Wealth Strategies

Age-Based Planning and Tax Strategies

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In today's world, more and more of the responsibilities of preparing for retirement seem to fall on each of us as individuals. As you prepare, you will unfortunately find that income taxes don't stop when you stop working. It's for this reason that tax planning is an integral part of your overall retirement strategy.

Evaluate Your Financial Strategy

Staying abreast of all the tax-advantaged strategies available to you as you age will help you to maximize your retirement savings. Wealth managers can guide you on a path to achieving financial success by helping you take advantage of appropriate age-based planning opportunities.

Be Aware of Important Milestones

As you reach age 50, it's important to be aware of certain milestones that create opportunities for you to maximize savings.

Here are the most important milestones to remember:

Age 50 – Catch-Up Contributions Allowed for Both 401(k)s and IRAs

Age 55 – Some 401(k) Distributions Allowed

Age 59 ½ – IRA and 401(k) Distributions Allowed

Age 62 – Social Security Eligibility Begins

Age 65 – Medicare Enrollment Begins

Age 70 – Maximum Social Security Benefits Achieved

Age 72 – Required Minimum Distributions Begin

Ages 60–72 – Roth Conversion Opportunities

Taking Advantage of Catch-Up Contributions – Age 50

In 2001, Congress passed a law to help workers make up for lost time if they feel that they are behind in their retirement savings. This provision allows workers age 50 and older to make contributions to their retirement plans in excess of the limits younger workers must abide by.

At age 50, you may contribute up to the regular 401(k) limit—$19,500 for 2020—and if you reach that limit, you may also make a catch-up contribution of an additional $6,500 (giving you a total of $26,000 you can contribute annually). Setting aside an extra $6,500 each year into a tax-deferred retirement account can have a big impact on the eventual balance of the account.

Additionally, individuals at least 50 years old may also make catch-up contributions of $1,000 per year to their IRAs. This amount is in addition to the regular contribution limits for both traditional and Roth IRAs, currently set at $6,000.

Catch-up contributions are a smart way to make up for lost time in retirement planning. Of course, catch-up contributions only come into play if you maximize the elective deferral amounts in your 401(k) or reach the contribution maximums in your IRAs. Aiming to do so is a good starting goal. However, be sure that you have the information you need to leverage this tool wisely; consult an experienced wealth manager to learn how to make catch-up contributions work for you.

Penalty-Free 401(k) Distributions – Age 55

Normally, you're not allowed to take distributions from a 401(k) until you reach age 59 ½. However, there's a special provision in 401(k) plans for people who leave their employer between age 55 and age 59 that allows them to take distributions exempt from the 10% early withdrawal penalty.

Beware: Once you move funds from your 401(k) to your IRA, the age 55 penalty-free withdrawal provision no longer applies, and you'll have to wait until age 59 ½ or pay the penalty.

Penalty-Free IRA Distributions – Age 59 ½

Under IRA tax rules, the earliest you can begin withdrawing funds from your IRA without penalty is age 59½ .

However, that doesn't mean you must—or should—withdraw money. Many people wrongly assume they must start drawing down their IRA once they become eligible. If you are still earning income at age 59 ½, the best tactic may be to leave your IRA alone and let it continue growing.

A great source of information regarding IRA accounts is IRS Publication 590. It offers a detailed explanation of IRA regulations, including those pertaining to distributions. Free copies are available by visiting the IRS website at ***www.irs.gov***.

Social Security Eligibility – Age 62

Social Security benefits are another integral part of retirement planning, so it's important to understand the procedures and other details of filing. The Social Security Administration offers a wealth of information on this subject online at ***www.socialsecurity.gov/retire***.

How and when to begin taking Social Security benefits can be a difficult decision. Please feel free to visit our website, www.rfadvisors.com, and read our Wealth Strategies piece discussing Social Security benefits at length.

Medicare Enrollment – Age 65

Medicare is the health insurance program of the United States government that helps provide payment coverage for health and medical care. It was first enacted in 1965 to help those who could not afford health or medical care in their retirement years. Today, millions of American citizens age 65 and older receive Medicare assistance.

Medicare Initial Enrollment Period

For most people, enrollment in Medicare Part A is automatic. However, there are instances where you may have to manually enroll in Medicare Part A and/or Part B during your **initial enrollment period** (IEP), which is the seven-month period that begins three months before you turn 65, includes the month of your 65th birthday, and ends three months later.

Here are some situations where you would need to enroll in Medicare during your IEP:

If you are not yet receiving Social Security retirement benefits

If you are not yet receiving retirement benefits and

close to turning 65, you can sign up for Medicare Part A and/or Part B during your IEP.

If you do not qualify for retirement benefits
If you are not eligible for retirement benefits from Social Security, you will not be automatically enrolled into original Medicare. However, you can still sign up for Medicare Part A and/or Part B during your IEP.

Medicare General Enrollment Period

If you do not enroll during your IEP when first eligible, you can enroll in Medicare during the general enrollment period. The general enrollment period for original Medicare is January 1 through March 31 of each year.

Keep in mind that you may have to pay a late enrollment penalty for Medicare Part A and/or Part B if you did not sign up when you were first eligible.

Health Savings Accounts – Age 65

Health Savings Accounts (HSAs) are triple-tax advantaged medical savings accounts available to taxpayers in the United States who are enrolled in a high-deductible healthcare plan. The funds contributed to an HSA are not subject to federal income tax at the time of deposit. Additionally, HSAs allow funds to be invested, and the growth on the investment is tax-deferred and potentially tax-free if the distribution is used to pay for qualified medical expenses. Prior to age 65, if you withdraw the funds for something other than a qualified medical expense, the withdrawal will be taxable and face a 20% penalty. However, once you reach age 65, if the distribution is for a non-qualified medical expense, it will still be taxable but the 20% penalty will not apply.

Required Minimum Distributions (RMDs) – Age 72

While the primary benefit of most IRS-sanctioned retirement accounts is their tax-deferred status, this benefit does not last forever. You must begin taking your taxable withdrawals no later than April 1 of the year after you turn 72. Subsequent annual withdrawals are then due by December 31 each year thereafter. If you postpone your initial distribution to the first quarter of the year after you turn 72, you will have two distributions that year.

There are many details that accompany the start of these distributions, but one is certain: failure to comply with this requirement carries a full 50% penalty of the required amount not withdrawn. As an investor, the tax burden created by these withdrawals can be quite an eye opener. By planning in advance, there may be ways to minimize the impact of the taxes your RMDs generate.

For example, it may be advantageous to systematically draw down your IRA in the years prior to age 72 in order to reduce the size of the account and, in turn, the RMD. Often, this can be accomplished by employing a Roth conversion strategy (which we will detail in the next section).

Using Roth IRA Conversion Opportunities – Ages 60 to 72

An important point to remember is that regardless of when you choose to remove funds from your traditional IRA, those funds are reported as ordinary income for the year in which they are received.

However, converting funds at the right time can help you minimize those taxes. This is the concept of harvesting/accelerating income to years where you are in a lower tax bracket. For many, converting traditional IRA holdings to a Roth IRA helps reduce the amount of RMDs and also allows those funds to continue growing tax-free.

The Advantages of a Roth Conversion

There are a couple of distinct advantages to using Roth conversions as an effective tax strategy:

- **It can minimize your taxes owed over your entire retirement period**
  When you have different types of accounts with varying types of tax treatment (e.g., taxable at ordinary income tax rates, taxable at capital gains rates, or tax-free), you get to choose the optimal way to withdraw from them. Many retirees find themselves in low tax brackets early in retirement and higher tax brackets later in retirement. Roth conversions aim to capitalize on this period by choosing to pay taxes (via conversion) at the lowest rate.

- **It can decrease the amount of future RMDs**
  Retirees typically have an overabundance of tax-deferred savings. By decreasing your traditional 401(k) or IRA balance prior to beginning your RMDs, you will reduce the size of your RMDs. This could mean that future RMDs are small enough that they no longer push you into higher brackets. Roth IRAs are different because they do not have RMDs.

When to Consider a Roth Conversion

- **When you are in a lower tax bracket now than you anticipate you will be in the future**
  If your tax rate is likely to be lower now than in the future, this may be reason enough to

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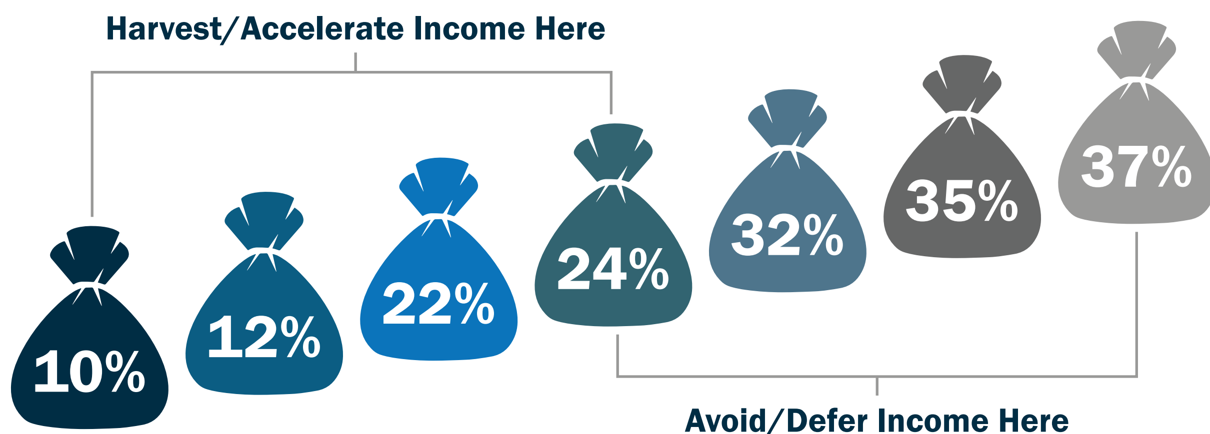

This graphic depicts a retiree who might consider Roth conversions to accelerate income away from 32% or higher brackets to the 24% or lower brackets.

convert now in order to avoid being hit with higher rates in the future. Some reasons your income tax rate could be lower now than in the future include the following:

- Because your or your spouse's income has gone down
- You have retired but are not yet taking Social Security and can withdraw from taxable (at capital gains rates) investment accounts
- You believe RMDs will force you into higher brackets in the future
- You want to plan for the possibility that you outlive your partner and know that filing single could put you in a higher bracket
- You believe Congress will raise tax rates in the future (or will at least allow the Tax Cuts and Jobs Act rates to expire at the end of 2025)

- **When you have after-tax funds to pay for the conversion**
  The most effective way to perform a Roth conversion is to pay the tax on the conversion from funds that have already been taxed.

- **As you consider estate planning**
  Often, a retiree may not need to spend all his or her IRA money. By converting traditional IRA funds now, one could pay taxes on the conversion at a lower rate than his or her beneficiaries might face when they inherit the account. This scenario is even more likely with the passage of the SECURE Act, which eliminated the ability for non-spousal beneficiaries to "stretch" inherited IRA withdrawals over their lifetime. Now, inherited IRAs must be fully withdrawn 10 years after the death of the original owner. For those with large IRA balances at death, this can become a big tax problem for heirs.

Rise to the Challenge

The biggest challenge in retirement is making your funds last a lifetime.

Just as a builder uses a blueprint to construct a home, a retiree should have a similar plan for achieving his or her own retirement goals. Being aware of the important dates along the way will help you to take full advantage of the tools available to you.

Using your retirement plan assets in a strategic way to minimize income tax should be an important part of your overall strategy, as it will allow you to preserve as much of your retirement savings as possible.

Reilly Financial Advisors is a fee-only RIA aimed at helping clients both define and achieve their individual financial goals through four unique service offerings:

- **Wealth Building**
  For those still accumulating their investment portfolios
- **Wealth Management**
  For those who have amassed savings and have specific needs associated with their wealth
- **Wealth Legacy**
  For those who have accumulated a significant amount of wealth and face unique wealth transition needs
- **Corporate Retirement Services**
  Providing tailored solutions for plan sponsors and participants

Reilly Financial Advisors, founded in 1999 and headquartered in San Diego, California, serves clients around the United States and in more than one dozen countries worldwide.

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