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LAGOS WEALTH ADVISORS
BUILDING, PROTECTING AND PERPETUATING FAMILY WEALTH

# ADVISOR'S BULLETIN

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## WHAT'S IN THIS MONTH'S NEWSLETTER

# INCOME TAX PLANNING POSTRETIREMENT: WHAT FINANCIAL PROFESSIONALS NEED TO KNOW

## A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

Financial professionals work with their clients to accomplish a variety of goals, including:

- Maximize wealth accumulation
- Protect assets from potential creditors
- Manage risk—investment or otherwise
- Plan for postdeath transfers to others
- Reduce or manage taxes

In working toward the last objective, the biggest bill we're usually trying to make smaller is the liability for federal income taxes.

The good news about federal income taxes is that for many of our high-income clients, the rates are lower today than they have been in the recent past. The outlook isn't all rosy though.

The current low federal income tax brackets for individuals may be increased in the near future due to sunset rules and a possible change in Washington's political control.

Not every client has benefited from the changes made by the Tax Cut and Jobs Act (TCJA).

Though high-income clients may pay less in direct federal income taxes than they would have paid in 2017, some taxpayers have potential indirect costs that must be considered.

The last point, particularly as it affects those nearing or at retirement age, is the one we want to focus on in this issue of *Advisors Bulletin.* Most of our retiring clients want to be assured they will enjoy a comfortable income stream in their postworking years. Financial professionals working with them will want to help evaluate the impact of taxes on a stress-free retirement.

Regards,

Michael W. Lagos, CFP®

# INCOME TAX PLANNING POSTRETIREMENT: WHAT FINANCIAL PROFESSIONALS NEED TO KNOW

## POSTRETIREMENT INCOME TAX PLANNING

The conventional wisdom has been that our clients will have higher federal income tax rates during their working years, and they will be in lower brackets once they retire. Is that necessarily true?

### *Federal Income Tax Brackets*

As a result of TCJA, the rates imposed in federal income tax brackets—especially the higher ones—were reduced. Here's how the 2019 federal income tax brackets look for a married taxpayer filing jointly:

| Taxable Income | Tax |
|---|---|
| Not over $19,400 | 10% of the taxable income |
| Over $19,400 but not over $78,950 | $1,940 plus 12% of the excess over $19,400 |
| Over $78,950 but not over $168,400 | $9,086 plus 22% of the excess over $78,950 |
| Over $168,400 but not over $321,450 | $28,765 plus 24% of the excess over $168,400 |
| Over $321,450 but not over $408,200 | $65,497 plus 32% of the excess over $321,450 |
| Over $408,200 but not over $612,350 | $93,257 plus 35% of the excess over $408,200 |
| Over $612,350 | $164,709.50 plus 37% of the excess over $612,350 |

The bracket tax rates for single taxpayers mirror those for married couples, although the rates kick in at lower taxable income thresholds.

If Congress and the president leave the current structure unchanged, the rates are scheduled to revert to the pre-TCJA percentages beginning with tax year 2026. If that happens, the top federal income tax rate for individuals will once again be 39.6 percent.

Of course, if there is a change in control in either the presidency or Congress—or both—the federal government could decide to change the income tax rules. With the current national debt sitting at more than $22 trillion, it seems unlikely that income tax rates will be reduced anytime soon.

What does that mean for those who are at or nearing retirement? It is probably prudent for them to imagine that the federal income tax rates will rise as the years go by.

### *Taxable Income During Retirement*

Our clients may expect that taxable income during retirement will be lower than during working years, and thus taxes will be less. While for many this will be true, some may actually have higher taxable income during retirement.

PENSION

While in the past, a majority of workers were covered by a defined benefit (DB) retirement plan, statistics published by CNN at their website indicate a much smaller DB-covered group these days:

(https://money.cnn.com/retirement/guide/pensions_basics.moneymag/index7.htm)

Still, the actual number of clients who can expect to receive a monthly pension benefit in retirement is significant. The actual benefit paid to a participant depends on a number of factors, including:

- Average salary while working
- Age at retirement
- Years of service
- Type of benefit chosen

For some, the retirement benefit paid under the DB plan may be as much as 60 percent or more of the person's salary during working years. When combined with other potential sources of income, some of which we will explore in more detail in the following sections, a significant minority of our clients may have higher income in retirement than they do during working years. If that's the case, their income tax bill might actually be higher after age 65 or 70 than it was earlier.

MINIMUM DISTRIBUTIONS

As of the date this article is being written, most of those older than 70½ still have an obligation to take required minimum distributions (RMDs) from their traditional IRAs and from most employer qualified plans. For taxpayers who have successfully accumulated substantial funds in their qualified accounts—$2 million or more is not uncommon—the RMDs could be $100,000 a year or more. These amounts must be taken whether the taxpayer needs to use the money or not.

When RMDs are taken during lifetime, most or all of the distribution is subject to federal income tax.

DEFERRED COMPENSATION

Some of our clients who are nearing retirement may be entitled to money from some type of nonqualified deferred compensation (NQDC) plan. There are several different types of such plans, each of which may have slightly different income tax results.

To make matters more complicated, benefits under an NQDC may also be subject to FICA taxes. Retirement benefits from a qualified plan are generally not subject to FICA.

Here's an example of how FICA might affect a nonqualified retirement benefit. Many implementations of NQDC in a for-profit company are structured in this way:

- The employer makes an unsecured promise to pay a key employee extra at retirement or preretirement death. The extra payment promised might be structured as a lump sum or as a series of payments over time.

- The promise is memorialized in a written agreement that conforms to Section 409A deferred compensation requirements.

Since under this type of implementation only the employer's money is being earmarked for deferred compensation payout, there is generally no income tax or FICA tax liability while employment continues. After retirement, it's usually a different story. Under Treasury Regulations Section 31.3121(v)(2)-1, the employer and employee portion of FICA tax is applied to the present value of the deferred compensation benefits at the time those benefits are vested.
The FICA bill could be as high as 15.3 percent of the deferred compensation benefit amount.

Furthermore, depending on the plan details, the participant may also have to pay income tax on the entire value of the NQDC plan at retirement. The combination of federal income tax and FICA tax could result in the loss of up to half the benefit in the year of retirement. That loss due to taxes may affect the client's expected retirement reserve.

OTHER FACTORS

A client may experience relatively high federal income taxation in retirement due to other considerations, including:

**1. Fewer tax deductions.** A taxpayer may have fewer itemized deductions in retirement due to a home mortgage being paid off. In addition, with the increase in the standard deduction that was part of the TCJA, fewer taxpayers overall have been taking advantage of itemized deductions than have done so in the recent past.

**2. Increased investment income.** If a taxpayer and her financial professional have done a good job in accumulating assets for retirement, they may decide to turn on the retirement income spigot. In some cases the income generated postretirement may be taxable and may have a bigger impact on taxable income than preretirement income—much of which may have been tax-deferred.

***Indirect Effects of Postretirement Taxable Income***

While managing the effect of direct federal income taxes during retirement is important, there are also potential indirect consequences of high taxable income:

- Social Security benefits might be taxed.
- The 3.8 percent Medicare surtax could be imposed.
- Medicare premiums could be higher.

SOCIAL SECURITY RETIREMENT BENEFITS

Understanding how Social Security retirement benefits are taxed for federal income purposes is important. Up to 85 percent of an individual's Social Security benefits could be taxable. This doesn't mean the taxpayer can lose up to 85 percent of her benefits; it simply means the taxable portion of her benefits may be added to gross income and potentially taxed at her normal income tax rates.

The first step in calculating how much of a taxpayer's Social Security retirement benefits are taxable, the taxpayer must calculate her provisional income for the year. Provisional income is generally the sum of:

1. the individual's adjusted gross income (AGI),
2. her tax-exempt interest (e.g., interest from municipal bonds), and
3. half of her Social Security benefits.

For example, if an individual's AGI is $22,000 and she earns $3,000 of interest from tax-exempt municipal bonds and $14,000 in Social Security benefits, her provisional income is $32,000 ($22,000 AGI + $3,000 tax-exempt interest + ½ of her $14,000 Social Security benefits).

The next step is to compare the individual's provisional income to the base amount and adjusted base amount. The applicable base amount depends on filing status:

| Filing Status | Base Amount | Adj. Base Amount |
|---|---|---|
| Unmarried individual | $25,000 | $34,000 |
| Married filing jointly | $32,000 | $44,000 |
| Married filing separately (lived apart) | $25,000 | $32,000 |
| Married filing separately (lived together) | $0 | $0 |

If provisional income is less than or equal to the applicable base amount, none of the taxpayer's Social Security retirement benefits are taxable. If the provisional income is larger than the base amount, a portion of the benefits may be taxable.

For a taxpayer whose provisional income exceeds the applicable base amount but not the adjusted base amount, she must include in gross income the lesser of:

- 50 percent of the excess provisional income over the base amount or
- 50 percent of the Social Security benefits received that year.

Additionally, if a taxpayer's provisional income exceeds the applicable adjusted base amount, 85 percent of the excess is generally taxable. However, the highest total percentage of Social Security retirement benefits that may be taxable is 85 percent.

Here's an example. Say Maude received a Social Security retirement benefit of $24,000 last year. Also assume she had other income of $30,000 for the year, making her provisional income $42,000 ($30,000 AGI plus ½ of her $24,000 retirement benefits).

For the first $9,000 of provisional income over the base amount, but less than the adjusted base amount, the tentative amount taxable is $4,500 (50% of $9,000).

For the extra $8,000 of provisional income over the base amount, the tentative amount taxable in this segment is $6,800 (85% of $8,000).

The sum of these two segments is $11,300, meaning she tentatively adds this amount to her gross income. We say these amounts are tentative because she can't add more than 85 percent of her total Social Security benefits to gross income. Since 85 percent of her $24,000 Social Security benefits ($20,400) is more than the tentative amount of $11,300, $11,300 of Maude's Social Security benefit is taxable.

MEDICARE SURTAX

Although the Tax Cut and Jobs Act reduced the tax rate imposed in the highest federal income tax brackets, it left the 3.8 percent Medicare surtax intact.

The 3.8 percent surtax on net investment income (NII) has been in effect since 2013. As with most other taxes, the amount of the surtax is the product of (1) the tax rate and (2) the amount subject to the tax. The tax rate is always a flat 3.8 percent. The taxable base depends on three factors:

1. the taxpayer's modified adjusted gross income,
2. the taxpayer's applicable threshold amount, and
3. the taxpayer's amount of net investment income on the year.

If a taxpayer's modified adjusted gross income is less than the threshold amount or if the taxpayer has no net investment income, he will not incur any NII surtax on the year.

*MAGI* is essentially adjusted gross income increased by any foreign earned income which was from gross income under Code Section 911(a)(1). For many taxpayers MAGI and AGI will be the same number.

An individual's *threshold amount* depends on the individual's marital status as follows:

- $250,000 for married individuals filing a joint return,
- $125,000 for married individuals filing separate returns, or
- $200,000 for everyone else (e.g., single or head of household).

The threshold amounts are not indexed for inflation, so as time passes more taxpayers will become subject to the surtax, and it will no longer affect only high earners.

The third component of the taxable base is *net investment income*. This amount is essentially income received through investment assets, such as interest, dividends, and capital gains. If an individual does not have net investment income, he will not incur the surtax.

For individuals earning more than the appropriate threshold amount and who have at least some NII on the year, the taxable base is the lesser of:

1. the amount a taxpayer's income exceeds the threshold; and
2. the taxpayer's net investment income, discussed later.

Here's a basic example. Thom, a single-filing taxpayer, earned $190,000 in 2019, which includes $50,000 of net investment income. He incurs no surtax because his income does not surpass his $200,000 threshold.

One year later, in 2014, Thom's income increases to $220,000, which again includes $50,000 of net investment income. His taxable base would equal $20,000 (the lesser of (a) $50,000 NII, or (b) $20,000 excess of his MAGI over the threshold amount), resulting in a $760 NII surtax (3.8 percent of $20,000).

MEDICARE PREMIUMS

For those who are 65 or older, the federal government's Medicare program is the most common way for them to secure health insurance coverage. People who are eligible get Medicare Part A coverage, which is generally provided at no extra cost, and Part B coverage. Part B has a premium associated with it based on the individual's taxable income from the second prior calendar year.

Here are the 2019 Part B premium amounts based on 2017 taxable income.

| **Beneficiaries who file individual tax returns with income:** | **Beneficiaries who file joint tax returns with income:** | **Income-related monthly adjustment amount** | **Total monthly premium amount** |
|---|---|---|---|
| Less than or equal to $85,000 | Less than or equal to $170,000 | $0.00 | $135.50 |
| Greater than $85,000 and less than or equal to $107,000 | Greater than $170,000 and less than or equal to $214,000 | $54.10 | $189.60 |
| Greater than $107,000 and less than or equal to $133,500 | Greater than $214,000 and less than or equal to $267,000 | $135.40 | $270.90 |
| Greater than $133,500 and less than or equal to $160,000 | Greater than $267,000 and less than or equal to $320,000 | $216.70 | $352.20 |
| Greater than $160,000 and less than $500,000 | Greater than $320,000 and less than $750,000 | $297.90 | $433.40 |
| Greater than or equal to $500,000 | Greater than or equal to $750,000 | $325.00 | $460.50 |

Source: https://www.cms.gov/newsroom/fact-sheets/2019-medicare-parts-b-premiums-and-deductibles.

It's interesting that the thresholds are hard numbers. A person who had $85,001 of taxable income in 2017 instead of $85,000 will pay more than $500 more in Part B monthly premiums because of the extra dollar of income. It's easy to see why managing taxable income would be important for Medicare recipients.

***Tax Management Strategies***

Our clients should consider several strategies that would reduce the potential tax on income during retirement.

TAX-DEFERRED AND TAX-FREE

One simple strategy for planning to manage taxes in retirement is to focus on investing in tax-deferred and tax-free vehicles.

Tax-deferred investments, such as deferred annuities, allow the investment to grow without an immediate income tax result. The client has the ability to choose when to take distributions and to recognize the accompanying income tax result.

Likewise, a person may also choose to seek to invest in assets that provide tax-free returns. The most obvious example of this type is a Roth IRA, which if held long enough could provide completely tax-free income to the account owner.

ROTH CONVERSION

So if Roth IRAs are so useful in helping manage taxes during retirement, should our clients convert their qualified pension and IRA monies to Roth? The answer is that it depends.

Conversion to a Roth IRA may make sense in the following situations:

1. The client expects the IRA account to grow substantially and would prefer to pay taxes on the lower current account balance instead of on the expected large future amount.

2. The client expects that future income tax brackets will be the same or higher than the current one.

3. The client expects to live for a long time after conversion and does not want to have to take distributions from the IRA if they are not needed.

4. The client wants to avoid RMDs and leave a large tax-free amount to heirs.

If the taxpayer is a candidate for conversion, it would also be important to evaluate whether there is enough non-IRA cash on hand to pay the tax associated with the conversion. If other assets have to be liquidated to pay the tax, the potential tax liability associated with liquidation would have to be factored into the conversion analysis.

QUALIFIED CHARITABLE DISTRIBUTIONS (QCDS)

A qualified charitable distribution is an otherwise taxable distribution from an IRA (other than an ongoing SEP or SIMPLE IRA) owned by an individual who is actual age 70½ or older that is paid directly from the IRA to a qualified charity.

The QCD amount is limited to $100,000 per calendar year. The taxpayer may not receive the funds in the taxpayer's name and then make a charitable gift; the IRA custodian must send the IRA funds directly to the qualified charity.

The QCD technique, when available, is a more efficient way for most taxpayers to make charitable gifts than to make such donations in cash because

- QCDs count toward satisfying RMDs, and
- QCDs do not count as income for federal income tax purposes.

In addition to these benefits, there is an added advantage if the taxpayer has after-tax monies in traditional IRA accounts. Normally distributions from IRAs are considered to come out pro rata from the pretax and after-tax amounts. For QCDs a special rule says the charitable distributions drain the pretax amounts first. The unique tax-ordering rule helps ensure that QCDs are tax efficient.

Those taxpayers who have traditional IRAs and are inclined to make charitable gifts should consider QCDs to help manage their taxable retirement income.

MINIMIZING TAX ON SOCIAL SECURITY RETIREMENT BENEFITS

Taxpayers often try to minimize the amount of their Social Security retirement benefits subject to taxation with a number of strategies. Particularly, taxpayers can delay filing for Social Security and use up their taxable retirement assets in the meantime.

Taxpayers can maximize their monthly retirement income from Social Security by waiting until age 70 to claim their own benefit. The strategy of waiting could reduce or eliminate income taxes on Social Security benefits. Of course, whether this technique might work depends on their particular numbers.

There are other ways a client might plan to reduce provisional income and thus potentially lower the tax on Social Security benefits. For example:

- Keep assets inside qualified retirement plans since distributions from tax-qualified plans are generally added to AGI.
- Invest in after-tax retirement plans such as Roth IRAs or designated Roth-qualified accounts.

As with other tax-reduction strategies, the benefits of reducing the taxation of Social Security benefits should be weighed against the costs of each of these strategies.

**CONCLUSION**

People who want to maximize their retirement income must consider the direct and indirect effect of federal income taxes.

- Current income taxes imposed on retirees affect not only the portion of income they are able to keep; they may also play a role in the amount of future premiums the retiree must pay for Medicare coverage.
- For those collecting Social Security benefits, taxable income may increase the tax rate on those retirement benefits.
- Even if income is not needed, under current tax rules qualified plan and IRA account owners may be forced to take taxable distributions under the government's required minimum distribution rules.

Those who are worried about income taxes in the future may be able to employ strategies to manage and prospective liability and permit them to keep more money over the long term:

- Choose tax-deferred investment vehicles, such as deferred annuities, to allow flexibility over the timing of income tax results.
- Focus on tax-free investments, such as Roth IRAs, so that qualifying distributions made to clients and their heirs are not subject to income tax at all.
- Consider repositioning assets—a Roth conversion is one such strategy—so that in exchange for a relatively small income tax result today, the taxpayer might reap bigger tax benefits in the future.

Our retiring clients want to be assured that they will enjoy a comfortable income stream in their postworking years. It is up to us to help them manage taxes—before they retire and after—so they can live comfortably in their golden years.

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## IN THIS ISSUE OF ADVISOR'S BULLETIN

# INCOME TAX PLANNING POSTRETIREMENT:

# WHAT FINANCIAL PROFESSIONALS NEED TO KNOW

***Building Protecting and Perpetuating Family Wealth***

LWA strives to develop and maintain sound financial plans designed to achieve our client's wealth accumulation, preservation and transfer objectives, with the goal of preserving their wealth for multiple generations. We provide these services in a confidential and consultative manner, building life-long relationships based upon education, trust, communication and service.

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