The Colony Group

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The Truth About Taxes in Retirement

Taxes are a fact of life—even in retirement. How much you will be required to pay could have an effect on your lifestyle during this phase of your life. Whether you're just beginning this new chapter or are already in retirement, it's important to understand the potential tax impacts as you move through various stages of your retirement.

Some key facts to keep in mind are that, beginning at age 59 ½, distributions can be taken from your retirement accounts without fear of the 10% early withdrawal penalty. And withdrawals from retirement plans including a 401(k), 403(b), traditional IRA or a SEP are taxed as ordinary income. At age 73, required minimum distributions (RMDs) are mandatory. The minimum age will increase to age 75 beginning in 2033.

Whether you're still in the accumulation phase or beginning to enter semi-retirement, ask yourself the following questions so that you're not surprised at tax time.

If you're semi retired

An increasing number of aging Americans are choosing to try out retirement by continuing to work part-time before they transition to full retirement. If you're considering a reduction in your hours, here are three questions to consider:

1. How will I pay for healthcare?

If you plan to reduce your hours, make sure you understand how this will impact the cost of health insurance, especially if your employer covers some or all of the premiums. One way to save for semi-retirement health care costs is to maximize Health Savings Account (HSA) contributions. HSAs are only available if you have a high deductible health plan. HSAs allow contributions up to $7,750 for a family plan or $3,850 for a single person, plus a catch-up contribution of $1,000, if you are at least age 55.

HSAs are great for several reasons. First, contributions are pre-tax. Second, as long as the funds are used on qualifying medical expenses, all distributions are not taxable and the growth is tax-free. The funds can be used whenever needed and can accumulate for as many years as you wish. You don't need "earned income" to contribute to an HSA. Once enrolled in Medicare, however, you are no longer allowed to contribute to an HSA, so get it funded before you turn age 65.

Also, keep in mind that the deduction for medical expenses will need to exceed 7.5% of your adjusted gross income.

2. Can I contribute to a retirement account?

We recommend you defer as much of your earnings towards retirement as you can afford, even if you're in semi-retirement. If possible, defer income to a 401(k) plan, especially if the employer matches contributions. Some employers allow Roth 401(k) contributions, so make sure to review the options. If you're over age 50, you can defer up to $30,000 to a 401(k). Also consider post-tax retirement contributions. You are allowed to defer a total of $73,500, including both your employee and employer's contributions. So, if you maximize your pre-tax 401(k) contribution at $30,000 (over age 50) and your employer matched another $5,500, you could defer another $38,000 with post-tax dollars.

We want women to be prepared for all of these situations through thoughtful engagement and education rather than waiting until a crisis hits before taking action. At that point, options are limited, and it may be too late.

3. Should I rollover my retirement accounts to an IRA?

Once you fully retire, you may choose (or be forced to) move assets out of your company retirement plan. There are many reasons to consider this option including greater investment choice, lower expenses or consolidation of accounts. What many people don't know is that some employers allow an "in-service withdrawal" prior to retirement. In the example above, if you've contributed to both a pre-tax and post-tax account, you can move the money over to two IRA accounts. The pre-tax dollars go into a traditional IRA and grow tax-deferred. The post-tax dollars go into a Roth IRA and grow tax free!

4. What if I own a business?

If you own a business during your retirement years, one tax law change that could be very favorable is the 199A Qualified Business Deduction. A 20% deduction is allowed on the combined qualified business income for individuals and trusts.

If you're retired and deferring Social Security

Given the additional benefit you receive by deferring Social Security to age 70, many retirees are living with no Social Security in the first few years of their retirement. If this is the case for you, the following two questions may arise:

1. How should I withdraw funds to cover my living expenses?

The first step is to determine how much money you need to cover your cost of living. Then, the harder question is where to take that money from. If you don't have or need much income, you may want to consider tapping into your taxable IRA first. Although proceeds may be taxable, you may be able to stay in a low or perhaps zero tax bracket. If you are already in a high tax bracket, it may be better to tap any taxable accounts or Roth IRA assets first.

2. When should I begin taking Social Security?

The answer to this question depends on many factors including your health, how much money you need to live on, your marital status and partner's benefits, and current market rates of return. One tax impact many miss is that if you both defer Social Security until age 70 and also have a sizeable RMDs from and IRA, the combined income can push you into a higher tax bracket. If this is your situation, it may make sense to accelerate income prior to enrolling in Social Security in order to reduce taxable income after age 73.

Another strategy for taking advantage of low income years before Social Security and RMDs is to use low-bracket years to convert IRA assets to a Roth. Doing so can have long term positive income tax and estate planning benefits for you and your family.

Unfortunately, filers can no longer recharacterize Roth IRA conversions back to a Traditional IRA. This would typically be done if the stock market took a downturn after conversion.

If you're retired and receiving Social Security

Once you begin receiving Social Security, consider that income as you determine the most tax efficient way to supplement with withdrawals from other assets. It's helpful to understand the potential additional income tax you may owe if you tap into taxable assets versus using retirement funds. If you're not careful and add too much taxable income, you could unwittingly trigger taxation of your Social Security benefits. Simplistically, 85 percent of your social security benefits are taxed once joint income exceeds $44,000. That limit is $32,000 if you file as a single individual.

If you're fortunate enough to have more income than you need to cover your living costs, you may ask a common question, "What are my options if I don't need my RMD?"

Of course, one option for RMD funds is to simply deposit them into your taxable account and save them for future spending needs. Alternatively, if you are charitably inclined, you can direct some or all of your RMD to be paid directly to a charity. That reduces your taxable income and effectively makes the charitable contribution paid for with pre-tax dollars.

Gifting your RMD is particularly effective because, if you defer your RMD(s) to charity, you pay tax on that much less income and still get the newly increased $27,700 standard deduction (for joint filers)! We recommend if you want to employ this tax strategy you wait until December to take your RMD and crunch some numbers to get a sense for what the tax savings will look like if you itemize versus taking the standard deduction.

Communication with your advisors is key through all stages of life. If you act early and ask tax-related questions along the way, you may be able to implement strategies to reduce your tax costs in retirement. Doing so can improve your financial situation and your chances of fulfilling your retirement goals.

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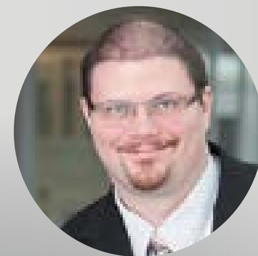

Sean is a Director of Tax Services at The Colony Group specializing in tax planning strategy, as well as preparation of individual, trust, gift, pass-through entity, and foundation tax returns. Sean is a Certified Public Accountant (CPA) and a member of the American Institute of CPAs, the Massachusetts Society of CPAs, and the Boston Estate Planning Council. He earned a Master of Science in Taxation (MST) and Master Personal Financial Planner (MPFP) designation from Bentley University. He earned a Bachelor of Science in Accounting as well as a Master of Science in Management (MSM) from Bridgewater State University.

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Dawn's experience spans more that 25 years providing wealth management, financial planning and corporate finance solutions for clients. As an MBA, CPA, Certified Financial Planner (CFP®), and a Certified Divorce Financial Analyst (CDFA®), she is uniquely qualified to understand the challenges and financial needs of clients from executives to entrepreneurs, as well as single breadwinner parents.