Retirement Distribution and Tax Saving Strategies

By Susan Talton, CFP®

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A LOT is written about retirement planning — 7.2 million references, to be exact, according to a recent Google search. I would venture to say that a lot of that info is about saving for retirement. What doesn't get as much attention is how to maximize control over the retirement savings you do have. We find that control requires advance planning and sometimes going against conventional wisdom.

In addition to age-related milestones, we think it's useful to think of retirement planning as three distinct phases – Saving, Living/Giving and Preserving. Below, I put the typical advice in context of what we think is important in each phase.

Saving – Stay Flexible

Typical advice: Put as much as you can into tax-deferred retirement accounts. *We suggest:* Structure your savings more deliberately, so you'll be able to take retirement income from tax-deferred, tax-free and taxable accounts.

Why: **Varied sources of income mean more flexibility in timing of withdrawals and taxes.** Each major way to save for retirement has its pluses and minuses (see page 3). The big minus with tax-deferred retirement accounts is that you'll be required to take annual withdrawals – known as RMDs (required minimum distributions) – starting at age 70 1/2. The more money in these types of accounts, the higher the forced withdrawals. And the more likely you are to be bumped into a higher income tax bracket during retirement.

Use All Your Savings Options

- **Roth IRAs.** In terms of taxes, a Roth IRA is the opposite of a regular IRA: you don't get a tax break up front, but after that there are no taxes on growth or qualified withdrawals, and no required distributions. Higher-income households (above $196,000 annually for married filing jointly) are not eligible to fund Roth IRAs directly. However, it is possible in this case to roll over certain retirement accounts into Roth IRAs:

  (1) Fund a Roth 401(k) at your job, if your employer offers one. People of all income levels can contribute to a Roth 401(k). While you won't get a tax break up front, the growth on that money is tax free. As you leave the company or retire, roll over some or all of your Roth 401(k) into a Roth IRA.

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(2) If you have an existing IRA, convert all or a portion of it into a Roth IRA at an opportune time — a year when your income is low because of job transition, high medical expenses or another reason. The conversion amount will be taxed at your highest personal income tax rate. But after that, you get all the benefits of the Roth IRA. The tax cost for conversion will be lower if you've made non-deductible IRA contributions in the past.

- **Health Savings Account (HSA).** This is the only savings account that is totally tax free if you use it for medical expenses. Contributions are tax-deductible (up until age 65), money can be invested and grow tax-free, and withdrawals for medical expenses at any age are tax-free.

  To optimize savings: Fully fund an HSA each year until age 65 and invest the proceeds; do not withdraw from the HSA to pay for medical expenses until after you retire. As of 2017, a family can contribute up to $6,750 annually to an HSA ($3,400 per individual).

  Note: To qualify for an HSA, your health insurance policy must have an annual deductible that is at least $2,600 per family ($1,300 per individual).

- **Taxable investment accounts.** Don't forget these have their own tax benefits: Long-term investment gains and dividends are taxed at about half the rate that income is taxed at the highest brackets (39.6%). In addition, you can time the taking of losses to offset gains now and into the future. Tax-efficient assets (growth stocks, municipal bonds) that you buy and hold are ideal for such accounts.

Saving To Spending

At LNWM, we do periodic and thorough "cash flow sustainability" analyses to confirm that each client's retirement funding can comfortably cover current and future spending. Even so, many people find it difficult to start spending the money they've always thought of as savings. One way to ease the transition: send yourself a monthly "paycheck," in the form of a transfer from savings into checking.

You're likely to have many years in retirement, but good health and interest in travel/adventure are usually strongest in the first couple of decades. Spending on yourself, your family and the causes you care about can be enormously fulfilling.

Living and Giving - Have a Plan

Typical advice: Keep money in tax-deferred retirement accounts as long as possible.
We suggest: It can be wise to start taking occasional withdrawals from IRAs and 401(k)s before retiring. The early withdrawal penalty on IRAs is lifted at age 59 1/2, and even earlier on 401(k)s – at age 55 — if you leave your job or retire.

Why: (1) To take advantage of any low-income years to streamline and restructure your savings. Say you have rolled over 401(k)s from previous jobs into an IRA. As you start working less, you may want to make some IRA withdrawals, pay the income taxes, and fund a Roth IRA. Or invest the withdrawal(s) in tax-efficient assets – muni bonds, growth stocks, etc.

(2) To help with living expenses so you can postpone collecting Social Security until age 70. Your benefit can then increase 8% annually between ages 66/67 and age 70. If you were due $1,000 monthly from Social Security at age 67, this will become $1,240 if you wait until age 70, not including the annual cost of living increases.

Consider All Your Savings Options: Mix & Match

	Account Type	Max Contribution Each Year	Tax-Deductible IN?	Tax-Free OUT?	Early Withdrawal Penalty	Exceptions to Penalty*	Mandatory
Individual Retirement Accounts	Roth IRA#	$5,500; $6,500 over age 50	**NO**	**YES**, after age 59½ and if Roth has existed for at least 5 years	10% plus income tax on all withdrawals higher than contributions	Higher education costs; $10,000 for 1st home purchase; certain medical expenses	**NO**
Individual Retirement Accounts	IRA^	$5,500; $6,500 over age 50	**YES**, if within contribution limits	**NO**, all withdrawals are taxed as income in year received	10% in addition to income tax on all withdrawals before age 59½	Same as Above	**YES**, age 70½
Job Related Accounts	Simplified Employee Pension (SEP) IRA	20% of net self-employment income (minus expenses); 2017 max = $54,000	**YES**	**NO**, Same as Above	Same as Above	Same as Above	**YES**, age 70½
Job Related Accounts	401(k)	$18,000; $24,000 over age 50	**YES**	**NO**, Same as Above	Same as Above	Certain medical expenses; leaving job or retiring after age 55	**YES**, later of age 70½ or retirement
Medical Accounts	Health Savings Account (HSA)	$3,400 individual; $6,750 family; PLUS $1,000 over age 55	**YES**, until you enroll in Medicare, usually age 65	**YES**, for eligible medical costs	20% plus income tax on all non-medical disbursements	Over age 65	**NO**
Taxable Accounts	Taxable accounts and investments	Any amount	**NO**	Long-term capital gains and dividends taxed at lower rates; deductions for realized losses	**NO**	**NO**	**NO**

* Disability and death are always exceptions to early withdrawal penalties. Other exceptions are described as above.

\# Singles with annual income of up to $133,000 ($196,000 married) can contribute to Roth IRAs (as of 2017).

^ Tax deductions for regular IRAs begin to phase out starting at income of $62,000 for singles, $99,000 marrieds (as of 2017).

SOURCE OF DATA: Laird Norton Wealth Management.

Be purposeful with your gifts to family and charity. For many high-net-worth individuals, especially those who have done in-depth financial planning, putting off major giving until after death often doesn't make a lot of sense. Giving to family during your lifetime, or making meaningful gifts to a charitable cause that's important to you, can increase your sense of purpose and bring a great deal of happiness.

Preserve and Protecting More Important Than Ever

Typical advice: If you've funded your retirement and your kids are grown, risk management and insurance aren't as important.
We suggest: Adequate insurance, investment risk management and an estate plan are even more important during retirement, especially for high-net-worth households.

Why: No matter how significant your assets, they can be greatly depleted by accidents, illness, natural disasters, market sell-offs.

Be sure to have an extended coverage ("umbrella") policy, which pays out after your other insurance policies have reached their limits. Umbrella coverage is relatively inexpensive and especially important for business owners and households with large estates.

Starting in your late 50s, consider adding long-term care insurance, because Medicare does not cover nursing home stays or other types of long-term care. The younger you are, the lower the premiums and the easier it is to qualify.

Get your estate documents in order (will, power of attorney, etc.) and properly title your assets to save time, money and preserve family harmony. For example, if you plan to leave major gifts to charity upon death, consider naming the charity as the beneficiary of your IRA. Your other, taxable assets can then pass on to your heirs at current market valuations (resulting in lower taxes when they sell), and your heirs can avoid having to take required mandatory distributions from an inherited IRA.

Retirement Countdown

In Your 40s, 50s and 60s: Accumulate savings in tax-deferred, taxable and tax-exempt accounts.

Age 55: If you leave your job or retire, you can start withdrawals from 401(k)s without a 10% penalty; withdrawals are taxed as regular income.

Age 59 ½: Can start withdrawals from IRAs with no 10% penalty. Withdrawals taxed as regular income.

Age 62: Earliest you can collect Social Security benefits. But if you collect early, benefits will be roughly 30% less.

Age 62: Retiring early? You'll need health insurance to close the gap before Medicare begins at 65. Consider extending your employer coverage through COBRA, coverage under your working spouse's plan, or purchase private medical insurance.

Age 65: Enroll in Medicare within 7 months of your birthday (starting three months before you turn 65). If you miss this window, you may have higher premiums for your lifetime. Revisit your plan choices during Open Enrollment each fall, to make sure you've got the coverage best for you.

Age 66-67 (depending on year of birth)**:** Social Security full retirement age. If you defer filing, your benefits will increase 8% annually until age 70.

Age 70: File for Social Security if you haven't yet. Your benefit won't increase beyond age 70.

Age 70 ½: Required Minimum Distributions (RMDs) begin from your non-Roth retirement accounts. Required annual withdrawals are based on your age and account balance, and there's a stiff 50% penalty on the amount of any shortfall. Also, even if you're still working, you can no longer contribute to retirement accounts.

We're Here To Help

Retirement as a way of life takes years to get used to. Whether you ease into it or jump in with both feet, it's very comforting to know that you have in place plans for saving, living/giving and preserving what you've worked so hard to build. We are here to help with all this and to make sure your plans reflect any changes to laws and regulations.

ABOUT THE AUTHOR

SUSAN TALTON, CFP® is a Client Advisor at Laird Norton Wealth Management (LNWM) and a founding member of LNWM's Retirement Life Planning Group. With more than 25 years of experience in financial services, Susan especially enjoys working with clients undergoing major transitions in their lives, be it retirement, a new career or divorce/separation. Susan is on the Board of the Washington Planned Giving Council and is a member of the Financial Planning Association. She has been featured in SmartMoney and is a regular contributor to the LNWM blog.

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