Taxes in Retirement Series
Part I

Jeff Clark, CFP®

pine grove FINANCIAL GROUP

JULY **2023**

In this series, Jeff Clark explores the impact of taxes in retirement. Over a series of short articles he identifies the tax risk facing retirees today and several strategies to diversify one's "tax risk" so that they can more proactively adapt to changing taxes in the future as well as avoid being trapped by higher rates eroding their wealth in late retirement.

A Proactive Guide to Taxes In Retirement

No one can predict the future, and this is especially true when it comes to taxes in retirement. With changing tax laws, shifting financial markets, and unpredictable life events, it's also no wonder that many retirees feel uncertain about their tax situation.

But the more you understand the factors that can impact your taxes in retirement, the better equipped you'll be to make informed decisions and manage your finances. In this article, we'll break down some of the common concerns people have about taxes in retirement and offer advice for addressing these issues.

How Much of My 401(k) or IRA is Mine?

For most Americans, the bulk of their retirement savings has been accumulated in tax-deferred accounts, which means those dollars have never been taxed. These accounts include IRAs, 401(k)s, 403bs, 457s, deferred compensation, pensions, and many other common retirement savings plans.

So ask yourself this question: How much of my 401(k) or IRA will be mine after taxes? Unfortunately, taxes can reduce a 401(k) substantially, sometimes even by half, due to unforeseen life circumstances.

The farther we look into the future, the more likely it is that the answer to "how much is yours to keep" will be affected by external factors beyond our control. Factors such as inflation, tax policy, and market forces will affect how taxes are applied to those dollars. These variables work together to determine the amount of money that must be withdrawn annually from a retirement account as well as the tax rates that are applied to those funds as they come out.

However, there are concrete actions you can begin taking today to mitigate these risks. This process involves beginning to diversify the tax status of where your savings reside as well as paying slightly more in taxes today, on purpose, to proactively avoid having even higher tax costs erode your wealth in the future.

pine grove FINANCIAL GROUP

A Retirement Crystal Ball

Many of us have been told that our taxes will go down in retirement. But will they? And haven't we also been told that during the highest earnings phase of our careers, we should do everything we can to lower our taxes? The truth is that every tax deferred is ultimately a tax that will be due. In deferring taxes today, we may unintentionally be backing ourselves into a corner as we age. This is similar to paying the minimum payment on a credit card: Eventually, the bill is going to come due with interest.

To be clear, not everyone is at risk of seeing higher taxes in retirement. Some may have already jumped over their tax hurdle by having built most of their wealth outside of these tax-deferred accounts — maybe they sold a business, cashed out rental property, or received a cash inheritance. There is also meaningful portion of the population who just won't accumulate enough resources to retire. If a person spends down all of their wealth, then their taxes will ultimately go to zero as well.

But for those who have already put in the hard work to build the wealth needed so they could retire with a similar lifestyle to what they had while working, they may see their taxes actually rise over time unless they take action today to preserve what they've built. Fortunately, that doesn't need to happen.

3 Factors Driving Higher Taxes in Retirement

Not surprisingly, the top factor influencing taxes in retirement is inflation, which continues to make headlines year after year. Tax policy and market forces also play critical roles here.

1. **Inflation:** As people enter retirement, they face the reality of increasing expenses over time. Everyday necessities such as gas, groceries, and medicine, as well as variable costs like maintenance and vacations, all become more costly over time. Since the Consumer Price Index was established in 1913, the average inflation of those costs has been 2.6%.

   To fund these rising expenses, retirees may need to tap into their retirement savings, especially if their pensions and Social Security are not enough. These withdrawals will rise over time with inflation, pushing the tax rate on those withdrawals into higher brackets over time. As you know, in a progressive tax system, the more you spend in a given tax year, the higher the tax rate that is applied. This means Uncle Sam's fee to use your money goes up the more of it you use. And even if you were frugal enough to avoid using your wealth in your early years of retirement, eventually the IRS requires you to begin taking Required Minimum Distributions (RMD) in your 70s so that your wealth can eventually be taxed.

2. **Tax Policy:** Required Minimum Distributions impact all the pre-tax wealth a person holds in tax-deferred accounts when they reach their Required Minimum Distribution age. The rule

is in place to prevent people from being allowed to get a tax deduction initially and then let their money avoid taxes for their lifetime. For example, when your income is reported to the IRS each year by your employer, the contributions you made into your 401k are not reported as taxable wages and therefore non-taxable. This means that although you earned those dollars without yet paying taxes on them, they could live inside your 401k for a lifetime without ever being taxed unless there was a rule in place to ultimately force them to leave that account and become taxable.

Upon reaching RMD age, everyone is required to withdraw a specific percentage of their retirement dollars each year so that they can become taxable. The percentage, which is based on age, rises each year so that a higher and higher percentage of retirement accounts are required to be distributed. As you can imagine, this can lead to a very different tax situation once this avalanche of additional income begins.

Over the last few years, the starting age for these withdrawals has been pushed forward to as late as age 75 depending on a person's birth year. Pushing back the due date on these RMDs only exaggerates the tax impact by letting people wait longer and ultimately creating an even larger windfall of income with a more exaggerated tax rate on those dollars.

But there is also an opportunity in this. The time remaining between now and RMD age creates a window of opportunity to begin repositioning that wealth through a process called “Roth Conversion.” And better still, the time between now and 2025 creates an even bigger opportunity, possibly the best opportunity to address this in our lifetime: The Tax Cuts and Jobs Act (TCJA) of 2017 reduced tax rates today to arguably the lowest levels we have seen in a generation.

Many forget the highest federal income tax rates in the United States were seen in the mid-20th century, particularly during World War II and in the decades following. From 1944 to 1963, the top marginal income tax rate was over 90%, with a peak rate of 94% in 1944 and 1945. Today's federal income tax rates are much lower. For the tax year 2021, the highest marginal income tax rate was a mere 37%. This may feel like a lot, but it represents a significant decrease from historical peak rates.

Those entering retirement today will likely see tax policy in the future bring back higher rates. As of 2023, it is estimated that around 10,000 baby boomers per day (those born between 1946 and 1964) will turn 65 and become eligible for Medicare. This trend is expected to continue for several years, leading to a significant increase in the number of people collecting their benefits from Medicare and Social Security.

According to the Congressional Budget Office (CBO), in fiscal year 2021, Social Security and Medicare accounted for approximately 40% of federal non-interest spending. In addition, the fiscal response to the COVID-19 pandemic expanded the federal debt and the cost of servicing that debt along with it. As of 2021, the total federal debt is over $28 trillion, an increase of over $5 trillion since the start of the pandemic.

Since then, the inflation seen in the US led to a swift rise in interest rates in 2022. In general, rising interest rates can increase the cost of servicing the federal debt as the government must pay more in interest payments to service its outstanding debt.

Without including additions to other spending, Social Security, Medicare, and servicing the national debt alone are enough to put an additional burden on the federal budget, resulting in the need to raise tax revenues.

For now, the Tax Cuts and Jobs Act is still in place — although it does have a sunset provision to automatically expire in 2025 unless there is Congressional action to extend it. If no action is taken, tax rates will go up across all of the brackets, and if we have learned anything from Congress these last few years, inaction is what they do best.

As we'll see later, the lower rates we are seeing today pose a significant tax savings opportunity for those who proactively begin to use them to their advantage. Through a series of strategies, even while still working, a person can begin to proactively re-position their wealth to reduce their long-term tax rate, as well as create future flexibility for themselves within the tax code when it comes to spending that wealth by building tax diversity within how those assets are held.

3. **Market Forces:** The third force that may lead to higher taxes in the future is the growth of a person's wealth over time. It's quite natural to underestimate the impact of compound growth over time. If your wealth were to grow over the next 20 years like it did over the last 20 years, what would happen? A quote has often been attributed to Albert Einstein in saying "Compound interest is the eighth wonder of the world. He who understands it, earns it... he who doesn't... pays it."

   The balance of a person's portfolio in retirement will fluctuate, so it can be hard to predict what path it might take. Fortunately, there has been a vast body of research to help people predict what path is most likely, given they follow a consistent process when managing the portfolio and taking withdrawals from it. Using research, we can gain some insights into just how large of a portfolio a person might have in the future and thus what amount of taxes might be applied to that wealth eventually.

   If a person followed the traditional 60/40 "balanced" portfolio strategy and started retirement with a "budget" of 4% of their investment portfolio, (Also known as a 4% withdrawal rate) and then kept to that same spending (plus inflation) over time, historically they could reasonably expect to see their retirement accounts hold their value and even rise over time. Each year's performance would vary, of course. At times they would see their portfolio drop during recessions and then rally again with the recovery that eventually follows, but so long as their investments were consistently rebalanced back to that 60/40 blend, there is a reasonable level of predictability in how it is likely to behave.

Since 1871, there have been 152 years of turbulent market events but there has never been a 30-year period where a person with a 60/40 portfolio would have run out of money if they kept to that 4% annual spending budget.

For good reason, this has become the standard practice for retirees to follow entering retirement, and it leads to a portfolio that stands the test of time. Of course, this will not be the scenario for everyone since some people retire with more resources than others, and everyone has a different tolerance for risk.

The Result

What this ultimately leads to is a family with expenses that rise as they age, facing increasing tax rates over time, and wealth that is holding its value and potentially growing faster than they are using it.

If inflation isn't enough to force them to spend more, eventually the IRS will require it of them when they reach the Required Minimum Distribution age. Then, if a couple is to have one spouse outlive the other (which is almost guaranteed), the surviving spouse is pushed still higher up the tax brackets as single filers pay higher rates than those who file their taxes married filing jointly.

This brings us to a key insight. Recognizing that taxes are low today and likely to rise in the future means that there is a significant savings opportunity for every dollar that can find its way into a Roth IRA. The process of moving those dollars into Roth proactively over time can take 3 forms. Dollars can get into Roth status through payroll deferrals, direct contributions, or Roth conversions. Only one of these pathways is limited by a person's income level, meaning just about everyone has access to these options.

In part II, I'll dive into the Roth Opportunity, and how you can begin to take advantage of it for yourself before it's too late. Even if you're approaching your 60's, there is still time to make meaningful Roth progress and potentially save yourself significantly from facing unnecessarily high tax costs on your wealth in retirement.

pine grove FINANCIAL GROUP

pine grove FINANCIAL GROUP

635 Bielenberg Drive | Suite 210
Woodbury, MN 55125 | **pinegrovefg.com**

Jeff Clark is an Enrolled Agent Admitted to Practice before the IRS and a CERTIFIED FINANCIAL PLANNER®