Retirement Planning

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Defer No More? Why You Should Rethink Your Retirement Strategy

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

There's a new way of thinking about saving for retirement in a rising tax environment. Let's explore the tax changes that are taking place and outline several strategies that help you achieve tax diversification in retirement.

The conventional wisdom for success in real estate has always been "Location. Location. Location." Similarly, the formula for retirement and tax planning has been "Defer. Defer. Defer."

Just as the increase in home deliveries has altered the business recipe, so has an evolving tax landscape, which has changed how we view our retirement plans. Deferring income and taxes may not always be the best strategy. In fact it may prove to be more costly and more tax-inefficient over time.

Here are three reasons why:

- The potential for higher tax rates: The Biden administration has proposed raising the tax rate on upper-income earners making $400,000 or more though that legislation seems stalled in Congress. Nevertheless, the Tax Cuts and Jobs Act of 2017, which lowered taxes, is set to expire at the end of 2025 absent further legislation.
- The SECURE Act: The Setting Up Every Community for Retirement Act was signed in 2019 and it appears that we finally have some clues for how it will affect the tax code. The most fundamental change for retirement accounts in the SECURE Act was eliminating the so-called "stretch IRA" for most beneficiaries inheriting retirement accounts. In the past, beneficiaries had the option of distributing inherited retirement account assets over their expected lifetimes. Under the SECURE Act, a spouse named as a beneficiary can continue to receive distributions based on his or her life expectancy. For all other beneficiaries (with limited exceptions), the inherited retirement account must be fully paid out in 10 years. For higher-income heirs, the combined federal, state and local taxes on withdrawals from an inherited IRA can be as high as 40% or more.
- Medicare surtaxes: The Affordable Care Act introduced two Medicare surtaxes to fund Medicare expansion. Some high earners must pay both taxes. The additional Medicare tax rate of 0.9% applies to individuals whose earned income exceeds $200,000 for single filers and $250,000 for married couples filing jointly. The net investment income Medicare surtax is 3.8%. The tax is imposed only on a portion of the taxpayer's income. The tax is paid on the lesser of the taxpayer's net investment income, or the amount the taxpayer's adjusted gross income (AGI) exceeds the applicable AGI threshold ($200,000 for single filers and $250,000 for married couples filing jointly).

For example, if you and your spouse's net investment income is $150,000 and your AGI is $550,000, you would pay 3.8% tax ($5,700) on the $150,000 because it is less than $300,000 which is the amount over the $250,000 married filing jointly threshold.

A fourth variable could be the Federal Reserve's plan to raise interest rates aggressively to combat rampant inflation. Generally, the Fed's rate hikes show confidence in the economy and can increase the overall size of your portfolio. But how inflation responds to the rate hike could affect how much your money is actually worth down the road.

So, given the uncertainty of the future tax landscape, it raises the question of "when is the optimal timing to end tax deferral and withdraw from tax-deferred accounts" and "What other strategies can increase tax-efficiency?"

We recommend six potential strategies:

1. Contribute to Roth accounts. Roth contributions are made using after-tax dollars. Qualified Roth distributions from Roth IRA's and Roth employer plans are tax free if certain holding requirements are met. Higher earning taxpayers who cannot contribute directly to a Roth IRA may be able to contribute $6,000 in 2022 ($7,000 if over age 50) to a non-deductible IRA that might later be converted to a Roth IRA.

If you have after-tax amounts in your traditional, SEP, or SIMPLE IRA, you must aggregate these accounts. The portion of the conversion that is nontaxable must be prorated with amounts that are taxable, and must continue until conversion or distribution. For instance, if the individual contributed $2,000 in after-tax amounts and has a pretax balance of $8,000, a distribution of $5,000 would be prorated to include $1,000 after-tax and $4,000 in pretax assets.

Many employer-sponsored plans also now offer a Roth contribution option in their 401(k), 403(b) and 457(b) plans. If contributing through an employer plan the maximum contribution amount in 2022 is $20,500 with a $6,500 catch up for those individuals over age 50.

2. Roth conversions: With the potential for future higher tax rates, many more individuals are considering a Roth conversion and paying the tax on the conversion now at the lower rates. As you get closer to year-end, determining your marginal tax bracket and projected investment income can be done with more certainty. Consult with your advisor to ensure your conversions do not push you into the next tax bracket and ensure the accuracy of tax calculations.

3. Project future required minimum distributions: Required minimum distributions (RMDs) are amounts the federal government requires you to withdraw annually from certain retirement savings vehicles after you reach the required beginning date, age 72 for years after 2019. This includes traditional IRAs, SEP-IRAs, and SIMPLE IRAs. Employer-sponsored retirement plans that are subject to RMD rules include, 401(k), 457(b), and 403(b) plans. Work with your advisor to determine whether your guaranteed sources of income and your RMD will provide you more income than you need in retirement.

Converting traditional IRA and 401(k) balances to a Roth IRA also reduces the value of the traditional IRA and/or employer-sponsored plan, resulting in lower required minimum distributions in the future.

Consider taking distributions before you reach age 72 to lower the overall value of your qualified retirement accounts, thus reducing the dollar figure your RMD will be based on when you do reach the mandatory withdrawal age.

4. Consider life insurance policies: Life insurance can provide benefits that go well beyond replacing income to support beneficiaries when you pass away. When included as part of a comprehensive estate plan, life insurance can provide liquidity to pay estate taxes, allow beneficiaries to retain ownership in important assets like family businesses and real estate, equalize inheritances among survivors, maximize your wealth and secure your legacy. A permanent life insurance policy provides flexibility to access the policy's cash value with tax-favored distributions, as well. Life insurance also can be an effective vehicle for those who wish to contribute beyond the limits of their 401(k)s and IRAs.

5. Accelerate income: With the potential for an increase in tax rates, those with incomes above $400,000 may want to consider accelerating income in 2022. Roth conversions, harvesting gains and deferring loss harvesting, exercising stock options, increasing bonuses, expediting the installment sale gain, or moving up the closing date of a sale are just a few strategies to consider. Defer deductions that can be used to offset future income that could be taxed at higher rates.

6. Contribute to a Health Savings Account (HSA). If you're healthy now, a health savings account can be used as a retirement savings vehicle to take advantage of its triple tax-free nature. If you are a participant in a high-deductible health plan you can contribute up to $3,650 annually (2022 limit) and contributions go into an HSA pre-tax. This reduces your taxable income, grows earnings tax free and allows for tax-free distributions if they are used for qualified medical expenses. Since HSAs have no limit on carryovers or when the funds can be used, they are an excellent savings vehicle to use for medical expenses in retirement, when health care expenses generally rise.

Our recommendation

The right strategy can help you and your family get the most out of your golden years. Work with your advisor to analyze your unique financial picture and consider the various strategies to determine which approach fits within the context of your complete financial picture.

For more information, please contact your advisor.

About the Author

Gretchen Miller focuses on planning and executing her clients' wealth management plans to meet their unique financial objectives and grow and preserve wealth. She coordinates the implementation of wealth management strategies while proactively delivering the latest insights and advice to benefit clients' particular situations. Before Key, she served as Director of Advanced Planning for Prudential Financial, where she was a subject matter expert on financial and estate planning and on a host of retirement topics.

Gretchen has more than 25 years of experience in financial services and earned an MBA from the University of Phoenix. She also obtained her certification as a CERTIFIED FINANCIAL PLANNER ™.

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