The Impact of Taxes on Retirement

Income taxes can be a retiree's largest expense, according to FINRA. Yet, surveys show the majority of older Americans lack knowledge about the impact of taxes on retirement. Annuity.org's team of tax experts put together this free guide to help you understand how taxes can affect your retirement funds.

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Taxes are an important consideration for people who rely on financial assets, such as a 401(k) or IRA, for security in retirement, according to the Center for Retirement Research at Boston College. People at or nearing retirement age can assess their retirement security by understanding the size of this liability – and options for minimizing its impact.

For example, the IRS provides additional tax assistance for older adults. If you're 65 or older, you get a higher gross income threshold for filing and a higher standard deduction, and you may qualify for a credit for the elderly or disabled.

Continue reading to learn how types of retirement income are taxed and the best tax-efficient investment strategies to reduce your losses.

How Taxes Affect Retirement Savings

Planning for taxes throughout retirement is one of the most effective ways to preserve your wealth, David Edmisten, CFP® and founder of Next Phase Financial Planning LLC, told Annuity.org.

"Creating a tax-efficient retirement income plan can help retirees use their savings without overpaying on taxes," Edmisten said.

3 Types of Taxes That Affect Retirement Savings

Income Tax

You will owe income tax on your pension and on withdrawals from tax-deferred investments, retirement plans and annuities in the year you take the money. You may also pay taxes on part of your Social Security income.

Capital Gains Tax

Capital gains taxes are applied to investments or assets you sell, like your home, stocks or bonds. For most, the tax rate on net capital gains isn't higher than 15%, according to the IRS.

Estate Tax

Estate tax is a tax on your property or other assets that are transferable from a deceased individual to their heirs. If the value of your estate surpasses the federal tax exemption amount, you can expect a 40% tax rate for most of the estate's value.

Tax-Efficient Investment Strategies

Consider opening a 401(k) or individual retirement account to reduce your taxes as you near retirement. You can defer paying income tax on your savings by keeping the funds in a 401(k).

How your IRA is taxed depends on the type of account you open. If you want a tax break now, opening a traditional IRA would be a good tax-efficient investment strategy. If you want a tax break later, consider a Roth IRA instead.

If you're over 50, take advantage of catch-up contributions, which allow you to contribute extra money to your account, beyond the standard contribution limit.

You can also consider opening a taxable brokerage account and investing in municipal bonds and tax-efficient mutual funds.

"Retirees can also utilize taxable brokerage accounts to help be more tax-efficient in retirement," Edmisten said. "Withdrawals from a taxable brokerage account can be managed for more tax efficiency."

Tax Planning in Retirement

Plan when you will take money from your accounts to reduce your tax burden in retirement and avoid penalties.

“To withdraw funds in a tax optimal way, it’s important to understand your tax brackets at retirement and expected tax brackets in the future,” Edmisten said. “The goal of a tax-efficient retirement income plan is to realize income at the time when you can pay the lowest tax rates on your income.”

Reduce your income and avoid being placed in a higher tax bracket by contributing the maximum to retirement plans. Avoid selling too many assets and plan costly expenses around tax season.

Tax Rate	If You’re Filing as Single	If You’re Filing a Joint Return
10%	$0 - 11,000	$0 - $22,000
12%	$11,001 - $44,725	$22,001 - $89,450
22%	$44,726 - $95,375	$89,451 - $190,750
24%	$95,376 - $182,100	$190,751 - $364,200
32%	$182,101 - $231,250	$364,201 - $462,500
35%	$231,251 - $578,125	$462,501 - $693,750
37%	$578,126 or more	$693,751 or more

Depending on your income, your Social Security benefits could be taxable up to 85%. The lower your income, the less taxes you owe. In some cases, you won't be taxed at all. Reduce your income by making tax-deductible contributions to retirement accounts to lower your Social Security taxes.

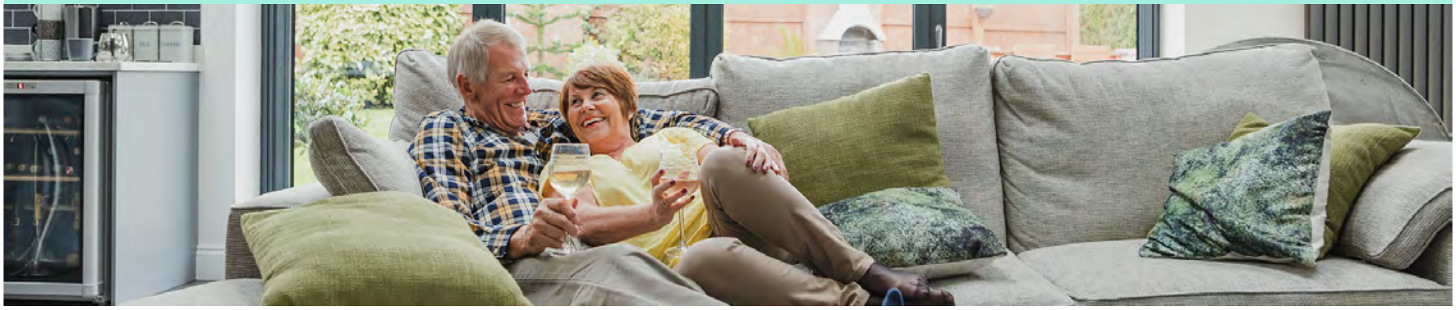
"For many retirees, there is a unique planning opportunity available during the period from retirement age until age 70," Edmisten said. "Many people will find themselves with a few years in lower tax brackets before they begin accessing Social Security benefits, pension income and required minimum distributions from their IRA or 401(k) accounts."

Estate Planning and Taxes

The federal estate tax applies only if your estate is worth more than $12.92 million in 2023. If the value of your estate is less than $12.92 million, you're exempt from the federal estate tax.

However, there are state inheritance and estate taxes to consider. Seventeen states and the District of Columbia have an estate or inheritance tax, which can heavily impact your heirs.

Transfer portions of your wealth, give costly gifts to family members, make charitable donations and lower the property's value to reduce estate and inheritance taxes.



Conclusion

Planning ahead is vital to lowering the impact of taxes on retirement. You can best prepare by opening tax-deferred retirement accounts, taking steps to put yourself in a lower tax bracket, minimizing taxation of your Social Security benefits and leaving less estate tax for your heirs.

With so many moving parts to a successful retirement plan, working with a financial advisor can provide you with peace of mind and a plan to reduce your tax burden in retirement. Get matched with a financial advisor to help plan for retirement taxes.

Contributors / Sources

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