

6 Tax Tips

For Retirees

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FINANCIAL

1. The Order You Pull From Different Accounts Matters

[A lot of tax planning is tax timing](#). There are three different types of places where you can put money when it comes to generating income for retirees: [tax-deferred](#), tax-free, and taxable accounts. Each type of account has different tax implications when you withdraw.

Tax-Deferred Accounts:

- Tax-deferred accounts include traditional 401(k)s and traditional IRAs.
- When you withdraw money from tax-deferred accounts, it is taxed as income in the year of withdrawal.
- These accounts offer an immediate tax advantage, allowing investors to put more money into their accounts due to tax deferral.

Tax-Free Accounts:

- Tax-free accounts include Roth 401(k)s and Roth IRAs.
- Withdrawals from tax-free accounts are completely tax-free.
- Contributions to these accounts are made with post-tax money, so the withdrawals are not subject to income tax.

Taxable Accounts:

- Taxable accounts are in the tax-now world and include brokerage and non-qualified investment accounts.
- Growth in taxable accounts is taxed as income each year.
- When you sell assets in taxable accounts, you are taxed at capital gains rates.

The Correct Order to Withdraw Money from Different Types of Investment Accounts

The general rule is to withdraw money from the least tax-efficient place first and leave the most tax-efficient dollars for later. The correct order to withdraw from these accounts, all other things being equal, is as follows:

1. Taxable Accounts: Withdraw from your non-qualified investment or brokerage account first. This account is taxed annually on growth and when assets are sold, making it the least tax-efficient place to hold money.

2. **Tax-Deferred Accounts:** Withdraw from your traditional IRAs or 401(k)s after using taxable accounts. Withdrawals are taxed as income, so it's more tax-efficient to leave these accounts until later.
3. **Tax-Free Accounts:** Finally, withdraw money from your Roth IRAs or 401(k)s. Withdrawals from these accounts are completely tax-free, making them the most tax-efficient place to hold your money.

By following this order, you can potentially save hundreds of thousands of dollars in taxes over your lifetime. Individual circumstances may vary, so consult a financial advisor or tax professional to determine the best strategy.

2. Understanding Roth Conversions and Their Benefits: “Realize” Income on Paper at the Most Strategic Time

[Roth conversions](#) move money from traditional tax-deferred accounts to Roth tax-free accounts. This involves realizing income on paper and strategically converting funds to fit into a lower tax bracket. The three main reasons for Roth conversions are:

1. **Taking Advantage of Lower Tax Brackets:** One benefit of Roth conversions is pulling money into a lower tax bracket, especially for individuals who retire in their sixties. By converting a portion of their traditional IRA to a Roth IRA, individuals can realize income in a year when they are in a lower tax bracket, potentially saving on taxes in the long run.
2. **Defensive Strategy for Future Large Distributions:** Another reason for Roth conversions can act as a defense mechanism in case individuals need to take a large distribution later in life, such as for a long-term care event or to support a family member. By converting funds gradually, individuals can control and manage their tax payments, rather than facing higher taxes from a lump sum withdrawal from a traditional account.
3. **Uncertainty of Future Tax Rates:** Roth conversions can also be a strategy to hedge against the uncertainty of future tax rates. Many people believe that tax rates are more likely to increase in the future, so paying taxes now through Roth conversions can help avoid potentially higher tax rates later on.

It's important to note that Roth conversions do not directly affect the investments held within the accounts or the income individuals are living off of. The main goal is to strategically manage income on paper to fit into a desired tax bracket based on current tax rates and individual circumstances.

Roth conversions are a valuable tax planning tool, especially in the early years of retirement. It's essential to consult a financial advisor or tax professional.

3. Understanding the Taxation of Social Security Income

[Social Security income is subject to federal income tax](#) for most people, although a portion of the benefits may be exempt from taxes. The amount of Social Security income that is taxable depends on various factors, including your total retirement income and filing status.

If you rely solely on Social Security income and have no other sources of income, it is unlikely that your benefits will be taxed. However, if you have additional income from sources such as work or retirement account withdrawals, there is a higher chance that you may owe taxes on a portion of your Social Security benefits.

The taxable portion of Social Security benefits is determined by calculating your combined income, which includes 50% of your benefit amount plus any other earned income. If your combined income exceeds \$25,000 for an individual taxpayer or \$32,000 for a married couple filing jointly, a portion of your benefits may be subject to federal income tax.

It's important to note that not all states tax Social Security benefits. Most states do not tax Social Security income, but there are exceptions. For example, Connecticut, Kansas, Minnesota, Missouri, Montana, Nebraska, New Mexico, Rhode Island, Utah, Vermont, and West Virginia may have different rules regarding the taxation of Social Security benefits. It's advisable to check with your state tax agency for specific information.

Strategies to Minimize Taxes on Social Security Income

Most people are subject to federal income tax on their Social Security income, although a portion of the benefits may be exempt. The amount of taxable Social Security income depends on factors like total retirement income and filing status.

If you only have Social Security income, your benefits will be taxed. However, if you have additional income from sources such as work or retirement account withdrawals, you may owe taxes on a portion of your Social Security benefits.

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Not all states tax Social Security benefits. Most states do not tax Social Security income, but there are exceptions. For example, Connecticut, Kansas, Minnesota, Missouri, Montana, Nebraska, New Mexico, Rhode Island, Utah, Vermont, and West Virginia may have different rules regarding the taxation of Social Security benefits. It's advisable to check with your state tax agency for specific information.

Strategies to Minimize Taxes on Social Security Income

If some of your Social Security income is taxable, there are strategies you can consider to reduce the tax implications:

4. **Manage your total income:** Keeping your total combined income below the thresholds for tax payment can help minimize taxes on your Social Security benefits. This can be achieved by carefully managing your other sources of income, such as investments or part-time jobs.
5. **Consider timing:** Claiming Social Security benefits and withdrawing from retirement funds can impact your overall tax liability. Being strategic about when you do this is important. Consulting with a tax professional can provide guidance on the best timing strategies for your specific situation.
6. **Withholding request:** You have the option to [request the IRS to withhold](#) federal taxes from your Social Security benefit payment throughout the year. This can help you avoid a large tax bill at the end of the year and ensure that your taxes are paid in a more manageable manner.
7. It's important to note that these strategies may not be applicable or suitable for everyone. Consulting with a tax professional can provide personalized advice based on your individual circumstances.

Taxation of Social Security income depends on various factors, including your total retirement income and filing status. Only a portion of Social Security benefits may be [subject to federal income tax](#). You may be able to minimize the taxes owed on your Social Security income by managing your total income, considering timing strategies, and requesting withholding.

4. Spousal IRA Contributions for a Retired Spouse

When one person in a married couple retires while the other spouse is still working, the retired spouse can still contribute to an [individual retirement account \(IRA\)](#) through a spousal IRA. A spousal IRA allows the non-working spouse to contribute to a traditional IRA or a Roth IRA based on the other spouse's earned income, even if the retired spouse doesn't have any earned income themselves.

[The spousal IRA](#) allows a non-working spouse to contribute to a traditional or Roth IRA, up to the maximum limit, if their working spouse earns an income.

This is a commonly missed opportunity for retirement savings because couples often don't retire at the exact same time. This results in a period of overlap where the retired spouse can still contribute to an IRA based on the working spouse's income.

It's important to note that the contribution limits for IRAs may vary depending on the tax year. For tax year 2023, the annual contribution limit for both Roth and traditional IRAs is \$6,500, and it increases to \$7,000 in 2024. Individuals who are age 50 or older can make an additional catch-up contribution of \$1,000 annually, with this amount adjusted yearly for inflation.

Spousal IRA contributions allow a retired spouse to contribute to an IRA based on the earned income of their working spouse. This is a commonly missed opportunity for retirement savings because it provides a way for the retired spouse to continue saving for retirement even if they don't have any earned income themselves. The spousal IRA can be a traditional IRA or a Roth IRA, and the contribution limits may vary depending on the tax year. It's important for couples to use this option to maximize their retirement savings.

5. Deduct Your Medicare Premiums

If you've retired from your main job but have [a side hustle](#), such as making items for Etsy or doing consulting work, and you have [self-employed income](#), you can [deduct](#) all of your Medicare premiums. This can be a significant deduction.

If you don't have self-employed income, Medicare premiums are only deductible under the health-related itemized deduction. To qualify, you need to spend a significant

amount on health-related expenses, which very few people do. Often, those who qualify have had a medical emergency and didn't have health insurance. However, if you're self-employed, you can deduct all of your Medicare premiums, which is common for many people when they retire and do something on the side.

Remember, self-employment taxes are the Social Security and Medicare taxes individuals pay on wages outside of a W-2. When you're an employee, your employer covers a portion of these taxes on your behalf, but for nonemployee compensation, you're responsible for the full amount.

If you're a freelancer or gig economy worker, you can lower your tax bill by making contributions to a solo 401(k) retirement plan, which you can deduct. Small business owners and self-employed people can deduct business-related costs when filing taxes, which can result in a lower tax bill. Self-employed workers can also deduct the employer portion of the self-employment tax – 7.65% of your net earnings – from your gross income to arrive at your adjusted gross income (AGI). And if you're not covered by another employer's plan, you may be eligible to deduct 100% of the cost of your health insurance premium from your AGI.

Consult with a tax professional to ensure you're taking advantage of all the deductions available to you and to ensure you're in compliance with all tax laws.

6. Charitable Giving

[Charitable giving](#) offers tax advantages, especially for retirees. Here are a couple of key strategies to consider:

1. **Qualified Charitable Distributions (QCDs):** When you reach the age of 72 and a half, you are required to start taking minimum distributions from tax-deferred accounts like traditional IRAs and 401(k)s. This is because these dollars haven't been taxed yet, and the IRS requires you to start withdrawing and paying taxes on them. However, if you donate part or all of that required minimum distribution to a charity through a QCD, you can avoid the income tax altogether.

While the gift amount won't qualify for a [charitable deduction](#), it won't be considered taxable income. This is a significant advantage over the common scenario where [donating money to a charity](#) counts as a deduction but is not completely exempt from income tax.

2. **Gifting Appreciated Assets:** If you have non-retirement assets, like a brokerage account or a non-qualified account, you can gift appreciated assets, such as

securities, to a charity. For example, if you own a stock that has significantly appreciated in value, you would typically have to pay capital gains tax on the growth if you sold it. However, if you donate that security to a charity, it exempts them from capital gains tax. So, if you plan to give money to a charity and have appreciated investments, you can avoid capital gains tax by transferring those assets.

Tax Timing

The overarching theme for tax planning for retirees is trying to limit your lifetime tax bill, not just lowering your tax bill for the current year. There are times when it makes sense to intentionally increase your tax bill in the current year to lower your total lifetime tax bill. Always keep this in mind when doing tax planning.

Remember, these are general tips and strategies. Everyone's financial situation is unique, so it's always a good idea to consult with a tax professional or financial advisor to understand the best strategies for your specific circumstances.

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