HAYES ADVISORY GROUP
RETIREMENT PLANNING

Knowledge is Power

Question Of The Month - August

"Hello, Brian. My wife and I are both 60 years old and are retiring this year. We have saved over a million dollars in our traditional 401(k)s and over a million dollars in our after-tax brokerage account. We will have a pension income that will start at retirement as well as a good amount of Social Security. We would like to have over $100,000 in retirement income. We are healthy and have longevity in the family and plan on delaying Social Security to age 70. We have talked to a few financial advisors, and they all recommend we draw the income we need to supplement our pension from our after-tax brokerage account to minimize our taxes. Is this the right way to set up our income plan? Thank you." Tim and Tina

Hello, Tim and Tina. Congratulations on your upcoming retirement. You have done a good job of saving and building multiple sources of assets to provide you an income in retirement. Even though you have worked very hard to do that over your career, now comes the very hard part – which is figuring out how to manage all those sources in order to provide you maximum lifetime income with minimal tax. Unfortunately, most people, financial advisors included, have no idea how to do that.

The accumulation stage of retirement is building your retirement nest egg. There are multiple ways to save for retirement and multiple types of investments to use. Most financial advisors focus on this area. However, upon retirement, it switches to the distribution phase where you have to know how to utilize all of your savings and income sources properly. If you do not understand how the tax system works in retirement, this could really cause your retirement plan to be a lot less effective than it should be and could subject your retirement plan to substantial taxes.

The traditional approach to income planning in retirement is what you have been advised to do, which takes the 'micro tax planning' approach. This strategy is designed to save as much tax as possible in that given year, and thus is the short term. So, this approach entails withdrawing first from after-tax brokerage and savings accounts, then, from tax-deferred accounts and from tax-free accounts. The goal and objective from this approach is to allow tax-deferred assets to continue to grow and push taxes owed into the future for as long as you can. While this may make sense for some people, there are two major problems with this approach.

First, because of the way the tax system is designed and set up, it subjects your retirement plan to the possible 'tax domino effect.' The 'tax domino effect' comes into play when income reaches a point where it causes other sources of income to become taxable as well. Here are the details of this:

Social Security is not taxable by itself. However, when other taxable income comes into play, that can cause Social Security income to be taxable.

Long-term capital gains and qualified dividends are not taxable in the lower income tax brackets. But if your taxable income gets above the lower brackets, then that will cause you to have to pay long-term capital gains tax and tax on your dividends.

An increase in taxable income above certain thresholds causes Medicare premiums to be higher.

A net investment income tax comes into play when certain types of income exceed relevant thresholds.

All four of these types of incomes get taxed when certain types of taxable withdrawals occur in retirement. Thus, the 'taxation domino effect.'

The second major problem with the traditional approach to retirement income planning (micro tax planning) of deferring taxes as long as possible is it subjects you to potentially higher taxes in the future. With the national debt currently over 30 trillion dollars and growing rapidly based on all the government spending in recent years, most economists say the only way to pay for all of this in the future is with higher taxes. In fact, the current tax code is set to expire at the end of 2025, and everyone will likely get a tax increase beginning in 2026.

So, in your specific case, if you do follow the traditional income approach, you could definitely minimize your taxes for the next several years. However, by taking this approach, your tax-deferred assets will continue to grow and have a much larger balance when you have to start taking required minimum distributions. This will cause all 4 areas of the taxation domino effect to come into play for your remaining retirement years, which probably would be the majority of your retirement years. So, your tax bill would be substantially higher at that time, even if tax rates do not increase.

A better approach in your case would be to at least start taking withdrawals from your taxable 401(k) to at least take advantage of the room you have left in the lower tax brackets. This would enable you to pay taxes on taxable money now at the lowest rate you will ever see, and also lower your taxable withdrawals later in retirement which could lower or eliminate the taxation domino effect. The ultimate goal in your case would be to get your traditional taxable account bucket down to a level where the required minimum distributions would be low enough not to trigger maximum taxes on your Social Security and not cause your Medicare premiums to be higher.

When it comes to retirement income planning, a strategic plan needs to be developed using the 'macro tax approach.' The macro tax approach focuses on minimizing your taxes over your retirement lifetime instead of in the current year. I would suggest working with a retirement planning specialist with expertise in income and tax planning to develop the proper income plan that will strategically draw your needed income from your different asset sources properly, and in the right percentages, each and every year, in the most tax efficient way. By doing this properly, taxes that you pay over your retirement lifetime can be substantially less and put your retirement plan in the most tax-efficient position possible, no matter how high tax rates go in the future.

Join me this weekend on The Retirement Money Matters Radio Show as we will go over this question in much more detail as well as answer many more retirement planning questions sent in from our readers and listeners. The show airs on Saturday afternoon at 4 on WFRN (93.7 FM), Sunday morning at 8 on WWKI (100.5 FM), or online at www.theretirementmoneymattersshow.com. You can also obtain this information by reaching out to us at Hayes Advisory Group at 765-452-PLAN (7526), 800-939-1603 or brian@hayesadvisorygroup.com.