Moves That Can Reduce Your Taxes in Retirement

One of the daunting issues that hangs over many people's picture of their ideal retirement is the tax implications when they start withdrawing funds from their 401(k) plan or IRA.

If you've been diligent about socking money away in your retirement plans, your income distributions will be taxed at the going rate at the time. If you've been especially dedicated to saving, you could end up retiring at your current marginal tax rate or a higher one.

If you are in this category, you may want to set time aside to study the tax efficiency of your portfolios in order to gauge how much you'll be paying the feds and if you have some wiggle room to reduce your tax obligations.

To get to that point, you'll first need to understand the difference between pre-tax and after-tax investments, and their advantages.

Pre-tax investments

Your 401(k) plan and traditional IRA fall into this category. In both cases you fund these accounts with pre-tax dollars. You essentially delay paying taxes on these contributions until after you withdraw the contributions and earnings you made on them.

After-tax investments

One investment vehicle that you fund with dollars you've earned after paying taxes is exempt from taxes when you withdraw funds: The Roth IRA.

You won't pay taxes on withdrawals from your Roth IRA if you've had the account for five or more years and you are at least 59 and ½ years old when you start withdrawing. Having a Roth IRA will not increase your taxable retirement income, in other words.

To manage their tax rates, many prudent investors will hold both a traditional IRA and a Roth IRA. By holding both, you have the option to vary the amount and source of your IRA distributions depending on whether taxes have increased or decreased over the years.

Other ways to reduce your taxes

You can reduce your taxable income and taxable estate in other ways, such as gifting securities that have appreciated in value. This can be a better option than giving cash.

The benefit to you is that you can potentially get a tax deduction for the fair market value of the securities in the year you gifted them. Later, when the charity sells the securities, it won't result in capital gains taxes for you.

The annual gift tax exclusion is $17,000 in 2023, meaning you can give up to that amount to as many individuals as you wish in the year, as long as your total gifts don't breach the lifetime estate and gift tax exemption, which is $12.06 million.

One word of caution if you are considering this route. You cede control of those securities and assets once you gift them.

The takeaway

If you have had success saving for retirement and are concerned about tax implications when you start taking your withdrawals, you do have a few options to reduce your overall tax bill.

For some people, that means just a few tweaks to your finances. We can help you get it right. Give us a call.

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