Minimizing Taxes on Retirement Income As a Priority in Every Retirement Plan

No matter how well a person believes they have planned for a retirement income stream that will keep them living comfortably throughout their golden years, if they haven't planned adequately for minimizing taxes there can be serious implications to their financial stability.

Recent studies on the retirement readiness of baby boomers find that a majority of 21st century seniors enter their golden years less prepared than they realize, particularly when it comes to giving some thought to the potential effect of taxes on their retirement nest egg. According to a 2014 study by the Center for a Secure Retirement, 36 percent of retirees reported that taxes cost them more than they had anticipated, and 23 percent admitted that they never even thought about planning for taxes before retiring.

The consequences of underestimating how significantly federal taxes can impact one's retirement income can be severe. No matter how well a person believes they have planned for a retirement income stream that will keep them living comfortably throughout their golden years, if they haven't planned adequately for minimizing taxes there can be serious implications to their financial stability.

People between the ages of 60 and 70 have a variety of options available for managing their taxable income after they retire, and the earlier they start planning the better. Although retirees are no longer absorbing payroll taxes, they will most likely continue to owe income tax on at least a portion of the savings from which they draw an income for living expenses, and will be forced to take required minimum distributions at age 70.5, which are 100 percent taxable.

According to Kirk Cassidy, co-president of Senior Planning Advisors in Farmington Hills and Ann Arbor, MI, people are paying hundreds of thousands of dollars more in taxes than they need to be.

Tax planning in retirement requires taking income from designated sources at a specific age to minimize taxation throughout retirement. Some strategies allow retirees to minimize taxation on social security, reduce tax liabilities associated with required minimum distributions, and harvest appreciated assets at the right time. This can be done by a combination of using donor advised funds, Roth converting, using taxed favorable income, charitable trusts and tax-favorable investments.

"Many retirees with defined contribution plans such as a 401(k)'s 403(b)'s, etc. or traditional IRAs in place are completely unaware of the serious tax penalties that apply if they stray from the strict tax rules that are common to these plans," Cassidy says. "Understanding the laws, making sure to claim all eligible deductions and dependents, reducing and/or converting the amount of retirement assets—these are just a few of the things that can significantly reduce a retiree's total tax burden.

"The problem is, most middle-income Americans over age 50 are not able to identify many of the tax strategies that are associated with retirement, which is why a qualified financial advisor who is a fiduciary is critical to creating an effective retirement plan."

One tax strategy utilized to minimize taxes on highly appreciated assets is a donor advised fund, a public charity program that permits donors to make an irrevocable contribution and recommend gifts to qualified nonprofits according to their own timeframe.

A donor-advised fund allows the donor to take an immediate tax deduction of up to 50 percent of the adjusted gross income for cash, or 30 percent for appreciated assets.

The donor can eliminate capital gains tax for gifts of long-term appreciated securities and can name successors to continue the fund as a family trust or foundation.

Finding ways to minimize income and federal gains taxes after retirement is critical to establishing and maintaining the lifestyle most seniors expect to enjoy after leaving the work force. Seniors who land in a lower tax bracket after their fulltime salary ends may still have significant levels of taxable income based on pension income, withdrawals from investment and retirement savings accounts, Social Security benefits, and other income sources.
Conventional wisdom encourages retirees to tap into their taxable accounts first, followed by any tax-deferred retirement accounts in their portfolio, and then tax-exempt Roth individual retirement accounts. However, this type of withdrawal schedule can backfire by unintentionally increasing the retiree's overall tax burden, boost the portion of Social Security benefits subject to income taxes, and prompt higher Medicare premiums once their income surpasses certain thresholds.

For most people, the challenge of performing smart tax planning for retirement is probably best met with the help of a professional retirement planner with a background in tax planning, along with a CPA or other tax professionals with PFS designation and a track record in long range retirement tax planning. It is important to avoid people who call themselves financial advisors and work for large investment firms or banks that prohibit them from offering tax advice.

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