TENON FINANCIAL
RETIREMENT PLANNING & INVESTMENT MANAGEMENT

Retirement Planning Insights

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Up Front

Free tax return checklist and my new podcast!

Now that we're in February, tax return season is officially open; the IRS started accepting 2021 tax returns for processing on Monday, January 24th.

Depending on the sources of income you had last year, you might get all the necessary tax documents you need by early-February. Or, if you have a brokerage account, you may not get its 1099 until the end of February or later. Or, maybe you won't receive everything you need until AFTER April 15th, which is unfortunately common if you had income from a partnership, as many partnerships are often tardy in producing and distributing their K-1 forms.

To help make your tax return season a bit easier, I created a helpful 2021 tax return preparation checklist that's free to download and share.

Also, while not necessarily specific to doing your taxes, I'd like to remind you of the boat loads of free info and downloads available on my website in the Free Resources section. Definitely check it out!

And speaking of free resources, I'm proud to formally announce to you all the recent launch of my new podcast, Retirement Planning Education!

For those of you familiar with this newsletter, my Facebook group Taxes in Retirement or my YouTube channel Retirement Planning Demystified, you'll find the podcast has a familiar look, feel and sound.

Each week's episode does a deep dive into a particular topic related to retirement planning. As with the rest of my content venues, the episodes are all about meaningful and practical education communicated in plain-English.

As of the release of this newsletter, there are seven episodes already published. You can find, subscribe and listen to the them through all of the major podcast platforms like Apple Podcasts, Google Podcasts, Amazon Music, Spotify, Stitcher, etc.

I hope you enjoy the podcast. If you do, please do me a favor by subscribing and leaving a smashingly positive review, thank you!

-Andy

Retirement Planning News

Planning considerations across the four phases of retirement

On January 24, 2022, *Kiplinger* published the article, "The 4 Phases of Retirement."

This article does a great job of breaking down a typical retirement into four sections, and giving guidance as to what those sections generally look like and how to fold each into your retirement planning.

For those of you familiar with the concept of the "go go," "slow go" and "no go" stages of retirement, these four phases will look very similar. The only real difference is this article adds a fourth "pre-retirement phase:

- **Phase 1: Pre-retirement** – This phase starts approximately 10 years before you actually retire. While you've likely been saving for retirement for a while, you may not have started to do any "real" planning. In this phase, start to get serious about planning the specifics of your retirement. Have an idea of what you want retirement to look like in terms of what you'll do, where you'll live, what your expenses will be, what sources of income you'll have and how much savings you'll likely need. From a financial perspective, retirement planning all revolves around knowing how much money you'll think you'll need each year. Only after you know the answer to that can you start to figure out if your sources of income and savings are "enough."
- **Phase 2: The Early Years** – These are otherwise known as the "go go" years of retirement. Your mind and body are feeling good, you have lots of free time now that you're no longer working, and you probably have a wish list of things you want to do with your newfound freedom. Expenses in this phase are typically the highest of all phases, as you're likely to spend a lot on discretionary items such as hobbies, travel, etc. This phase is also a good time to consider a part-time job; not necessarily for income but to help you gradually transition out of working full-time. It can be a shock to the system to go from working full-time for decades to all of a sudden stopping completely. Part-time work can be very beneficial from a mental and emotional perspective. This phase is also a great time to get serious about living arrangements and deciding whether you downsize, move, split time between two homes, etc.
- **Phase 3: Middle Retirement** – This phase is commonly called the "slow go" years. Your mind and body may be slowing down a bit, which means your discretionary activities and expenses will likely decrease. For many people, this phase is the least expensive phase of retirement. However, while discretionary expenses naturally start to taper off, medical expenses often start to increase. Estate planning is also an important part of this phase. For example, you may have created your Last Will & Testament, Power of Attorney, Advanced Healthcare Directive, etc. years ago, perhaps when your kids were young or other people were in your life. Now would be a good time to refresh your estate plan and make any necessary changes to ensure everything is up to date with your current circumstances and wishes.
- **Phase 4: The Later years** – These years are commonly referred to as the "no go" years. In this phase, your mind and/or body may have slowed down substantially. As such, discretionary expenses are likely much lower than they were in the previous phases. However, healthcare expenses may be significantly higher now. The article cites data from Fidelity that say the average 65-year-old couple should plan to spend about $300,000 on health care throughout their retirement. This doesn't necessarily mean you need to earmark $300,000 of cash and leave it untouched throughout your retirement planning. But definitely make sure your planning considers likely increases in medical expenses. At a minimum, assume your Medicare premiums and routine out-of-pocket medical expenses will go up each year - I typically assume annual inflation of 5% per year for medical expenses. Also be sure to have a plan for how you'll address more substantial healthcare events like long-term care.

Practical Retirement Planning

Beware of the "pro rata" rule when doing Roth conversions

If you have a tax-deferred retirement account, such as a traditional IRA, and you've ever made after-tax contributions to the account, you will be subject to the "pro rata" rule whenever you take money out the account. This applies to distributions from the IRA as well as conversions to a Roth IRA.

With tax-deferred accounts, the main benefit is the ability to get a tax deduction for your contribution in the year of the contribution.

For example, assume you have $100k of wages and you contribute $5k to your traditional IRA. You can potentially get a deduction for that contribution such that you'll be able to reduce your taxable income by the amount of the contribution. In other words, instead of having to pay tax on $100k of income that year, you'll only have to pay tax on $95k (i.e. $100k of wages minus the $5k IRA contribution).

On the other hand, with an "after-tax" contribution, you do NOT get a deduction for the contribution. Assuming the same scenario of $100k of wages and $5k of IRA contribution, if you do the contribution on an after-tax basis, you'd have to pay tax on the full $100k of earnings that year.

If all of the money in your traditional IRA is pre-tax (i.e. you took a deduction on the contribution(s) and there have since been earnings on those contributions), you will have to pay tax on every dollar you take out of the account.

Conversely, if you have some after-tax money in your traditional IRA, you won't have to pay tax on 100% of the money you take out of the account. That's because some of the money you take out is deemed to be a return of the after-tax money you put in, and the government is kind enough to not tax you a second time on that money. The rest of the withdrawal is deemed to be a removal of the money that has not yet been taxed. The "pro rata" rule is what determines the amount of the withdrawal that's non-taxable vs taxable.

Assume you have $95k of pre-tax money in your traditional IRA. And further assume you put in another $5kk, but that contribution is on an after-tax basis. You now have $100k in your IRA. 95% of that money has not yet been taxed, 5% of it has.

If you take money out of that IRA, whether through a distribution or a Roth conversion, 95% of that money will be included in your taxable income that year. Only 5% of it will be deemed a removal of a portion of the after-tax money in the account. This is the pro rata rule.

Where the pro rata rule often trips people up is the fact they're simply not aware it even exists! Like in the example above; an unsuspecting person may think he or she could make the $5k contribution on an after-tax basis and then immediately convert that $5k over to a Roth IRA and not pay any tax on the conversion since tax was already paid on the money before it went it into the IRA. The person will be in for an unwelcomed surprise at tax return time when they realize 95% of that $5k conversion is taxable…

If you want to see firsthand how the pro rata rule works, take a look at IRS **Form 8606,** which is the form that you'll have to include in your tax return whenever you do a Roth conversion and/or take any money out of an IRA if it has after-tax money in it.

Also, you can check out my YouTube video, **"How to Do a Backdoor Roth Contribution,"** that further explains how the pro rata rule works. Additionally, the sixth episode of **my podcast** details the pro rata rule. Spoiler alert – the pro rata rule has more nuances than what's discussed in this newsletter.

You don't have to let the pro rata rule prevent you from doing Roth conversions. But make sure you're aware of it's impacts before you pull the trigger.

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