 66 and recently retired. Bean has all of his savings in a 401(k), while Frank has about three-quarters of his savings in a 401(k) with the other quarter is in a Roth IRA.

To keep this example simple, we won't consider possible deductions and exemptions that would lower their taxable income. We will assume that neither Frank nor Beans will receive any Social Security nor do they have any other sources of income. They each need $60,000 a year and it must come entirely from their savings.

Because Beans has all of his savings in a 401(k), he only has this one account that he can use as the source of the withdrawals he needs.

If Taxable Income is:	The Tax is:
Not over $9,700	10% of the taxable income
Over $9,700 but not over $39,475	12% of the excess over $9,701
Over $39,475 but not over $84,201	22% of the excess over $39,475

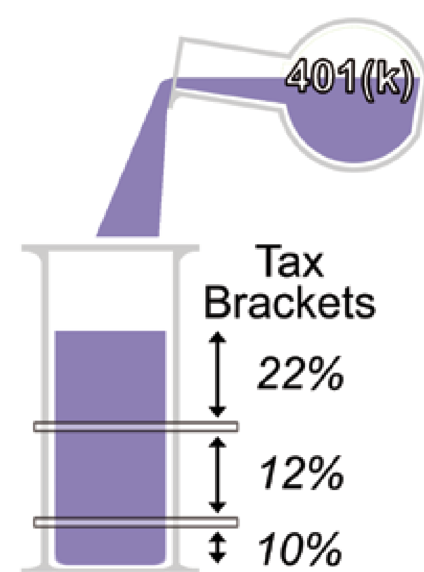
2020 Federal Tax Rates - Single

Frank has more flexibility with regards to where he takes his withdrawal since he has both a 401(k) and a Roth IRA.

Let's consider Frank and Beans' options with regards to being "tax-wise" about their retirement income strategies.

In 2020, single taxpayers with taxable incomes not exceeding $84,201 would be subject to the tax brackets shown in the table above.,

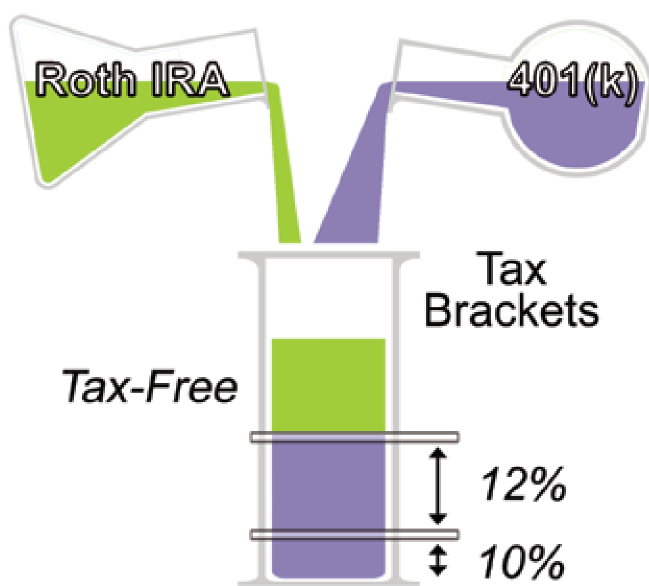
Beans doesn't have any flexibility, because his only option is to withdraw the entire $60,000 from his 401(k). Since the withdrawal is coming from a tax-postponed retirement plan, it is 100 percent taxable.



Consider that this withdrawal exceeds the $39,476 starting amount for the 22 percent tax bracket by $20,524 ($60,000 - $39,476 = $20,524). As a result, Beans is pushed into the 22 percent tax bracket: part of his withdrawal is taxed at 10 percent and 12 percent and the rest is taxed at his top rate of 22 percent.

Because Frank has two accounts from which to withdraw from, he has more options and greater flexibility. For example, he might choose to be "tax-wise" and limit the withdrawal from his 401(k) to $39,475 and take another $20,525 as a qualified withdrawal from his Roth IRA.

Frank ends up withdrawing the same $60,000 total as did Beans, but his tax situation is much different. Because the $20,525 from his Roth IRA is 100 percent tax-free, his only taxable income is the $39,475 401(k) withdrawal. And because his taxable income does not exceed the $39,475 ceiling for the 12 percent tax bracket, Frank's top tax rate is only 12 percent. As a result, part of his withdrawal is taxed at 10 percent and the rest at his top rate of 12 percent. And no portion of his income is taxed at the 22 percent bracket.



Even though the amount of Frank's and Beans' total withdrawals were identical, we can expect that Beans will pay a much larger amount of taxes and have less spendable income available.

Now let's assume that Frank gets the great idea that he and his buddy Beans should travel to Scotland for a golf vacation. This once-in-a-lifetime trip will cost them each $4,000.

Beans would love to go, but after paying all of his bills, buying his groceries, paying other expenses, and paying his higher taxes, he doesn't have enough spendable income remaining to go on a vacation. Of course, Beans could withdraw some extra money from his 401(k), but because of the tax bracket that he is in, each additional dollar he takes will be taxed at least at that 22 percent tax rate. If he limits additional anwithdrawal to $4,000, it will create another $880 in taxes, so he still doesn't have the money he needs. If he adds another $880 to the withdrawal, it creates another $194 in taxes. He is still short so he must withdraw more. And so on.

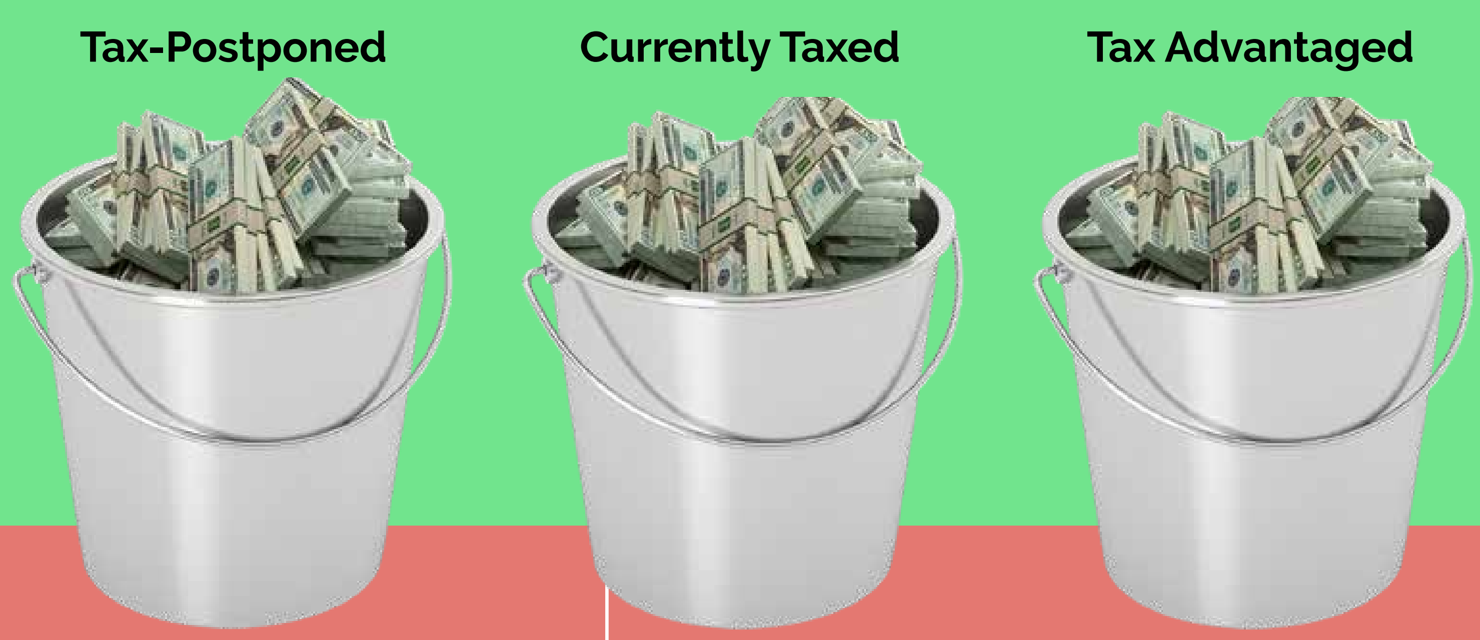
Beans is trapped in a vicious cycle of taxation.

Tax Buckets

One way that some people might possibly avoid this cycle is by diversifying their portfolio between different financial instruments that are taxed in different ways. Generally speaking, you can place most financial instruments into one of three broad categories, depending on tax treatment. We will refer to these categories as buckets.

Currently-Taxed Bucket

Currently-taxed financial instruments would typically include savings that you have in a bank CD, a brokerage account or other savings and investments that you accumulate with after-tax dollars. The interest and dividends you receive each year from these instruments are included in your taxable income in the year received.



Tax-Postponed Bucket

Traditional 401(k)s, IRAs and other so-called defined contribution retirement plans fit in the category of tax-postponed instruments. Your contributions to these accounts are made with pre-tax dollars, giving you a tax break at that time. When you retire and start taking withdrawals, 100 percent of the income you receive is taxable income.

Tax-Advantaged Bucket

In the category of tax-advantaged instruments, we are referring to financial instruments that are funded with after-tax dollars and for which the earnings or growth accumulates on a tax-deferred basis. But when certain conditions are met, the accumulations can be accessed free of income tax. Qualified distributions for Roth IRAs, proceeds from reverse mortgages and cash value loans from properly structured permanent life insurance contracts are some possible options in this catagory.

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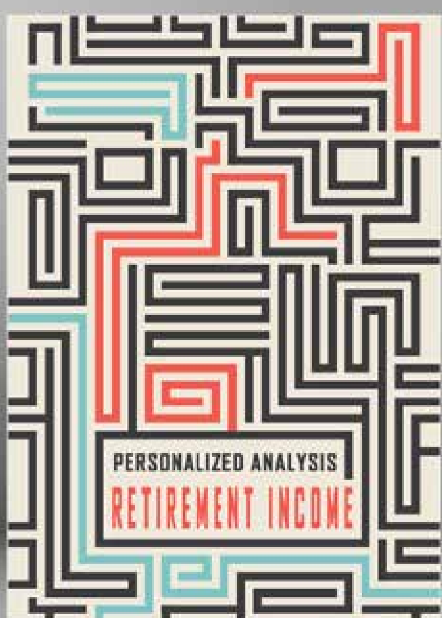

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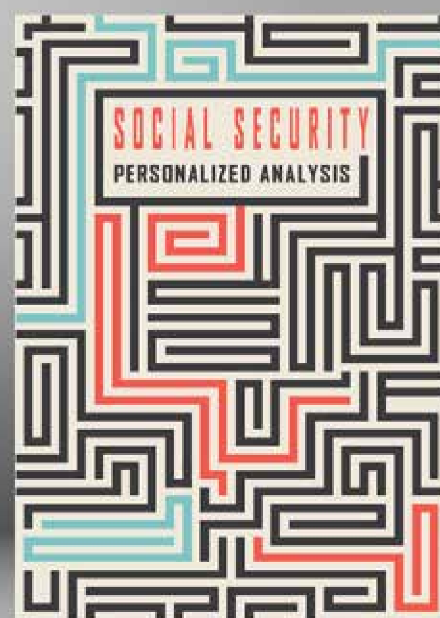

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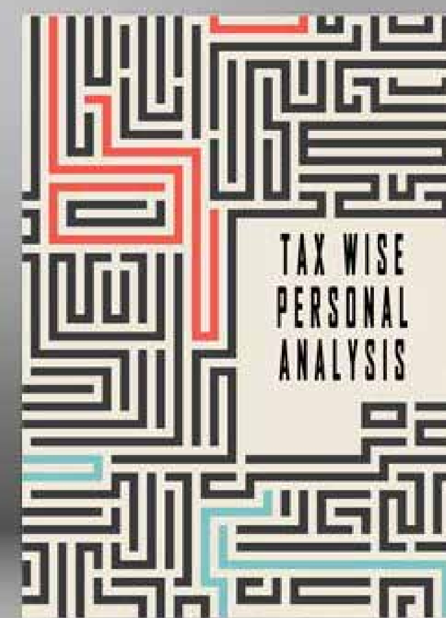

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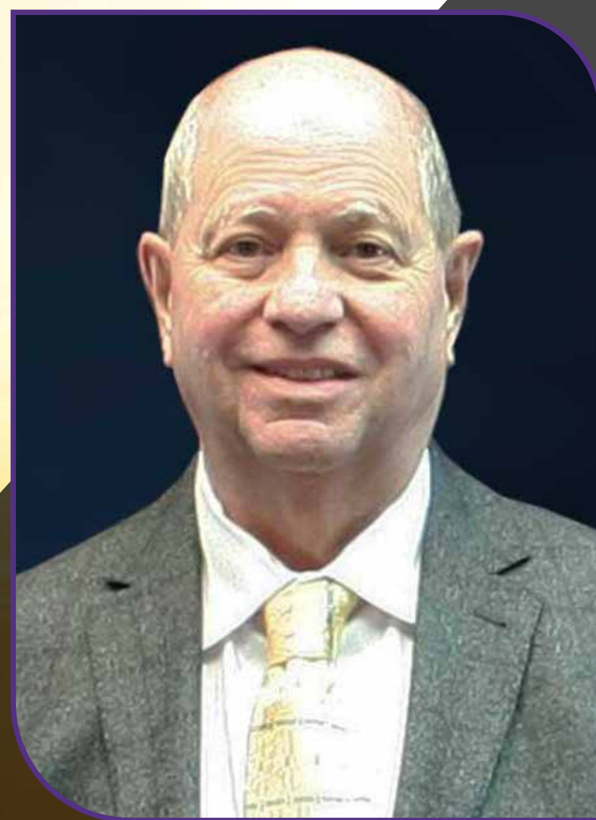

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