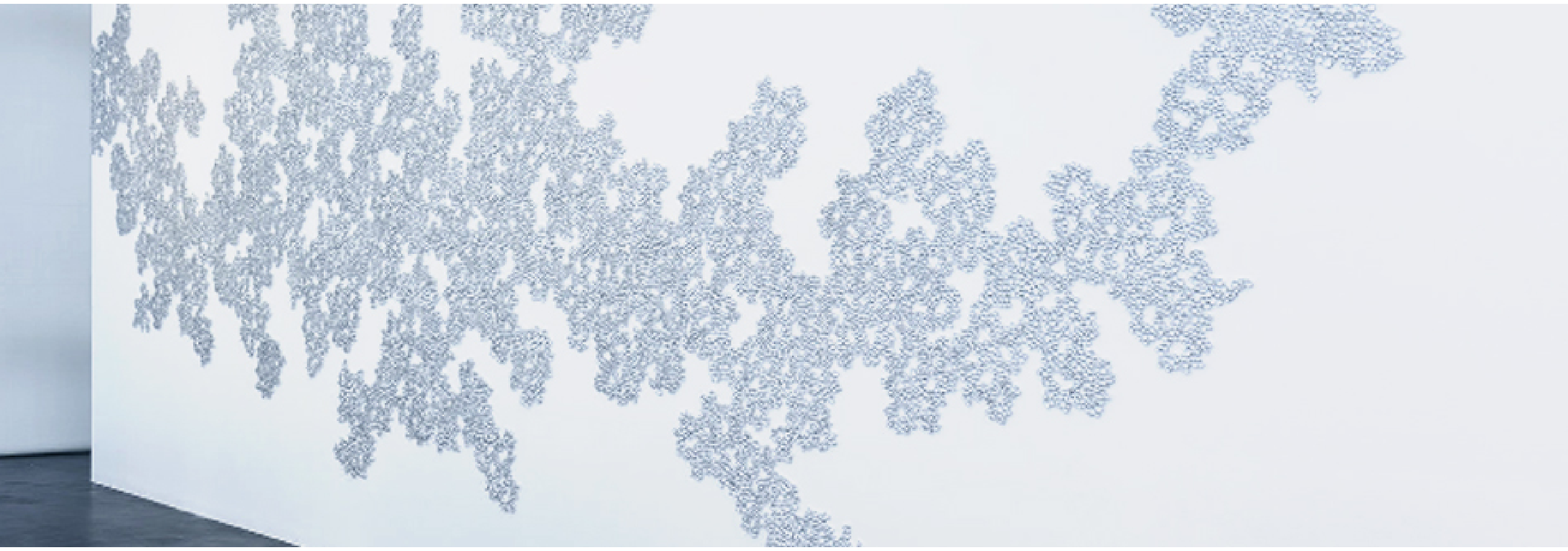
Sankala Group



Credit: *Private Client* - MCA Denver

Taxation in Retirement

Harold A. Hallstein IV

The topic of tax rates in retirement comes up frequently enough in our business that it deserves a formal letter. Recently, we unrolled a PDF calculator that helps clients understand how we look at the sustainability of a retirement budget. While this document does an excellent job of helping people see what their investments, Social Security, pensions, insurance, and other income sources allow them to spend annually, it also discreetly dodges an important question: *"How much of that number do I need to earmark for taxes?"*

We avoid this question for good reason. Neither we, nor your CPA, can tell you the answer to this question with the level of exactitude you deserve. There are just too many moving parts, and some variables frankly aren't known until the end of the tax year. However, I hope by highlighting the key levers in this IRS equation, your conceptual understanding will have you confident enough to say "I'm not really worried about it, because it will likely be the lowest effective rate I've seen for decades."

Social Security

Social Security is essentially an annuity with preferential tax treatment. Despite the fact that you (and your employer) pay into Social Security over the course of your life on a pre-tax basis, much of the income also comes back out to you non-taxable as well. Unfortunately, like everything in the tax code it can't be easy and it has its own special set of breakpoints. Luckily, these breakpoints apply to standard benefits, spousal benefits, survivor benefits, and disability benefits alike.

Before we can discuss the breakpoints, we also need to define a new income figure, which the IRS calls "Combined Income."

Combined Income =
Adjusted Gross Income + Nontaxable Interest (e.g. Munis) + ½ SS Benefit

As you can see, there are inputs here that are hard to know prior to year end. That said, if your portfolio is relatively consistently invested, and you are fully retired and don't have earned income, you can garner a good estimate from your prior year tax return and then apply the table below:

	Joint Return	***Individual Return***
Minimum Tax	**0% of SS Check**	**0% of SS Check**
Maximum Tax	**85% of SS Check**	**85% of SS Check**
Combined Income < 25k	0% of SS Check	0% of SS Check
Combined Income > 25k	0% of SS Check	50% of SS Check
Combined Income > 32k	50% of SS Check	50% of SS Check
Combined Income > 34k	50% of SS Check	85% of SS Check
Combined Income > 44k	85% of SS Check	85% of SS Check

Pension Income

Income from pensions is a bit easier to understand. It essentially boils down to a question of whether you have "basis" (a known investment cost) in your contract. For example, if your employer has given you a pension but did not withhold money from your salary, you have no basis and therefore the income will be fully taxable. If you contributed your own taxed money into your pension, you have basis, so you will pay tax only on amounts received beyond this basis. The basis payments themselves will be returned over time, tax-free. The allocation of taxable income versus non-taxable income in each payment is calculated through guidance in Publication 575. The calculation is slightly different for "qualified" versus "non-qualified" plans.

In general, the best practical approach is to run the worksheet in the first year you receive pension income, and then elect for ongoing tax withholding directly from the pension payment. This will simplify your estimated tax payment process materially.

Lastly, it is also important to know that certain pensions created by federal, state, or local government employers can reduce a retiree's spousal and survivor benefits under Social Security. The logic here is that since the employee didn't pay into Social Security during employment with the government, and instead has a government pension, any SS benefits due under spousal and survivor rules should be reduced. This is called the *Government Pension Offset (GPO*) and it states that spousal and survivor benefits are reduced by 2/3rd the amount of the government pension. In some cases spousal and survivor benefits can actually be reduced to zero if the pensioner is receiving material pension income from the government.

Insurance Income

Annuity income is taxed similarly to pension income. One of the attractions of annuities is that they are tax-deferred, meaning that once purchased, they grow with dividends and interest tax free. The divergence comes at the time income is received back out of the annuity. If the annuity is a "qualified" annuity (paid for with pre-tax money) all income coming back out of the annuity is taxed as income.

On the other hand, if the annuity was paid for with after-tax money, then income tax must be paid on investment earnings, but does not need to be paid on the basis paid for the annuity (principle). In practice, each income payment the annuitant receives is divided between earnings and return of principle based on what is called an "exclusion ratio" which marks the part of the principle being returned as non-taxable.

The exclusion ratio is based on actuarial tables of your life expectancy. Once all principle has been returned by the date of your life expectancy, all additional income received after that date becomes fully taxable again.

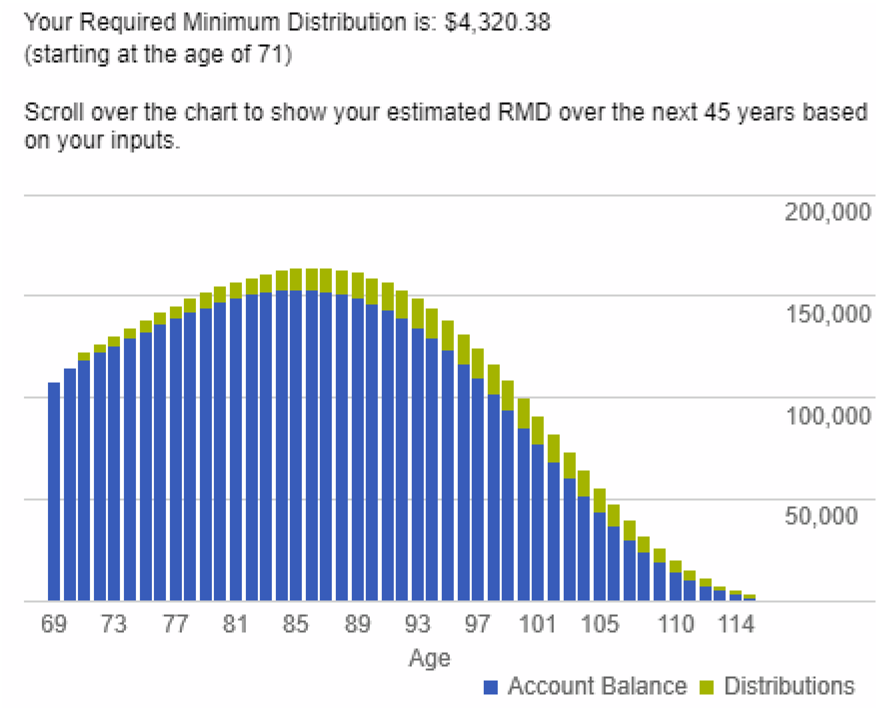
Required Minimum Distributions

One unique element of income tax most all retirees will face is the tax generated by IRS rules which require Traditional, SEP, SIMPLE and 401k retirement account/plan owners (and ultimately Inherited Traditional and Roth IRA owners) to take "minimum" withdrawals out of their retirement accounts. These withdrawals are more commonly known as RMDs (Required Minimum Distributions).

When a person turns 70.5 years old, they have until April 15th of the following year to take their first distribution. Thereafter, they have until the end of each tax year to take a distribution, which will be taxed in the calendar year in which it was taken out.

This is one of the most critical events in client's financial lives because missing these RMDs costs a fortune in IRS penalties. In fact, the penalty is literally half of what you were supposed to withdraw. As a result, we use a range of redundant systems to help ensure they are never missed for clients.

The calculation of the RMD utilizes the age of the retiree multiplied by an IRS factor called the *Uniform Lifetime* table. To best understand the way it works, an illustration is helpful. See below the RMD profile of an account with $100,000 current value, 7% returns over time, and an owner born on the last day of 1950:



If you have multiple accounts subject to RMDs, each account must have this calculation run separately. You can then choose to remove the amount of all RMDs from one account, or multiple, as you choose. These distributions will then be taxed as regular income.

If the original account holder passes away, the account will be held by an inheritor and the timing of distributions will remain based on the age of the original account holder, but the amount will be based on the inheritor's own life expectancy and the account value. If the inheritor is your spouse, the assets can simply be rolled directly into their own IRA and only the rules governing their own RMDs will apply going forward.

Regarding Roth IRAs, there is no RMD requirement during the Roth owner's lifetime. This makes them excellent vehicles to grow wealth during retirement. However, the IRS wants all IRA monies distributed ultimately, and this is achieved with Inheritor RMDs in the case of the Roth IRA. Again, here, a spouse can simply treat the money as their own. However, any non-spouse inheritor must transfer assets into an Inherited Roth IRA. They will then have 3 choices for RMDs: take a full distribution immediately (not often wise), take distributions over 5 years, or take distributions based on their own life expectancy.

Portfolio Income

Last but not least, we have portfolio income. This includes dividends, interest and other similar payments received from investments you own, both public and private. Of course, these payments will only count as income for tax purposes if they are received in a taxable account, not an IRA, which defers those taxes.

If your portfolio has been built well, a variety of good decisions have been made about the placement of investments in each account, and a great deal of interest and dividend income will be deferred and therefore not reach your tax return. Your taxable accounts also should likely be offering you organic deferral by letting you choose the timing of crystallization on capital gains. They also may contain non-taxable municipal bonds versus taxable bonds.

The dividends and interest coming off these taxable accounts is inherently variable, so it often makes sense once in retirement to establish tax withholding with your taxable account custodians so that a certain percentage of this taxable income is being immediately sent to the IRS. That becomes one less thing to worry about in terms of estimated tax payments, and the variability of the tax liability will essentially handle itself in perpetuity.

That said, paying estimated taxes quarterly does keep more control in the hands of the taxpayer, and good arguments can be made for trying to estimate the taxable outcome in these accounts. This is an area of specialty for us, and we can give fairly confident estimates of income and the blended rates that apply to it on a case by case basis. This helps people feel like they have the best of both worlds – correctly paying taxes on the income they earn, and also controlling the timing of those payments to maximize their time invested.

Conclusion

Now that you have seen the variety of levers that determine your taxation in retirement, it should be easier to accept when your CPA tells you they really can’t give a sharp annual estimate. However, it should also be quite clear that between preferential tax rates on Social Security, preferential tax rates on portfolio income, return of basis elements in both pensions and annuities, and the competing factors of IRA income deferral and RMDs, that we can help you pay quite a bit less in taxes, measured in both dollars and effective percentage rates.

For simplicity, you can pay estimated taxes using a 90% of prior year taxes approach (based on your pre-retirement tax return) and then likely be surprised with a refund in the first year. You will have a far better estimate in the form of a completed post-retirement return in April, and can then go back to paying estimated taxes using the simple *"100% of prior year taxes"* option.

No matter how we choose to handle the payment issue, it is clear to us that we must continue to speak about retiree's income on a pre-tax basis given uniqueness of situations and tax rates. This is why our materials are always presented on a gross income basis, despite our keen knowledge that after-tax returns are the final performance indicator of our work as fiduciaries.

In short, if you think you are going to retire in the next year or so, please do reach out to us, as we are delighted to give you specific advice to take back to your CPA. That will help you strike the right balance between cost and efficacy. We can then get straight back to generating new income for you, so you can better enjoy your most singularly important asset—*time.*

Best,

Harold A. Hallstein
Sankala Group LLC
T: (720) 310-0605

Sankala Group LLC's communications should not be considered by any client or prospective client as a solicitation or recommendation to affect any transactions in securities. Any direct communication by Sankala Group LLC with a client or prospective client will be carried out by a representative that is either registered with or qualifies for an exemption or exclusion from registration in the state where the prospective client resides. Sankala Group LLC does not make any representations or warranties as to the accuracy, timeliness, suitability, completeness, or relevance of any information presented in this communication, or by any unaffiliated third party. All such information is provided solely for illustrative purposes.