Beware the tax torpedo!

Managing retirement account balances can lower Social Security taxes

Building a nest egg and holding a majority of your assets in your retirement accounts as long as possible may seem like a good idea, but waiting longer than you need to start taking distributions can also cause a tax problem. When you reach age 72, the trigger mandating required minimum distributions (RMDs) from qualified retirement accounts is pulled and a potential tax torpedo may be launched!

RMDs explained

RMDs apply to traditional IRAs, SEP IRAs, SIMPLE IRAs, 401(k)s, 403(b)s, and other defined contribution plans. Required withdrawals must be completed by April 1 following the year you turn age 72 and Dec. 31 every year thereafter. Amounts not distributed on a timely basis can be subject to a 50% penalty. (Thankfully the RMD rules do not apply to Roth IRAs!)

The rules ensure the deferred-tax benefit you earned during your working years will be taxed during your retirement. The amount you must withdraw as your required distribution each year is based on your age, your spouse’s age, and your filing status.

The tax torpedo!

If you wait to withdraw money from your retirement accounts until you turn age 72, the balance in your retirement accounts may be extremely high. This will result in an RMD that may push you into a higher tax bracket. If your distribution is large enough, it may apply a higher marginal tax rate on your withdrawals, as well as trigger taxes on your Social Security income. Depending on your income and filing status, up to 85 percent of your Social Security income could now be subject to income tax!

What you can do

Thankfully, when you understand the risk of this tax torpedo, you can be more tax-efficient with your withdrawals each year. Here are some ideas.

● Plan withdrawals. Once you hit age 59½, you may withdraw money from qualified tax-deferred retirement accounts without experiencing an early withdrawal penalty. Manage annual disbursements from your retirement account(s) between the ages of 60 and 72 to effectively utilize your income tax bracket. You may not need the money now, but by being smart, you can lower the tax rate on some of your retirement income.

● Use your time wisely. Start early to use time to help grow the value in your retirement and education savings accounts. Take advantage of employer-provided 401(k) or similar retirement programs, especially if there is an employer match. After that, look into a Coverdell Education Savings Account and a 529 plan to maximize your education savings potential.

● Decide when to start collecting Social Security income. You may begin taking full Social Security benefits after you reach your minimum retirement age. In 2021, this minimum retirement age is 66 years and 10 months. However, your benefit amount can increase if you delay your start date up until age 70.

● See an advisor. There are many moving parts in planning for retirement. These include Social Security income, pension plans, savings, and retirement accounts. Ask for help to create the proper plan for you and your family. One element of the plan should include being tax efficient.

Remember, do not wait until the government tells you how much you MUST withdraw each year from your retirement accounts. A better strategy is to use each year to make tax efficient withdrawals from these accounts. You might be surprised how much money you save by avoiding the tax torpedo!
There’s little question the tides are moving towards a higher tax environment with multiple trillion dollar spending bills, a new administration, and deficits as far as the eye can see. Instead of feeling administration, and deficits as far as trillion dollar spending bills, a new

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(20% capital gains tax rate plus high unemployment and new federal benefits allowing employers to receive a credit on these taxes to help continue paying employees to take leave due to COVID-19. Over the next few years, there will be tremendous pressure to add funds back into the programs. This might be done by increasing the taxability of benefits or dramatically increasing the income subject to Social Security taxes.

Potential action: Continue to work on a retirement plan that is not as dependent on Social Security benefits. If you are a small business owner and your business income is subject to self-employment tax (SE tax), now is a good time to consider reorganizing your business to shield some of your business income by moving/owning a corporation.

► Capital gains tax rate increases

In 2021, the highest long-term capital gains tax rate is 28.8% (20% capital gains tax rate plus a 3.8% surtax as part of the Affordable Care Act) but if planned correctly, you could pay either nothing or 15% federal tax on long-term capital gains. Congress could see the sales of long-term securities and other assets as a valuable source of tax revenue by eliminating this preferential tax rate and instead using ordinary income tax rates (currently as high as 37%).

Potential action: Actively manage investment profits, netting your gains against your losses. If you have any assets that have appreciated over time and intend to sell in the near future, consider selling in 2021 to avoid a potential increase in the capital gains tax rates.

► Tax planning problems for your estate

There are several considerations to take into account when looking at your estate’s tax plan. Under current law, if your parents bought one share of stock in 1980 for $10 and you inherit the share of stock when it’s worth $100 and immediately sell it for the same $100, you would not owe any federal taxes on the $90 difference. In the future, that feature, called stepped-up cost basis, may be scrapped or limited or removed to increase tax revenue.

Second, the estate tax rate currently set at 40% is under pressure to be increased. This is entirely possible when you consider that this tax rate was 55% in 2001.

Potential action: Consider gifting money or securities to family, friends or a foundation during your lifetime. Individual gifts in 2021 of $15,000 or less ($30,000 for married couples) don’t count against your lifetime gift-giving limit.

► Tax rate volatility

With huge federal deficits that are now beyond the scope of imagination, what will happen next? The latest legislation alone adds a whopping $1.9 trillion to what must be paid back. While interest rates are being held at historic lows to help manage the cost of this added debt, it cannot continue unabated. And the meteoric rise in home prices is just one of the costs of the low-interest approach. The current proposals in Washington suggest an increase in tax rates is not too far in the distant future.

Potential action: If you think tax rates and your taxable income will be increasing in the next few years, you will want to move as much money as possible into tax-advantaged accounts like Roth IRAs. You should also understand any state tax ramifications to help with your tax planning.

While Congress is debating what to do with your tax rates, now is the time to create a strategy so that if or when tax rates do increase, you will be prepared.

Major life events may mean major tax changes

Here are some of the many life events that you’ll encounter and how these events could affect your taxes and finances.

Getting married. Your marital status affects the tax bracket you’re in and doubles your standard deduction to $24,800. If you are married and either you or your spouse is 65 or older, your standard deduction increases by $1,350. If both you and your spouse are 65 or older, your standard deduction increases by $2,700.

Get a bigger benefit: A spouse who doesn’t work can contribute to a spousal IRA if they file taxes jointly with a spouse who does work. If each spouse has an IRA, both can contribute up to $6,000 in 2021 ($7,000 if age 50 or older).

Getting divorced. If you have a divorce or separation agreement executed after Dec. 31, 2018, the payer spouse gets stuck with the tax bill, as alimony is no longer deductible from the income of the spouse paying it. On the other side, the spouse receiving the alimony payments doesn’t report the payments as income. Child support follows the same equation – it’s not deductible by the payer spouse, and doesn’t need to be reported as income by the spouse receiving the payments.

Get a bigger benefit: If the parents can agree, the spouse with the higher income can claim all or most of any kids in the family. Being able to claim one or more kids on your tax return means being able to file your tax return as Head of Household, which has a larger standard deduction ($18,800 in 2021) than a single taxpayer ($12,550 in 2021). The parent may also qualify for the $3,000 or $3,600 child tax credit for each kid.

Birth. You also have the option of withdrawing $5,000 per parent (or $10,000 total as a couple) without penalty from qualified retirement accounts to help with costs associated with your new bouncing baby. You’ll still owe income taxes on this distribution, but can avoid an early withdrawal penalty.

Get a bigger benefit: Parents who work can take a tax credit for expenses related to dependent care for a child under age 13, so a newborn child would qualify. In 2021, the maximum credit for one child is $4,000; the maximum for two or more children is $8,000.

Moving. Be careful if you make a move this year! Moving expenses used to be tax deductible, but that deduction has been suspended through 2026. If you incur any moving expenses, you can’t use those expenses to lower the tax bill. While the federal government won’t let you deduct moving expenses, you may still be able to claim a deduction on certain state tax returns.

Get a bigger benefit: One option is to ask your employer to reimburse you for moving expenses. While this is considered taxable income, some employers will gross up the amount of money they give you to cover the tax hit you’ll take. Another option is to do as much of the move yourself as you’re able to and try to move, if possible, during a low-demand time of the year.

Avoid these IRA mistakes

Don’t delay opening an IRA. The earlier you start, the longer your savings will compound tax-deferred. Even teenagers or college students can contribute up to $6,000 in 2021 ($7,000 if age 50 or older).

Don’t put the wrong investments in an IRA. Avoid putting tax-free investments, such as municipal bonds, in an IRA. You’ll end up paying ordinary income tax on money that wouldn’t have been taxed, or you’ll sacrifice earnings for a tax benefit you’ll never receive.

Don’t overlook the catch-up contribution. If you’re age 50 or older, you can contribute an extra $1,000 to your IRA. That’s in addition to the regular $6,000 limit for 2021.

Don’t name the wrong beneficiary. Your choice of beneficiary can affect how quickly IRA funds must be distributed. The longer money stays in the IRA, the longer it grows tax-deferred.

Don’t choose just one IRA beneficiary. Naming a contingent or backup beneficiary gives your heirs tax planning opportunities after you die.

Don’t choose the wrong type of IRA. Decide whether a Roth IRA or a traditional IRA is best for your age and circumstances. You can’t deduct contributions to a Roth, but distributions are generally tax-free when you retire.