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Doug's Insights

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Creating a Better Blend of Retirement Assets

"A Taxing Situation"

By: Doug Horn, CFP®

Whether around the corner or years in the future, having sufficient assets is not the only issue to need attention when planning for retirement. It's important to consider the blend of assets, which can make a significant impact on the availability of after-tax retirement income.

For most of us, Social Security benefits are the starting "base" of retirement income. For teachers and a few other occupations, a State pension is the starting point. There are a few remaining occupations which receive Social Security in addition to an employer provided pension. The objective becomes to build a retirement portfolio sufficient in size to provide a monthly distribution to fill the gap between desired income and that already in place from Social Security and pensions. Even those whose base meets their desired income should build a portfolio to handle life's curve balls.

There are several different strategies for building a well-blended portfolio. The first option is either Individual Retirement Accounts (IRAs) or an employer provided 401(k) plan. These are often selected for the reduction in current taxable income they offer, thus saving taxes each year. Since IRAs have an annual contribution limit of $5,500 unless you are 50 or older, then the limit is $6,500, this option may not permit sufficient contributions in order to meet the required portfolio size. Employer plans such as the 401(k) permit greater contributions and are also easy to utilize. This is the extent of most individual retirement plans. But, is it enough?

During retirement, managing the different segments of expenditures in the annual budget is one way to control how much income is needed. Many plan to have their home mortgage paid off by the time they retire. Doing so reduces the required retirement income, since a mortgage payment is no longer part of the expected retirement budget. Another potential large budget item is Long Term Care (LTC) insurance. Purchasing LTC insurance in your early 50's may result in a lower premium during retirement than waiting until your 60's to purchase coverage. And don't forget about income taxes, which are often overlooked but can be controlled provided the planning starts years before retirement.

Most retirement income is taxed as ordinary income tax rates based upon the total taxable income for the year. As most would suspect, income from pensions is taxed as it is received. For couples collecting Social Security and whose income is greater than $44,000, up to 85% of their benefits may be taxed. Those whose income takes a onetime jump may be surprised by the additional tax due, since the jump may cause their Social Security benefits which were normally not taxed to become partially taxable. Retirees have little control over income like Social Security Benefits and pensions which are paid monthly, needed or not, and the related tax on the income that's due.

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Depending upon the retiree's income tax bracket and the tax rate in place at the time, they could be facing marginal tax rates of 15% to 35% or higher. As we all know, life occasionally throws curves and additional cash may be needed for living expenses or special needs that arise. For those who took the normal route, the portfolio built for retirement is most likely pre-tax savings from contributions made through the years to a traditional IRA or to a 401(k) plan on a pre-tax basis. This means any distribution taken during retirement will be taxed in the year withdrawn. Thus, a $10,000 distribution from an IRA plan could lose $1,500 to $3,500 to Federal income taxes. Add this to what has already been paid, and anyone can see income taxes will remain a significant budgetary item for most retirees.

With advance planning, the tax impact may be reduced. Since the tax treatment and timing cannot be changed on pension or Social Security benefits, it is the taxes on the investment portfolio that may allow flexibility. In my opinion, it is worthwhile to redirect some of the retirement contributions to Roth plans instead of always contributing to the traditional IRA or 401(k) for the current year tax benefit. Many 401(k) plans now offer a Roth option. A portion can be directed to this benefit within the 401(k) regardless of an individual's annual income. Others may use Roth IRA accounts, if they remain eligible under IRS regulations. Roth accounts grow tax-deferred; and when distributions are taken, there is no income to recognize and no income tax to pay. Someone pulling $10,000 from their accounts could pull all or part from their Roth account reducing the tax burden.

In addition to Traditional pre-tax retirement plans and Roth after-tax plans, individuals have the option to build taxable accounts as well. Unlike retirement accounts, taxable accounts offer several desirable benefits. Since no one is perfect in their investment selection, losses taken in taxable accounts can be used to offset gains which also reduces taxes on the total gains earned. While present tax law should be expected to change over the years, dividend income and long term capital gains currently receive favorable tax treatment. Many individuals believe they will pay 15% tax on investment gains recognized each year, and some believe dividends are taxed like interest income. In fact, interest income is taxed like pensions, wages and other ordinary income. Qualified dividends are actually taxed like long term capital gains. Depending upon the taxpayer's overall income, they may find their qualified dividends and long term capital gains avoiding tax or being taxed at either 10% or a 15% rate. Only those with extremely high income will see this income taxed at the 20% rate. Having all three types of accounts provides higher flexibility on where distributions may be taken and with that flexibly greater control over the amount of taxes to be paid.

Proper retirement planning is not something done the week before the gold watch is delivered. When done properly, retirement planning is a process that takes many years and thoughtful preparation.

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