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SMART INSIGHTS FROM PROFESSIONAL ADVISERS

5 Often Overlooked Tax Strategies as You Approach Retirement

When you're working, you have limited control over the taxes you pay, because your salary largely determines your tax bracket. You owe what you owe, and that's about it. But once you retire and design your own paycheck to live off of, opportunities to better control your tax bracket suddenly open up.

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When you approach retirement, your financial situation changes, and that presents unique opportunities. One of those opportunities is an increased ability to better control your tax bracket.

When steady income from employment stops, it's replaced with other sources, such as pensions, Social Security and investments. You can usually control when to start these income sources and — in the case of investments — decide from which account to pull money from, as different accounts may have different tax consequences. This gives you a chance to explore tax strategies that can have a significant effect on your retirement, including the following five ideas.

Zero Percent Capital Gains

When you stop taking a salary, you're more likely to be eligible to pay zero taxes on your long-term capital gains. Low-income taxpayers (individuals with taxable incomes below $39,375 and couples filing jointly with taxable incomes below $78,750 in 2019) are eligible for this 0% long-term capital gains rate.

With advanced planning, even with significant assets you can intentionally find yourself in the lower brackets for the first couple years of retirement and take advantage of the zero percent long-term capital gains tax. For instance, you can delay taking Social Security for a couple years while you live off your zero percent capital gains. If you need more income, money withdrawn from a Roth IRA would not increase taxable income or affect the zero percent tax rate on the capital gain withdrawal.

To see how this could save you a lot of money, consider a couple with a $250,000 investment account with a $100,000 long-term capital gain. In most cases, this gain would result in $15,000 in taxes. But if the couple delay Social Security for a year and have no other taxable income, they can liquidate the $250,000 account and pay nothing on the $100,000 gain, saving them $15,000 in taxes. (Their income of $100,000 would be reduced by the 2019 standard deduction of $24,400, giving them taxable income of $75,600, under the $78,750 limit). Any of the

$250,000 not needed for expenses can be used to purchase the exact same investments at a now-higher cost basis.

Qualified Charitable Distributions

It never ceases to amaze me how generous people are with supporting their favorite charities. When nearing retirement, planning for charitable gift donations can yield extra tax benefits, too. Under current tax rules, most people will be taking the standard deduction, preventing them from deducting charitable gifts; however, taking a Qualified Charitable Distribution (QCD) from your IRA could be the ticket to getting the best tax savings on a charitable contribution.

With a QCD, make a charitable contribution up to $100,000 from your pre-tax IRA and the amount is excluded from your income. Not only are you able to take the standard deduction, you have effectively added the charitable deduction on top of that. Plus, a QCD counts toward satisfying your required minimum distribution.

One downside is you have to be over 70.5 years old to make a QCD, so those approaching retirement will have to wait to utilize it. To take full advantage, it might make sense to delay charitable contributions until you are eligible for the QCD. For those in the 24% tax bracket, every $1,000 QCD effectively saves $240 in taxes by keeping that $1,000 out of your income.

Roth Conversion

If you own a traditional IRA, and are able to keep taxable income low, you may want to consider a Roth IRA conversion. While it’s true that each dollar you convert will add to your taxable income, paying that tax now may result in less taxes paid overall. Also, money in a Roth is not subject to required minimum distributions at age 70.5.

One trick with Roth IRA conversions is to do a partial conversion in an amount that takes you to the top of your current tax bracket. So, if you are in the 12% tax bracket, convert enough of the traditional IRA into the Roth to stay in that bracket without moving up to the next one. Doing this over a few years can substantially reduce your overall tax burden moving forward.

Net Unrealized Appreciation

If you are retiring with a 401(k) plan that has company stock in it, you may have an important decision to make that will affect future taxes. If you qualify and follow IRS guidelines, you may be able to take advantage of special tax treatment for the net unrealized appreciation (NUA) of the company stock. NUA is the difference between the company's current stock price and the amount you paid for it.

A common approach to 401(k) distributions is to roll the 401(k) over to an IRA, where withdrawals are taxed at your ordinary income level. With NUA treatment, the gain in the company stock is taxed at more favorable capital gains rates when sold, with only the cost basis portion being taxed at ordinary income rates. If the NUA makes up most of the account value with a minimal cost basis, this can result in significant tax savings.

In the end, choosing between the continued tax deferral of the IRA versus the favorable tax rate offered by NUA will need to be analyzed and compared, with the decision having a considerable impact on retirement taxes and flexibility.

Strategic Investment Withdrawals

Investment accounts can be separated into three tax categories: taxable accounts (investments), tax-deferred accounts (traditional IRAs and 401(k)s), and tax-exempt accounts (Roth IRAs). Conventional wisdom is to withdraw first from taxable accounts, then tax-deferred accounts, while leaving tax-exempt accounts last. This allows the tax-advantaged accounts to continue growing. But this might be too simple of a solution.

A better idea is to take strategic withdrawals from whichever account best suits your taxable situation each year. One example is to tap the tax-deferred accounts in the early years of retirement to avoid large future required minimum distributions that push you into higher tax brackets. There are many other examples, too, but the idea is to have money in accounts that are taxed differently, allowing you to strategically tap them to minimize taxes through your retirement. This tax diversification also is helpful in responding to any future tax law changes.

As you can see, strategic tax planning offers opportunities to get more out of your investments, especially when you are in a position to better control your income sources. A sound investment strategy, coupled with efficient tax planning, will maximize after-tax money, resulting in a more secure retirement for you and your loved ones.

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