

The Tax Gotchas at the Four Stages of Retirement (Including the SECURE Act)

Most couples think that, by moving into retirement, the hard work is done. But the federal government ensures that's never the case! There are plenty of tricky tax rules and regulations that make handling finances in retirement a burden, and not knowing them can eventually cost millions of dollars both you and your children.

We are going to walk through the life of a hypothetical person in four stages, using a "base case" for comparison. First, we look at a typical married couple which has the most tax advantaged structure. Second, as our married couple ages, the Required Minimum Distributions (RMDs) will kick in at 72, creating an additional tax burden. Third, one spouse will eventually pass, meaning the remaining spouse is left as a widow and is subject to the Widow's Penalty. Fourth, the remaining spouse will ultimately pass, and the remainder of the IRA (which she was likely told not to spend down) will be left to the children, causing additional tax headaches thanks to the recently enacted SECURE Act.

Base Inputs: The Base Case takes a couple Married Filing Jointly at the age of 71, with no RMDs

Ages 71/71

\$2,000,000 Traditional IRA

\$1,000,000 Taxable account

Returns = 6% per year

Social Security (\$45,480 for husband & \$32,000 for wife)

Dividend Income: \$20,000 (every year)

Long-term Capital Gains: \$25,000 (every year)

Let's see how their tax picture looks prior to RMDs.

Stage 1: Married Filing Jointly at age 71

Taxable Income: \$57,379 (includes partial taxation of Social Security)

Total Tax: \$1,238

Marginal Bracket: 10%

Additional Annual IRMAA Surcharge: \$0

As you can see, the couple has a total taxable income of \$57,379, meaning they are in the 10% marginal tax bracket and their total tax burden amounts to \$1,238. Only \$39,779 of their Social Security benefit of \$77,480 is taxable. They're not yet age 72, which means they don't have to take any required minimum distributions, or RMDs, and there is no additional surcharge on top of their IRMAA premium. Right now, their tax situation is quite simple, but that's going to change in the next year when they turn 72.

Once they turn 72, they start collecting RMDs, which triggers all kinds of additional taxes.

Stage 2: Married Filing Jointly at age 72

Taxable Income: \$159,661 (includes RMDs of \$75,471)

Total Tax: \$23,358

Additional Tax from Stage 1: \$22,120

Marginal Bracket: 22%

Additional Annual IRMAA Surcharge: \$840 per person (includes Part B and Part D)

Under the SECURE Act, RMDs can be delayed until age 72. As the couple turns 72, their taxable income almost triples, increasing from \$57,379 to \$159,661 in the span of just one year simply as a result of the RMDs! With that increase in income comes a \$22,120 increase in their tax burden, amounting to a total tax of \$23,358. For example, now \$67,176 of their Social Security is taxable, whereas only \$39,779 of Social Security was taxable prior to taking RMDs. As a result, the couple is pushed into the 22% marginal tax bracket and incurs an additional IRMAA surcharge of \$840 per person for the year (\$5140.80 per year in total Medicare). As you can see, although the income increase is obviously appreciated, it often comes with a nasty tax burden, that is often not anticipated.

One of them will eventually pass, likely the husband, and we assume at age 78.

Stage 3: Widowhood at age 78

Taxable Income: \$185,734 (includes RMDs of \$111,448)

Total Tax: \$34,127

Additional Tax from Stage 2: \$10,769 (due to Widow's Penalty)

Additional Tax from Stage 1: \$32,889

Marginal Bracket: 24%

Additional Annual IRMAA Surcharge: \$4,656 (includes Parts B and D)

It's never fun to plan for death, but the federal government makes sure that the death of a spouse is always on your mind – and this stays true regarding taxation. The "Widow's/Widower's Penalty," as it's called, is the tax penalty often incurred with the death of a spouse. Typically, the remaining person's total income doesn't drastically change. At that point, the couple (and eventually the widow) is typically retired and living off savings, investment income, and potentially Social Security. However, as the tax brackets are more forgiving towards those Married Filing Jointly compared to Singles, the new widow is eventually forced to pay a tax penalty for her husband's death.

As you can see above, the taxable income actually increases slightly after her spouse's death – however, she is now forced to register as a Single filer, meaning she is in the 24% tax bracket, and incurs \$10,769 more in taxation than she would have if she were still Married Filing Jointly.

The IRMAA surcharge also jumps as a result, increasing from \$840 to \$4,656 per year, for an annual total of \$6,392.40 in Medicare charges.

Now, let's say that our widow increases her income slightly at age 78, to allow for additional gifting or medical or long-term care expenses.

Modified Stage 3: Widowhood at age 78 – Widow's Penalty plus an additional \$50,000 distribution from the IRA

Taxable Income: \$235,734 (includes RMD of \$111,448 and additional \$50,000 IRA distribution)

Total Tax: \$48,867

Additional Tax from Stage 3: \$14,740 (due to additional \$50,000 distribution)

Additional Tax from Stage 2: \$25,509 (due to Widow's Penalty)

Additional Tax from Base Case: \$47,629

Marginal Bracket: 32%

Additional IRMAA Surcharge: \$4,656 (includes Parts B and D)

Now, take Stage 3, but add in an additional \$50,000 IRA distribution taken by the widow. This increases taxable income to \$235,734 and pushes the widow from the 24% marginal tax bracket into the 32% bracket, meaning the total amount of tax increases by \$14,740 to become \$48,867, compounded by the Widow's Penalty. Clearly, even a seemingly small additional distribution of \$50,000 can incur thousands in additional taxes.

Now, let's see what happens when our widow eventually passes without the proper planning.

Stage 4: Wife dies at age 90 – the \$3.2 million IRA is passed to the beneficiaries, her two kids

Once both spouses have passed, the IRA is transferred to the beneficiaries – in this case, the two children. The SECURE Act forces each child to deplete the entire IRA account by the tenth year, and, if the Inherited IRA is Traditional, which in this case it is, they must pay income tax on it.

Consider that, if a large enough Traditional IRA is inherited, the beneficiaries might lose almost half of it to taxes.

In this case, the IRA is a Traditional IRA, now worth \$3.2 million. Splitting this up between the two kids, a **\$1.6 million balance must be withdrawn by each beneficiary within ten years** of their mother's passing. This can potentially equate to an extra \$160k+ in income per year if they choose to spread the distributions out for the length of the 10-year period. Keep in mind that the account will still be growing once inherited, so more than \$160k will have to be withdrawn each year for the two kids. They could also choose to withdraw the entire amount in one year, but this would push the beneficiary into the highest tax bracket on its own for that given year, regardless if Single or Married Filing Jointly.

To have a \$0 balance by the end of year 10, the heirs would have to withdraw about **\$205,000** per year, assuming 6% growth. As said before, assuming \$150,000 in income on top of the \$205,000 withdrawals, the beneficiary is forced into the 32% bracket if Married Filing Jointly (assuming **no** other income), and the 35% bracket if Single (assuming **no** other income). As you can see, under the SECURE Act, a large Traditional IRA balance can have daunting effects on the beneficiary of the account(s).

By simply planning ahead, much of the headache (and taxes) resulting from these tricky tax laws can be avoided, and anywhere from tens of thousands of dollars to millions can potentially be saved in the process.

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Distributions from traditional IRAs and employer sponsored retirement plans are taxed as ordinary income and, if taken prior to reaching age 59½, may be subject to an additional 10% IRA tax penalty.