INTEGRITY FINANCIAL SERVICE, LLC

*PLANNING · PROTECTION · PEACE OF MIND*

# 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 – because up to half of their Social Security benefits won't be counted as taxable income.1

Given these possibilities, affluent investors would do well to study the tax efficiency of their portfolios as some investments are not particularly 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 come retirement, you will pay taxes on the withdrawal. 2

Pre-tax investments are also called tax-deferred investments, as the invested assets can benefit from tax-deferred growth.Other stock market analysts feel high-speed trading helps investors more than it hurts them , citing what they see as improved market liquidity and referring to the reduction in bid-ask spreads (the differential between what buyers want to pay for a stock versus what sellers believe it is worth). Since the mid-1990s, bid-ask spreads have narrowed from the vicinity of 90 basis points to about 3 basis points as an effect of such trading networks.[3]

**What's an after-tax investment?** A Roth IRA is a classic example. When you put money into a Roth IRA during the accumulation phase, contributions aren't tax-deductible. As a trade-off, you don't pay taxes on the withdrawals from that Roth IRA (providing you have followed the IRS rules for the arrangement). Thanks to these tax-free withdrawals, your total taxable retirement income is not as high as it would be otherwise.2

As everyone would like to pay less income tax in retirement, the tax-free withdrawals from Roth IRAs are very appealing. Given the huge federal deficit, the pressure is on to raise tax rates in the coming years – and in that light, after-tax investments look even more attractive.

It is also possible to convert a traditional IRA to a Roth IRA, so many investors are considering paying taxes on a Roth conversion today in order to get tax-free growth tomorrow.

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Certain tax years can prove optimal for a Roth conversion. If a high-income taxpayer is laid off for most of a year, closes down a business or suffers net operating losses, sells rental property at a loss or claims major deductions and exemptions associated with charitable contributions, casualty losses or medical costs … he or she might end up in the lowest bracket, or even with a negative taxable income. In circumstances like these, a Roth conversion may be a good idea.

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

**Smart moves can help you reduce your taxable income & taxable estate.** An emphasis on long-term capital gains may help, as they aren't taxed as severely as short-term capital gains (which are taxed at the same rate as ordinary income). Tax loss harvesting (selling the "losers" in your portfolio to offset the "winners") can bring immediate tax savings and possibly help to position you for better long-term after-tax returns.

If you're making a charitable gift, giving appreciated securities 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, the charity can sell the stock without triggering capital gains. If you're reluctant to donate shares of your portfolio's biggest winner, consider this: you could donate the shares, then buy more of that stock and get a step-up in cost basis as a consequence.3

The annual gift tax exclusion gives you a way to remove assets from your taxable estate. In 2015, you can gift up to $14,000 to as many individuals as you wish without paying federal gift tax. If you have 11 grandkids, you could give them $14,000 each – that's $154,000 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.



**Citations.**

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3 – DESMOINESREGISTER.COM/STORY/MONEY/BUSINESS/2014/11/01/JIM-SANDAGER-DONATE-SHARES-DIRECTLY-CHARITIES/18304273/ [11/1/14]
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