TAX EFFICIENCY IN RETIREMENT

How much attention do you pay to this factor?

Presented by Glazer Financial Network

Could you end up paying higher taxes in retirement? Do you have a lot of money saved in a 401(k) or a traditional IRA? If so, you may be poised to receive significant retirement income.

Those income distributions will be taxed. As federal and state governments are hungry for revenue, you may see higher marginal tax rates in the near future.

Poor retirees with meager savings may rely on Social Security as their prime income source. They may end up paying less income tax in retirement, as up to half of their Social Security benefits won't be counted as taxable income. On the other hand, those who have saved and invested well may retire to their current tax bracket or even a higher one.[1]

Given this possibility, affluent investors would do well to study the tax efficiency of their portfolios. (Some investments are not particularly tax-efficient – REITs and small-cap funds, for example.) Both pre-tax and after-tax investments have potential advantages.

What's a pre-tax investment? Traditional IRAs and 401(k)s are classic examples of pre-tax investments. You can put off paying taxes on the contributions you make to these accounts and the earnings these accounts generate. When you take money out of these accounts come retirement, you will pay taxes on the withdrawal.[2]

Pre-tax investments are also called tax-deferred investments, as the invested assets can benefit from tax-deferred growth.

What's an after-tax investment? A Roth IRA is a prime example. When you put money into a Roth IRA during the accumulation phase, contributions aren't tax-deductible. As a trade-off, you don't pay taxes on the withdrawals from that Roth IRA (providing you have followed the IRS rules for the arrangement). These tax-free withdrawals lower your total taxable retirement income.[2]

As everyone would like to pay less income tax in retirement, the tax-free withdrawals from Roth IRAs are very attractive. As federal tax rates look poised to climb for obvious reasons, after-tax investments are starting to look even more attractive.

As anyone can now convert a traditional IRA to a Roth IRA, many affluent investors are considering making the move and paying taxes on the conversion today in order to get tax-free growth tomorrow.

Certain tax years can prove optimal for a Roth conversion. If a high-income taxpayer is laid off for most of a year, closes down a business or suffers net operating losses, sells rental property at a loss or claims major deductions and exemptions associated

with charitable contributions, casualty losses or medical costs ... he or she might end up in the lowest bracket, or even with a negative taxable income. In circumstances like these, a Roth conversion may be a good idea.

Should you have both a traditional IRA and a Roth IRA? It may seem redundant or superfluous, but it could actually help you manage your marginal tax rate. If you have both kinds of IRAs, you have the option to vary the amount and source of your IRA distributions in light of whether income tax rates have increased or decreased.

Your marginal tax rate might be higher than you think. Consider that about 25 different federal tax deductions and credits are phased out as your income increases. Quite a few of these have to do with education. If your children (or grandchildren) are out of school when you retire, good luck claiming those deductions.

Smart moves can help you lower your taxable income & taxable estate. An emphasis on long-term capital gains may help, as they aren't taxed as severely as short-term gains or ordinary income. Tax loss harvesting - selling the "losers" in your portfolio to offset the "winners" – can bring immediate tax savings and possibly help to position you for better long-term after-tax returns.

If you're making a charitable gift, giving appreciated stock or mutual funds you have held for at least a year may be better than giving cash. In addition to a potential tax deduction for the fair market value of the asset, the charity can sell the stock later without triggering capital gains. If you're reluctant to donate shares of your portfolio's biggest winner, consider this: you could give the shares away, then buy more shares of that stock and get a step-up in cost basis for free.[3,4]

The annual gift tax exemption gives you a way to remove assets from your taxable estate. In 2011, you can gift up to $13,000 to as many individuals as you wish without paying federal gift tax. If you have 11 grandkids, you could give them $13,000 each – that's $143,000 out of your estate. All appreciation on that amount is also out of your estate.[5]

Are you striving for greater tax efficiency? In retirement, it is especially important – and worth a discussion. A few financial adjustments could help you lessen your tax liabilities.

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