Don’t Assume You’ll Pay Less in Taxes in Retirement

Plan now for the taxes of tomorrow. Here are some ways to limit them, stretching your income further throughout your retirement years.

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Imagine being a passenger on a 747 jumbo jet, sitting on a runway and preparing for takeoff.

But, there’s one big problem: Your large plane will be trying to get up to speed and into the sky while going down a tiny municipal airport runway.

How unsettling would that feel?

This is similar to where we are as a society in terms of how taxes and the tax code will likely change our future financial lives. We have a short runway to do something about it right now, but the end of that runway is quickly approaching.

Today’s retirees have possibly more money than any previous generation – and this could mean they’ll also pay the most in taxes. This generation of retirees has a substantial amount saved in tax-deferred retirement accounts as well as other taxable assets, which means they shouldn’t assume they’ll pay much less in taxes in retirement. There are a few reasons, including changing tax policy and **required minimum distributions**.

Plan for the taxes of tomorrow

Although no one can predict the future, there’s substantial evidence suggesting that taxes will rise. The Tax Cuts and Jobs Act will expire at the end of 2025, but we could see major changes before then.

Currently, we may be experiencing relatively low tax rates. In 1944, the highest income tax rate was **94%**, and in 1978 the **maximum capital gains tax rate was almost 40%**. Currently, the **highest income tax bracket is 37%**, and the highest long-term capital gains tax rate is 20%.

The Biden administration's proposed tax changes include increasing the top marginal income tax rate from 37% to 39.6%. Additionally, the long-term capital gains rate of 20% for those making more than $1 million would disappear. This means that capital gains would instead be taxed at 39.6%, plus the additional 3.8% **Net Investment Income Tax**.

How much of your retirement income will be taxable?

Once you retire, although you won't receive a paycheck anymore, many of your retirement income sources will be **taxable**, possibly including **your Social Security benefits**, if your income is high enough. In fact, if your combined individual income is between $25,000 and $34,000 or is between $32,000 and $44,000 as a married couple filing jointly, up to 50% of your benefit may be taxable. And, if your combined income as an individual is above $34,000 or above $44,000 as a married couple filing jointly, up to 85% of your benefit may be taxable. Beyond Social Security benefits, capital gains, home sales and inheritance may also be taxable – at unknown future rates.

It's also important to factor in taxes when withdrawing from your tax-deferred 401(k), IRA or other retirement account. While you can decide how much to withdraw at first, starting at age 72 you will have to take out an annual amount specified by the IRS. This means you may have to withdraw more than you normally would, potentially pushing you into a higher tax bracket.

If you're worried about making your money last for the rest of your life, consider how much of your retirement savings will go toward taxes and whether you could be paying less.

What can you do?

Rather than wait and watch, you can act. Create a long-term tax-minimization strategy and plan for the tax rates of the future, not the rates of today. There are numerous strategies to help minimize taxes on your retirement income, as well as your estate, and a professional can walk you through them. Here are three strategies gaining in popularity:

- **A Roth conversion.** You pay tax on the amount converted from a traditional 401(k) or IRA to a Roth, and then later withdraw it tax-free. By contrast,

with a traditional IRA, you can contribute pre-tax money that reduces your taxable income at the time you contribute, but when you withdraw the money later in retirement, it is taxed as regular income. The **maximum annual Roth contribution is 2021** is $6,000, plus $1,000 if you turn 50 by the end of the tax year.

- **Health Savings Account. HSAs may be offered** by your employer or opened on your own. As with a 401(k), money is contributed to an HSA before taxes. It can be an effective savings vehicle as investments grow tax-free, and you pay no tax on withdrawals for qualified medical expenses. HSAs are also exempt from RMDs. For 2021, the **maximum deductible contribution** is $3,600 for an individual and $7,200 for a family.
- **Municipal bonds.** Interest on municipal bonds is exempt from federal taxes. Basically, when you buy a municipal bond, you are lending money to a local or state government entity. Once the bond reaches its maturity date, the full amount of the original investment is repaid to the buyer.

Most agree that taxes will be going up. Now is the time to create a plan to protect against higher taxes that could potentially eat up your retirement savings. Be sure to consult with your tax professional before making any decisions regarding your personal situation.