A ‘taxing’ retirement story

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Many things change in retirement, but taxes are forever. But, there are many significant factors to know and act on when thinking about taxation during your retirement years.

Most people in retirement drop down to a lower marginal tax rate, as their income is both lower than when working, and also derived from a mix of after tax money, dividends, capital gains and other income taxed as “ordinary” instead of primarily all earned/ordinary income when working.

Being in a lower tax bracket in retirement is the strongest rationale for funding pretax retirement plans during the working years. You get to take a deduction at a higher marginal rate, let the funds make earnings on a tax deferred basis, and then take out distributions at a lower tax rate. Being in a lower tax bracket can make investments such as municipal bonds much less attractive. These tax free bonds are set to give an approximate “after tax” yield equal to a taxable bond, but for a taxpayer in a high tax bracket. If you are in a lower tax bracket in retirement, taxable bonds may be a better investment.

A common strategy in retirement is to “fill the bracket.” For example, in 2016 a married couple was in the 15% top tax bracket until they had over seventy five thousand dollars in taxable income. If near year end, the couple realizes that they may have only sixty thousand dollars in taxable income, they might elect to take more distributions from their taxable retirement accounts (and/or make a Roth IRA conversion) to take advantage of being able to stay in the 15% bracket with another fifteen thousand dollars of taxable income.

Other tax concerns in retirement include the amount of your Social Security benefits subject to tax. Unfortunately, if you have any significant income outside of Social Security, your benefits are likely to be taxed. But if you are “close” to the income at which benefits are taxable, there are sometimes ways to reduce or eliminate this taxation.

Similarly, Medicare B premiums increase rapidly at incomes higher than eighty five thousand dollars per year per person. Working to keep incomes below this with a mix of different withdrawals from different type accounts might allow you to pay lower costs for health care.

On the positive side, you pay no FICA taxes on your income in retirement. During your working years, these taxes can consume as much as 16% of income (for self employed individuals), but these taxes are not applied to non earned income. Another potential positive aspect of taxation in retirement is the ability to move to a lower cost place to live. The majority of states will tax some of your retirement income stream, but at least seven states have no income tax. By looking for a place to live that has a lower tax burden (figure in state income tax, property taxes and sales tax) and a lower cost of living (where housing is cheaper for example), the retired family can achieve a much higher standard of living on the same savings.

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