BONUS CHAPTER:

NAVIGATE THE TAX RULES

for

RETIREMENT *GAME-CHANGERS*

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ALSO BY STEVE VERNON

Retirement Game-Changers: Strategies for a Healthy, Financially Secure, and Fulfilling Long Life

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The following bonus chapter supplements the book *Retirement Game-Changers: Strategies for a Healthy, Financially Secure, and Fulfilling Long Life.* It is intended to provide readers with additional insights to help implement the strategies that are discussed in *Retirement Game-Changers.*

For more information:

- *Retirement Game-Changers:* www.retirementgamechangers.com
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Project Management: Markman Editorial Services, www.MarlaMarkman.com

Design by GKS Creative, www.gkscreative.com

BONUS CHAPTER:

NAVIGATE THE TAX RULES

SUPPLEMENT FOR *RETIREMENT GAME-CHANGERS*

DON'T MAKE THESE MISTAKES:

- ⊘ Place more importance on minimizing income taxes than on building your portfolio of retirement income.
- ⊘ Be unaware of the special tax features that apply to Social Security benefits.
- ⊘ Pass up participating in a Health Savings Account, if you're eligible.

TRY THESE GAME-CHANGING STRATEGIES:

- ➔ Coordinate your strategy to claim Social Security benefits and draw down your retirement savings, with the goals to maximize your retirement income and minimize the income taxes that you pay.
- ➔ If you're eligible, put money aside in a Health Savings Account to help you pay for medical costs and reduce your income taxes.

Put taxes in the proper perspective

Many people obsess about reducing the taxes they pay for federal and state income taxes. Indeed, it's a good use of your time to make smart choices that reduce your taxes and help you avoid paying unnecessary tax penalties. However, many Americans will fall into low tax brackets during their retirement years, often due to modest levels of taxable income in retirement.

As a result, your first priority should be to build your portfolio of retirement paychecks and bonuses as described in my book *Retirement Game-Changers.* By analyzing and choosing the best retirement income generators (RIGs), you'll create streams of retirement income that will last as long as you live, no matter what happens in the economy.

Of course, you'll also want to maximize the amount of money you get to keep after paying federal and state income taxes on that income. Just keep in mind that strategies to minimize income taxes shouldn't get in the way of focusing on building your retirement income portfolio.

To help with the tax side of things, you'll want to learn how your "retirement paychecks" and "retirement bonuses" will be taxed, which depends significantly on the RIGs you use to generate your retirement paychecks and bonuses.

In addition to understanding how your income will be taxed, you'll also want to learn how you can avoid falling into a few tax traps that can result in unpleasant penalties. Although understanding the rules isn't rocket science, you do need to pay attention to some of the details to avoid tax issues later.

The tax rules that will apply to your income will depend on where and how your retirement savings are invested, as well as the specific RIG, or combination of RIGs, you choose to use to generate your retirement paychecks and bonuses. This bonus chapter of *Retirement Game-Changers* outlines some of the rules and offers some strategies for you to consider.

But before we dive into the various tax rules and strategies that apply to your retirement income, it's a good idea for you to have a basic understanding of the federal income tax structure under the new tax law that Congress passed in late 2017.

Determine your marginal tax rate

Federal income taxes are progressive, meaning that the different levels of taxable income are taxed at increasingly higher rates. You can understand this by looking at Table 1, which shows ordinary federal income tax rates for individuals and married couples that apply in 2018 under the new tax law.

Table 1: Ordinary income tax rates for 2018

Tax rate	Taxable income for single filers	Taxable income for married filing jointly
10%	$0 - $9,525	$0 - $19,050
12%	$9,526 - $38,700	$19,051 - $77,400
22%	$38,701 - $82,500	$77,401 - $165,000
24%	$82,501 - $157,500	$165,001 - $315,000
32%	$157,501 - $200,000	$315,001 - $400,000
35%	$200,001 - $500,000	$400,001 - $600,000
37%	Over $500,000	Over $600,000

It's important to understand that:

- The above tax rates apply to your taxable income, which is your total income after you've subtracted deductions and exclusions.
- The standard deduction from your total income is $12,000 for single filers and $24,000 for married couples filing jointly.
- If you're age 65 or older, blind, or disabled, you can add $2,600 to your standard deduction if you're married and both spouses are over age 65, and $1,600 if you're single.
- Your taxable income will exclude part or all your Social Security income, as discussed later in this chapter.
- The tax brackets are different from the above rates for married filing separately or head of household.

To get an idea of how these tax rates work, let's look at this example: Suppose you're married filing jointly, both spouses have attained age 65, and your *taxable income* is $75,000 after subtracting:

- the standard deduction of $24,000,
- the $2,600 additional deduction for people over age 65, and
- the portion of Social Security income that's excluded from taxes.

Here's how your federal income tax would be calculated:

- The first $19,050 of your taxable income would be taxed at 10%, which results in a tax amount of $1,905 on that portion of your income.

- Your taxable income between $19,051 and $75,000 would be taxed at 12%, which results in a tax amount of $6,714 on this portion of your income (12% of $75,000 minus the $19,050 that was taxed at 10%).

In this example, if you add up the amounts for each layer of your taxable income, the total federal income tax you owe would be $8,619. Keep in mind that this tax would be paid on gross income of well over $100,000 after adding up your taxable income of $75,000, the standard deduction of $24,000, the additional deduction of $2,600 for a married couple age 65 and older, and the portion of their Social Security income that's exempt from taxes (more on this topic later).

The tax that applies to your highest layer of income is called your "marginal tax rate." Think of this as the rate that would apply to one more dollar of income above your current income. Many readers will probably fall in the 10% or 12% brackets during their retirement. Count yourself lucky if you're in a higher tax bracket — although you'll pay higher taxes, it also means you're making good money! You should take the time to estimate your marginal tax rate to see if it's worth the effort to implement strategies during your retirement that will minimize your income taxes.

In addition to federal income taxes, most states (but not all) impose their own income taxes on retirement income generated from savings. The tax rate schedules for these states are usually progressive, like federal income tax rates, but the tax brackets are different and the tax rates are lower. You'll want to estimate your combined federal and state marginal tax rate for the purpose of minimizing all of your income taxes.

A maximum federal income tax rate of 15% applies in certain situations for investments held outside of any tax-advantaged account, such as IRAs or 401(k) accounts. This 15% rate applies to gains on the sale of individual securities or mutual funds that are held for more than one year; these are known as "long-term capital gains." The 15% rate also applies to dividends paid to investors from most stock investments, whether that's from individual securities or stocks held in mutual funds. The 15% rate applies to these investments even if the marginal tax rate on your other income is 22% or higher.

Next up — understanding how your Social Security benefits will be taxed.

Learn how much of your Social Security income will be taxed

It's important to understand the tax rules that apply to Social Security benefits, because they can have an impact on how much you'll pay in taxes on the retirement paychecks and bonuses you'll self-generate from your savings. Depending on the total amount of your income in retirement, part or all of your Social Security income will be excluded from your taxable income, which means you'll have more money to spend after paying taxes.

Many retirees will have half or more of their Social Security income excluded from taxable income. For example, in one study, a married couple, both age 65 with $1,000,000 in retirement savings, had between one-fourth and three-fourths of their Social Security income excluded from federal income taxes. The amount excluded depended on whether they optimized Social Security by delaying benefits and the specific RIG they chose to generate retirement income.[1]

For a 65-year-old married couple with $400,000 in retirement savings, none of their Social Security income was included in taxable income with most of the retirement income strategies that the same study analyzed. Strategies that delayed Social Security benefits produced the highest exclusions from income taxation and lowest amount of taxes paid.

For the very wealthiest retirees, at least 15% of their Social Security income will be exempt from federal income taxes. This special tax treatment is one reason why maximizing your Social Security income is a good strategy, and why many retirees will be in very low tax brackets when they retire.

The best way to understand how much of your Social Security benefit will be included in your taxable income is to use popular tax preparation software or work with an accountant who's skilled in preparing taxes for retirees. For this purpose, you'll need to estimate your total gross income with breakdowns for your different sources of income.

For those of you who want to understand the tax rules that apply to Social Security benefits, here's a summary:

- First, take one-half of the amount of your Social Security benefits and add it to all your other income, including any amounts payable from your RIGs that are included in your taxable income as well as any tax-exempt interest income on municipal bonds.
- If you're married filing jointly, you'll want to be sure to include the Social Security income of both you and your spouse.
- Then compare this amount to the two thresholds shown in Table 2 that are defined by the IRS rules.

Table 2: Thresholds for taxing Social Security income

Filing status	Base threshold	Additional threshold
Single or head of household	$25,000	$34,000
Married filing jointly	$32,000	$44,000

The amount of your Social Security income that will be taxed depends on how the total you computed compares to these thresholds:

- If the total falls below the base threshold, none of your Social Security income will be included in your taxable income.
- If the total falls between the two thresholds, then half of the amount of your Social Security income that exceeds the base threshold will be included in your taxable income.
- If the total is more than the amount listed in the "additional threshold" category and you're single, then the amount of your Social Security income that's included in your annual taxable income will be $4,500 plus 85% of the amount of your Social Security income that's over the additional threshold.
- If the total is more than the amount listed in the "additional threshold" category and you're married filing jointly, then the amount of your Social Security income that's included in your taxable income will be $6,000 plus 85% of the amount of your Social Security income that's over the additional threshold.
- It's important to note that the above thresholds aren't indexed for inflation, whereas most other tax brackets and thresholds are. This means that as time goes on, more and more people will have their Social Security income subject to income taxes.

Now let's turn to the tax rules that will apply to your other sources of retirement income.

Understand the tax rules for traditional IRA and 401(k) accounts

The tax rules are pretty simple for the part of your retirement savings that you invest in a deductible IRA, 401(k), 403(b) plan (for nonprofit employers), 457(b) plan (for government employers), or other tax-advantaged accounts. The money you invested in these accounts was pre-tax income, which means you didn't pay any federal income taxes on these funds when you made the contributions. Because of that, when you withdraw from these accounts, the money will be subject to ordinary federal income taxes. Most (but not all) states will also apply income taxes to the withdrawals you make from a tax-advantaged account. This is the case regardless of the method you use to calculate your self-generated retirement paychecks or bonuses. It's also the case regardless of the type of investment you use, whether that's stocks, bonds, cash, or some other type of investment.

There's one exception, and that's for amounts held in the stock of your employer; these are subject to the rules regarding net unrealized appreciation (NUA). These rules are complex and beyond the scope of this bonus chapter, so if you have a substantial amount of money in your 401(k) plan that's invested in your company's stock, you'd be best served to consult a tax accountant who's familiar with the NUA rules.

If you decide to use an annuity to generate a retirement paycheck and you purchase it with the money from your deductible IRA, 401(k), 403(b), or 457(b) account, you'll want to tell the insurance company the source of the purchase amount of the annuity. Make sure they get you into a tax-qualified annuity. This way, you won't be taxed immediately on the full value of the annuity purchase. Instead, the monthly income you receive each calendar year will be subject to ordinary federal income taxes for that year. This tax situation will apply for the rest of your life and the life of any beneficiary whom you designate on the annuity. Again, most (but not all) states will also tax your income from an annuity.

Be aware of required minimum distributions

For some tax-advantaged retirement accounts — deductible IRAs, 401(k)s, 403(b)s, or 457(b)s — Uncle Sam wants to make sure you eventually pay income taxes on the money you have in these accounts. So our good uncle applies required minimum distribution (RMD) rules that start when you turn age 70½.

Note that the RMD rules also apply to Roth 401(k) accounts, but not Roth IRAs. So if you have money in a Roth 401(k) account and you want to avoid the RMD requirements, you can roll over your Roth 401(k) account into a Roth IRA (the rules on Roth accounts are discussed later in this chapter).

While you'd have to be a tax accountant to understand all the intricacies of the RMD rules, the basic concepts are fairly easy to understand. Here I'll outline them in order for you to see how they might affect your retirement paycheck. Before we dig into the details, however, note that the word "distribution" is IRS jargon for "payment," so choose the word that makes you feel more at ease when reading my explanations below.

Let's begin with the first rule you need to know: In the year you turn age 70½, by December 31 of that year, you'll be required to withdraw minimum amounts from the applicable tax-advantaged retirement accounts and include the amounts you withdrew in your taxable income for that year. If you withdraw amounts that add up to less than the minimum, the amount of the shortfall will be subject to a 50% penalty tax! So you'll want to make absolutely sure you withdraw at least the minimum amounts necessary to comply with the RMD rules.

Normally, you'd need to make these withdrawals by December 31 of each year. For the first year the RMD rules apply, however, the IRS allows you to delay taking the minimum withdrawal as late as April 1 of the year following the year you reach age 70½. For every year thereafter, however, you'll need to withdraw the RMD amounts during each calendar year. If you elect to delay making the withdrawals as late as the following April 1 for the first year the rules apply to you, you'll need to make two withdrawals that year: by April 1 for the withdrawal that applies to the previous year, and by December 31 for the withdrawal that's required for the current year.

Using age 70½ as the threshold for the RMD rules sometimes creates confusion about when the rules apply. Think of it this way: If your birthday is on or between January 1 and June 30, your age 70½ year is the year you also reach age 70. If your birthday is on or between July 1 and December 31, your 70½ year is the year after you reach age 70.

The RMD rules don't apply to the following investments:

- Roth IRAs while the owner is alive
- Employer-based retirement plans, such as 401(k) accounts, if you're still working for the company that sponsors the plan, i.e., if you haven't yet retired from that employer. If you own 5% or more of that business, however, the RMD rules apply at age 70½ even if you're still working at that business
- Investments held outside of any tax-advantaged account

The RMD you'll have to pay is based on the value of your accounts as of December 31 of the previous year. The IRS requires that you divide this value by the "distribution period" for each age to determine the RMD you owe.

To help you out, I've done the math for you. Table 3 shows the distribution period and the minimum payout rate for each age (these figures apply to the majority of situations).

Table 3: Payout rates resulting from RMD rules

Age	Distribution period	Minimum payout rate
70	27.4 years	3.65%
71	26.5	3.77%
72	25.6	3.91%
73	24.7	4.05%
74	23.8	4.20%
75	22.9	4.37%
76	22.0	4.55%
77	21.2	4.72%
78	20.3	4.93%
79	19.5	5.13%
80	18.7	5.35%
81	17.9	5.59%
82	17.1	5.85%
83	16.3	6.13%
84	15.5	6.45%
85	14.8	6.76%
86	14.1	7.09%
87	13.4	7.46%
88	12.7	7.87%
89	12.0	8.33%
90	11.4	8.77%

A few essentials to note:

- Although I stopped the table at age 90 for brevity's sake, the IRS table continues beyond age 90.
- For Table 3, if you're the account-holder, use your age on your birthday during the calendar year.

- If you're married and your spouse is more than 10 years younger than you, a different table with payout rates that are lower than the above rates applies in your situation.
- A separate table also applies to beneficiaries after the account holder has died.

If you have more than one IRA, you must calculate the amount of the RMD separately for each IRA, although you're allowed to withdraw the total amount you owe from just one of your IRAs. Similarly, if you have more than one 403(b) account, you must calculate the RMD separately for each 403(b) account, but you can take the total amount you owe from just one of your 403(b) accounts. If you have more than one 401(k) or 457(b) accounts, you must calculate the RMD separately for each account and you must also withdraw the RMD you owe on each account from each specific account.

If you're using interest and dividends to generate your retirement paychecks or bonuses, or if you're using a conservative systematic withdrawal plan, your withdrawals might fall short of the required minimum distribution. For example, if you've decided to withdraw 4% from your account each year using systematic withdrawals, by age 73, you'll fall short of the RMD you're required to make. In this case, you'd need to withdraw more money to avoid a penalty. The good news is, you don't need to spend the withdrawals — you're just required to withdraw the money and include it in your taxable income. Then you can either spend the money you had to withdraw, or invest it an after-tax savings account.

If you use an immediate annuity to generate a retirement paycheck, you automatically comply with the RMD rules. That's because your paychecks are spread out over your expected lifetime, and the IRS assumes you've legitimately retired and aren't using IRA or 401(k) accounts to play games with federal taxes. This can be yet another reason to consider an immediate annuity in your later years: In addition to all the other decisions you'll need to make to manage retirement paychecks and bonuses, if you don't have an immediate annuity, you'll have to continue to worry about complying with the RMD rules.

If your retirement paycheck comes from a guaranteed lifetime withdrawal benefit (GLWB) or fixed index annuity (FIA) product, you'll want to check with your insurance company on what you need to do to comply with the RMD rules. Most insurance companies can provide such guidance.

To help you more fully understand how the RMD rules work, here's an easy example to review. Suppose your birthday is March 1, 1950, and you turn age 70 on

March 1, 2020. In this case, 2020 is the year you need to start complying with the RMD rules, although your RMD amounts will be based on your account values as of December 31, 2019, the year before your 70th birthday. Let's suppose this account value is $100,000. To determine your RMD for 2020, divide $100,000 by 27.4 years (from Table 3); you get a result of $3,650. This amount needs to be withdrawn by December 31, 2020, and included in your 2020 taxable income.

Remember, however, that just for your first year of complying with the RMD rules, you can elect to delay compliance into 2021. If you take advantage of this special rule, you'll have two taxable withdrawals in 2021: one for the RMD for 2020 that you're delaying into 2021, and one for the regular RMD you'll need to take for 2021.

Because a complete description of the RMD rules is beyond the scope of this book, I encourage you to consult either a tax accountant; your IRA, 401(k), 403(b), or 457(b) plan administrator; or an online source to learn more. And while your IRA or 401(k) institution may be able to calculate the RMD for you, the ultimate responsibility for complying with these rules lies with you. In other words, you're still on the hook if your IRA or 401(k) institution makes a mistake. So be sure to check the calculations yourself so you know you're paying exactly what you owe and don't get hit with a penalty later.

Avoid early distribution penalties

With deductible IRA, 401(k), and 403(b) accounts, the RMD rules discourage you from waiting too long before making withdrawals. There are also rules — and penalties — in place that discourage you from making withdrawals too early; after all, these accounts are supposed to be for your retirement, so the federal government wants you to think twice before withdrawing the funds for anything else.

The general rule regarding early withdrawals is fairly straightforward: With deductible IRAs and employer-sponsored 401(k) and 403(b) plans, any amount that you withdraw before attaining age 59½ is subject to a 10% penalty tax. This penalty tax is in addition to any ordinary income taxes you'll pay on the amount of your withdrawal.

There's an important exception that applies to employer-sponsored retirement plans such as 401(k) and 403(b) plans: The 10% penalty doesn't apply to withdrawals you make after attaining age 55, provided that the withdrawal is due to your termination of service from your employer and that you separated from service after attaining age 55. In other words, if you retire early from your employer and you're at least 55 years old, you won't be subject to the early withdrawal penalty.

Note that this exception only applies to amounts you withdraw from the tax-advantaged plan of the company that you retired from after age 55. If you have other 401(k) accounts from previous employers where you terminated employment before age 55, you'll need to wait until age 59½ before making a withdrawal in order to avoid an early withdrawal penalty.

There are a few more important exceptions to the early distribution rules for deductible IRA, 401(k), and 403(b) accounts. These situations occur if:

- you buy an immediate annuity with payments that are expected to be made over your lifetime,
- you don't buy an annuity but instead make withdrawals that are intended to be spread out over your lifetime,
- the payment is to an alternative payee under a Qualified Domestic Relations Order (QDRO) in the event of a divorce,
- withdrawals are needed to pay for qualified medical expenses that exceed 7.5% of your adjusted gross income, or
- withdrawals are due to the death or permanent disability of the employee or account-holder.

If you're considering any withdrawal before attaining age 59½, I would strongly suggest you consult a tax accountant or financial planner to make sure you aren't subject to the early distribution penalty.

Take advantage of the rules for Roth IRAs and Roth 401(k), 403(b), and 457(b) accounts

Here, the rules are pretty simple: Because your contributions to a Roth IRA or Roth 401(k), 403(b), or 457(b) account were included in your taxable income for the year you made these contributions, you don't owe any additional federal income taxes on them. So, during your retirement, any withdrawals you make from these accounts — whether that money comes from your contributions or your investment earnings — are tax free. To be eligible for this tax treatment, however, your withdrawal needs to take place at least five years after you established the Roth IRA or Roth 401(k), 403(b), or 457(b) account.

Now let's address the RMD rules. Although Roth IRAs aren't subject to the RMD rules mentioned earlier, Roth 401(k), 403(b), and 457(b) accounts are. If you want to escape the RMD for your investments in an employer-sponsored Roth account, you can roll this account to a Roth IRA.

Withdrawals of your *original contributions* to Roth IRAs or Roth 401(k), 403(b), and 457(b) accounts also aren't subject to the early distribution penalties noted above. If you withdraw your *investment earnings* before age 59½, however, the amount of that withdrawal would be subject to the early distribution penalty. The exceptions noted above for deductible IRAs also apply for Roth IRAs; there are also a few additional exceptions for the first-time purchase of a home or to pay for qualified educational expenses.

Again, if you're considering making any withdrawals before age 59½, I'd advise you to check with a tax accountant to be sure you aren't subject to the early distribution penalty.

Understand the tax rules for after-tax savings

If you have savings that are held outside of a tax-advantaged account, such as an IRA or 401(k), here's a brief summary of the tax rules that apply:

- You won't be charged any income tax if you withdraw your original principal.
- Any interest income you earn from bonds, CDs, and savings accounts will be taxed at ordinary income tax rates, although there are a few exceptions. For instance, interest from municipal bonds (the bonds of state and local governments) are usually exempt from federal income taxes and are often exempt from state income taxes as well.
- Long-term capital gains and dividends from qualified stocks are taxed by the federal government at a 15% income tax rate.
- If you buy an immediate annuity with savings you've held outside of a tax-advantaged account, then part of each monthly payment is deemed to be a return of your principal and isn't subject to income taxes. The remaining part of your monthly payment is deemed to be interest and is subject to ordinary income tax rates. Your insurance company will compute the breakdown between return of principal and interest so you know exactly how much of your annuity will be taxed.

Invest in a Health Savings Account to reduce your income taxes

If you're looking for tax-advantaged retirement savings, a health savings account (HSA) beats both an IRA and non-matched 401(k) contributions, provided you're eligible. Let's see why.

An HSA is an investment account meant for paying qualified medical expenses (defined below). You're eligible to contribute to an HSA only if you participate in a high-deductible health plan (HDHP) and aren't enrolled in Medicare. For 2018, an HDHP is a medical plan with at least a deductible of $1,350 for a single person and $2,700 for family coverage.

The maximum amount you can contribute to an HSA in 2018 is:

- $3,450 for single coverage
- $6,900 for family coverage
- An additional $1,000 catch-up contribution if you're 55 or older

Contributions are deducted from your gross income when calculating your net income for the purposes of federal and state income taxes.

Contributions to an HSA are invested and accumulated tax-free until you withdraw money from the account. If you withdraw to pay for qualified medical expenses, no income taxes are due at the time of the withdrawal. In this instance, you avoid altogether and forever any income taxes on the amounts invested in an HSA. From a pure tax perspective, this beats contributions to a 401(k) plan or an IRA because with these plans, you'll have to pay income taxes sooner (with a Roth 401(k) or IRA) or later (with a deductible 401(k) or IRA).

No other retirement savings vehicle offers these tax advantages. The only retirement savings opportunity that's better than an HSA would be matching contributions from your employer to your 401(k) plan or IRA. If that option is available to you, you should contribute the maximum that's matched first, then consider contributing as much as you can to an HSA.

Many employers package an HDHP with an HSA. That makes contributing to an HSA easy, with automatic payroll deductions and the company doing the investment shopping for you. If you're self-employed and participate in an HDHP, you can also set up an HSA with many financial institutions and invest in a variety of mutual funds or bank accounts.

You can withdraw money from an HSA at any time to pay for qualified health care expenses, including:

- medical, dental, prescription drug and vision expenses, including any deductibles and co-payments,

- premiums paid after age 65 for Medicare or your employer's retiree medical plan (but not for Medicare supplement plans),
- COBRA premiums,
- long-term care services, and
- premiums for qualified long-term care insurance.

If you withdraw money from your HSA to pay for a qualified expense, you'll receive the tax advantages identified above. Some people may hesitate to contribute to an HSA, thinking they won't be able to eventually spend all the money on qualified medical expenses. Think again. Given all the uses listed above, it's very likely you'll be able to spend tens of thousands or even hundreds of thousands of dollars on these expenses during the rest of your life.

You're also allowed to withdraw from an HSA to pay for expenses that aren't qualified medical expenses. If you do so, however, you'll pay ordinary income taxes on that money and be assessed a 20% penalty if you're under age 65.

HSAs have a few significant advantages over IRAs and non-matched 401(k) plans:

- You can withdraw money penalty-free from an HSA to pay for qualified medical expenses at any age, whereas IRA withdrawals are typically assessed a 10% early-withdrawal penalty before age 59½.
- Once you reach age 65, you can withdraw money from an HSA penalty-free to pay for expenses that aren't qualified medical expenses. In this case, you'll pay ordinary income taxes, which is the same outcome for any withdrawals from deductible 401(k) plans and IRAs.
- HSAs have no IRS required minimum distribution (RMD) at age 70½, whereas 401(k) plans and deductible IRAs are subject to such rules.

In essence, you have maximum flexibility with an HSA. Here are your options:

- Use it while you're working to pay for any medical expenses you incur during the year or any future year.
- Let it accumulate to pay for qualified medical expenses when you retire.
- Let it accumulate until after you've attained age 65 to pay for expenses that aren't qualified medical expenses, and then pay ordinary income taxes on the withdrawal.

Your HSA withdrawal strategy will influence your investment strategy. If you plan to use an HSA account to pay for current medical expenses, you'll want to avoid substantial stock market investments that can decline at any time and instead look for liquid investments that conserve principal.

On the other hand, if you plan to use your HSA contributions to pay for medical expenses in retirement, you might have a long investing horizon that can justify substantial stock investments. In particular, it's possible to delay using an HSA account until your 80s, when you might have high medical or long-term care expenses. That would give you a very long investing horizon.

The bottom line: If you're eligible, HSAs offer great tax advantages and flexibility. Many people who are eligible should consider first maxing out any matching 401(k) or IRA contributions, then max out HSA contributions, then max out non-matched 401(k) or IRA contributions.

Now let's turn our attention to some possible strategies you can use to minimize your income taxes.

See if these tax-saving strategies can help you

Here are six possible strategies you might be able to use to reduce the income taxes you pay in retirement:

Tax strategy #1: Coordinate your withdrawals from tax-advantaged accounts with the start of your Social Security benefits.

Let's suppose you're delaying the start of Social Security benefits to increase your lifetime payout from Social Security, a smart strategy described in *Retirement Game-Changers*. In this case, you may want to make withdrawals from your deductible IRA or 401(k) accounts *before* you start your Social Security benefits in order to replace the Social Security benefit that you're delaying.

There's another advantage to this tactic: Such withdrawals from your IRA and 401(k) accounts *before* you start your Social Security benefits will reduce your taxable withdrawals for the years *when* you're receiving Social Security benefits. This result will reduce the amount of total income that's used to determine the taxable portion of your Social Security benefits, as described earlier in this bonus chapter.

Here's one variation of this strategy to consider: Before you start receiving Social Security income, make withdrawals from your IRA or 401(k) accounts to pay off the mortgage on your house. This way, you'll permanently reduce your ongoing living expenses. These withdrawals will then reduce the amount of taxable income in future years that will be used to determine how much of your Social Security income is subject to income taxes. Of course, any withdrawals from your IRA and 401(k) accounts can create taxable income for the year they're withdrawn, so you'll want to make sure these withdrawals don't push you into a higher income tax bracket.

Tax strategy #2: Coordinate your withdrawals from tax-advantaged accounts so that they fall below Social Security thresholds.

If you plan ahead, you might be able to time taxable withdrawals from deductible IRA or 401(k) accounts to minimize the amount of your Social Security income that's included in taxable income. This means managing your total income so that it falls below the additional threshold levels described previously in Table 2 – $34,000 if you're single, $44,000 if you're married.

But be careful if you're making large withdrawals from IRA or 401(k) accounts. If they're large enough, your withdrawals could increase the amount of your Social Security income that's subject to income taxes, as described earlier in this bonus chapter.

Tax strategy #3: Liberate the maximum amount of income that will be taxed at the lowest rate.

If you're using either investment income or systematic withdrawals to generate your retirement paycheck or bonus, you have some control over how much you can withdraw each year. In this case, you can minimize your income taxes if your taxable income from all sources fluctuates substantially from year to year.

For example, suppose one year that your taxable income is well below the threshold for the 22% federal income tax rate but that you expect your taxable income will be well above this threshold in a subsequent year. This can happen if you expect to receive additional taxable income from other sources in future years; one example of this would be if you plan to take a large withdrawal from a traditional IRA or 401(k) account in a future year. Or you might have unusually large tax deductions, such as for medical expenses, in the current year that you don't expect to continue in future years.

If you find yourself in this situation, it might make sense to withdraw enough money from your deductible IRA or 401(k) accounts so that your annual taxable income lands right under the threshold of the 22% tax bracket, even if you don't need the full amount of your withdrawals to meet your living expenses. This action "liberates" some of your retirement savings to be taxed at the 12% rate instead of the 22% rate. You can then invest any money you don't need for current living expenses in an after-tax account; this saves the money to meet living expenses in a future year when your tax bracket is well above the threshold for the 22% tax rate and when you'll be trying to minimize your taxable withdrawals. If you have Roth accounts, you could also make withdrawals in future years to meet your living expenses; these withdrawals aren't subject to income taxes. You may need to work with a tax accountant to make this strategy work; an expert can help you estimate the maximum withdrawal amounts that would keep you below the 22% threshold.

This technique can also work in reverse. For example, if your current marginal tax rate is 22% or higher but you expect it to be lower in future years, you can make withdrawals from after-tax investments or Roth accounts in the current year instead of from tax-advantaged accounts. This would lower the amount of income taxed in the current year. This only works if you expect your marginal tax rate to drop in future years, when you'd make withdrawals from your deductible IRAs or 401(k) accounts. But watch out for the RMD rules that may apply after you attain age 70½.

Tax strategy #4: Take advantage of the 15% tax rate on long-term capital gains and qualified dividends.

This strategy can work for you if your taxable income is well into the 22% marginal federal income tax bracket or higher and you have savings in tax-advantaged accounts — such as IRAs and 401(k)s — as well as savings outside these types of accounts. If this describes your situation, it pays to have your stock investments in after-tax accounts and your bond investments in tax-advantaged accounts.

By having your stock investments in after-tax accounts, you can take advantage of the special 15% income tax rate on long-term capital gains and qualified dividends. This rate won't apply to stock investments held in tax-advantaged accounts.

But don't let tax considerations take priority over your investment strategies. If you have most of your retirement savings in tax-advantaged accounts and you're invested in stocks because of their long-term growth potential, it may be OK to keep these accounts in stocks. In other words, consider how you want to allocate your assets between stocks and bonds for all your retirement savings, taking into account both after-tax and tax-advantaged accounts. Then, to the extent that's possible, use after-tax accounts for your stock investments.

Tax strategy #5: Use index funds to enjoy after-tax savings.

This tax strategy only applies to retirement savings held in mutual funds outside of tax-advantaged accounts, such as IRAs or 401(k)s. Here's the secret upside to this type of account: If you have money invested in a mutual fund and don't sell it for an entire calendar year, you still might receive a deemed distribution of taxable capital gains if your mutual fund has sold securities during the same year at a gain. These types of gains are usually zero or minimal for index funds, since these funds don't do much selling of securities. When you consider that index funds usually outperform actively managed funds over the long run, you've got a powerful financial incentive to use index funds, instead of actively managed funds that buy and sell securities frequently, for your retirement savings.

Tax strategy #6: Use municipal bonds for more after-tax savings.

This strategy also only applies to any retirement savings held outside of tax-advantaged accounts, such as IRAs or 401(k)s, and if your marginal federal tax rate is 22% or higher. If that's the case, you might consider using municipal bonds for the part of your investments that you usually invest in bonds. Unlike other bonds, interest on municipal bonds is exempt from federal income taxes and most state income taxes.

When you're setting up your retirement income portfolio, it might make sense to consult with a tax accountant or financial planner. An expert can help you develop a course of action for your specific situation that minimizes federal and state income taxes, and avoids early distribution penalties before age 59½ or RMD penalties after age 70½. For ideas on selecting and working with financial professionals, see the bonus chapter titled *Get Help.*

Whew! If your head is spinning by now, take a deep breath, and don't let all this information stop you from learning all you can about retirement taxes. It's well worth your time to try to maximize the amount of total retirement income you'll receive as well as the amount you get to keep after paying federal and state income taxes.

ACTION STEPS:

- Develop a strategy to minimize the income taxes you pay by optimizing your Social Security benefits.
- Understand the marginal income tax rate that might apply to your income, taking into consideration the amount of your Social Security benefits.
- Determine if you're eligible to participate in a Health Savings Account (HSA) while you're working. If you are, decide on an investment strategy that's consistent with your plans to make withdrawals from your HSA.

HELPFUL RESOURCES:

- Special treatment of long-term capital gains and qualified dividends on stock investments:
  - Wikipedia: https://en.wikipedia.org/wiki/Capital_gains_tax_in_the_United_States
  - Wikipedia: https://en.wikipedia.org/wiki/Qualified_dividend
- IRS early payment penalty on IRAs and retirement plans: https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-tax-on-early-distributions
- IRS Required Minimum Distribution:
  - AARP: http://www.aarp.org/work/retirement-planning/required_minimuum_distribution_calculator/
  - Financial Industry Regulatory Authority (FINRA): http://apps.finra.org/Calcs/1/RMD
  - IRS website: https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-required-minimum-distributions-rmds
  - Many financial institutions and 401(k) administrators also have online RMD calculators and resources. Visit the sites of the ones where you have accounts to learn more.

- Social Security benefits taxation:
    - AARP: https://www.aarp.org/work/social-security/info-2014/social-security-benefit-taxes.html
    - Social Security administration: https://www.ssa.gov/planners/taxes.html
- Taxation of IRAs and retirement plans
    - AARP: https://www.aarp.org/content/dam/aarp/money/investing/2014-04/saving-for-retirement-through-iras-aarp.pdf
    - Efile.com: https://www.efile.com/retirement-planning-roth-ira-401k-distribution-tax-deduction/

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ABOUT THE AUTHOR

For more than 40 years, Steve Vernon, FSA, has analyzed, researched, and communicated about the most difficult retirement topics, including finances, health and lifestyle. He had a 30-year career as a consulting actuary with Watson Wyatt and Mercer, helping Fortune 1000 employers manage and communicate their retirement programs. During that time, he worked on the front lines of the extraordinary shift that's taken place in retirement plans, as employers switched from traditional, defined benefit pension plans to 401(k) and other defined contribution plans.

Steve has served for more than five years in his encore career as a Research Scholar at the Stanford Center on Longevity. He's also president of *Rest-of-Life* Communications, a company he founded that delivers retirement planning workshops and conducts retirement education campaigns. He has never sold insurance, annuities, or investments; this enables him to be unbiased in his writing and recommendations.

Currently, Steve writes a regular blog column for CBS *MoneyWatch* where he addresses the critical topics facing people in retirement. His previously published works include:

- *Retirement Game-Changers: Strategies for a Healthy, Financially Secure, and Fulfilling Long Life. Rest-of-Life* Communications, 2018.
- *Money for Life: Turn Your IRA and 401(k) Into a Lifetime Retirement Paycheck. Rest-of-Life* Communications, 2012.
- *Recession-Proof Your Retirement Years: Simple Retirement Planning Strategies That Work Through Thick or Thin. Rest-of-Life* Communications, 2009-2014.
- *The Quest: For Long Life, Health and Prosperity* (a DVD/workbook set). *Rest-of-Life* Communications, 2007.
- *Live Long & Prosper! Invest in Your Happiness, Health and Wealth for Retirement and Beyond.* Wiley, 2005.
- *Don't Work Forever! Simple Steps Baby Boomers Must Take to Ever Retire.* Wiley, 1995.

A Fellow in the Society of Actuaries, Steve graduated summa cum laude from the University of California, Irvine, with a double major in mathematics and social science.

Steve lives in Oxnard, California, with his wife, Melinda, where they're following the advice in this book for their own retirement and rest-of-life. For more information, visit www.restoflife.com.