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WEALTH MANAGEMENT

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Monthly Insight

Reaping the Harvest: Smart Tax Strategies for Your Retirement Income

Often, when I counsel clients about harvesting strategies to save money on taxes, I am talking about tax-loss harvesting: selling an asset below its purchase price to recognize a capital loss. At a future time, this loss can be used to offset gains in other parts of the portfolio, saving the client money on capital gains that would otherwise be taxable.

But in this month's newsletter, I want to consider a different type of harvesting: income harvesting. Similar to tax-loss harvesting, income harvesting is a strategy for reducing future tax liability on income. But unlike tax-loss harvesting, income harvesting is a longer-term, multi-year strategy that takes into account both current and future anticipated income, the recipient's tax bracket both now and in the future, and the recipient's overall financial plan and resources. The overall goal is to structure the income stream to accelerate taxes now, when the client is in a relatively low tax bracket, putting the client in a position to pay less in taxes on future income, when the client may be in an even higher tax bracket.

Most clients have heard their CPAs quote the familiar advice: "Defer income, accelerate deductions." That's usually good advice, especially if you're trying to shave as much as you can off the check you write Uncle Sam on April 15th.

But for some thriving retirees, this tried-and-true proverb needs a caveat or two. Many clients approaching retirement have been diligent for years about making systematic deposits into traditional IRAs, 401Ks, and other tax-favored plans—I call them "savings rock stars." After all, such plans are typically the cornerstone of most retirement savings strategies. But your financial plan needs to take into equal account what happens at the other end of the process, when required minimum distributions (RMDs) begin at age 72. (Remember, the SECURE Act of 2019 raised the mandatory beginning age for RMDs from 70 ½ to 72.) Some retirees could actually find themselves in a higher income tax bracket after retirement than while they were working. And with people living longer and longer, they could be stuck in that higher bracket for a long time! In other words, it really is possible to be too good at tax deferral.

To take full advantage of income harvesting, you should consult with your financial planner and your tax advisor. Beginning several years prior to retirement, you and your team should project current and future income, including tax-qualified and taxable accounts, and Social Security. Working together, you can balance your income for maximum tax efficiency, both now and after you stop working. Let's take a look at some real-world client examples of how income harvesting can benefit you—and help you save money on taxes.

Client A—we'll call him William—is 60 years old. He retired recently, and collects about $25,000 annually in Social Security benefits. He also has a pension plan through his former employer that is inflation-adjusted and will pay him around $45,000 a year. Further, he has a brokerage account worth about $300,000 and a traditional IRA account worth about $1.5 million. If William continues to defer income from his IRA until he reaches the mandatory withdrawal age in 12 years, his IRA is projected to be worth well over $3 million. At that point, his RMD would be $132,000 per year, on top of the $70,000 annual income from Social Security and his pension (and that's before taking into account the increases in this income from inflation adjustment). This will put William in the 32% tax bracket for the foreseeable future, once RMDs begin.

Upon the advice of his financial planner and CPA, William decides to begin converting $90,000 per year of his traditional IRA account into Roth accounts. Because he must pay taxes on the conversion amount, he will do so now, in his current 22% tax bracket (some years the conversions could put him in the 24% bracket). By maintaining this strategy until age 72, William's traditional IRA balance at that time would be reduced to about $2 million, making his RMD from the traditional account $84,000. Withdrawals from William's Roth accounts, which would not even be required during his lifetime—are not taxable. This will reduce the likelihood of William entering the 32% tax bracket—and staying there for the rest of his retirement.

Now let's look at an even more interesting example, one that could permit some retirees to pay taxes on long-term capital gains at the rate of 0%. Clients B, James and Sharon, were able to retire early, at age 55. James has an ongoing income stream of about $50,000 per year from residual commissions he generated during his sales career. They also receive about $12,000 per year in dividend income from their joint investment account. The account, with a value of about $400,000, includes some unrecognized long-term capital gains amounting to about $70,000. The couple also own an IRA worth around $300,000, and they become eligible to draw Social Security in as little as seven years (age 62 for early withdrawal). Their standard deduction under the CARES Act of 2019 is $24,800, which puts their taxable income at $25,200: in the low end of the 12% tax bracket. Significantly, those in the 12% tax bracket can qualify for 0% tax rate on both long-term capital gains and qualified dividends.

Accordingly, James and Sharon's financial advisor and CPA advise them to sell the most highly appreciated assets in their investment account, which generates a long-term capital gain of $40,000. This means that their taxable income for the year is $77,200 ($50,000 + $12,000 + $40,000, minus the standard deduction of $24,800). They are still in the 12% tax bracket, allowing them to pay 0% taxes on both their dividends and their long-term capital gain.

These are just a couple of the income-harvesting strategies available to certain thriving retirees. Of course, designing the right strategy for any individual involves thorough knowledge of your financial plan and assets, along with an accurate analysis of both current and future sources of income. If you are wondering whether you could benefit from income harvesting to save on future taxes, please get in touch and let's review your situation. To read my recent blog article, "Teach Your (Grand)Children: Creating the Financial Culture for Future Generations," please click here.

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KIMBERLY FOSS

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