Taxes in Retirement: Front-Load or Back-Load?

By Kerry Pechter *Thu, Sep 12, 2019*

Here are two ways a retired couple with a $1 million IRA might manage taxes: By either minimizing or maximizing them in the first 10 years of retirement. Zach Parker of Securities demonstrates.

People seem to dislike taxes even more after they retire. The tax bite becomes painfully obvious when not simply withheld from a paycheck, and a required minimum distribution (RMD) often means nothing to wealthy retirees but a thankless tax bill. Taxes on Social Security benefits can feel like an unjust clawback of just deserts.

The ability to reduce a high net worth retiree's tax burden—in the form of income tax, Medicare tax, Social Security tax, state tax, or taxes on bequests—therefore represents a rich opportunity for financial advisers to demonstrate their skills, bona fides and value.

In a presentation at Wealth2k's IFLM 2019 adviser conference two weeks ago, Zach Parker, a vice president at Securities America demonstrated how an adviser could use the "bucketing" technique of retirement income generation to minimize federal taxes during the first 10 years of retirement for a 65-year-old couple.

In Parker's hypothetical situation, the couple has $1 million in qualified accounts and $500,000 in non-qualified (taxable) accounts. They've expressed a need for $8,435 in gross real monthly income. Each will receive a Social Security of $18,000 a year, inflation adjusted, if they retire in the current year.

He offered two solutions. One of the solutions called for "back-loading" federal income taxes by minimizing them during the first ten years of retirement. That involved dipping into qualified savings as slowly as RMD obligations would permit. The second solution called for maximizing taxes in the first decade—front-loading taxes—by spending qualified assets or converting them to Roth IRAs within that period.

Back-loading federal taxes

To create the desired income for the couple during their first five years of retirement without triggering any federal tax, the hypothetical adviser recommends buying five-year period certain single premium immediate annuities (SPIAs).

In this case, the adviser uses $51,190 of the qualified money and $263,431 of the non-qualified money to purchase two single premium immediate annuities running concurrently for the first five years. The qualified SPIA will produce $10,500 in annual income, all of which will be taxable, and the non-qualified SPIA will produce $54,720 per year, of which only $2,025 will be taxable.

Using the Social Security tax formula, the adviser adds $10,500 + $2,025 + $18,000

(half the couple's Social Security benefit). It equals $30,525, which is under the $32,000 threshold for taxing any of the Social Security benefit. Total annual income for each of the first five years will be $101,220 ($54,720 + $10,500 + $36,000). Only $12,525 will be taxable, which is under the standard deduction ($27,000) for those over age 65. The couple pays no federal taxes.

Investing for the second five-year term or "bucket," the adviser uses income annuities again, but reverses the weight of qualified and non-qualified money in order to satisfy the couple's RMDs. This time, $262,621 of qualified money goes to a period-certain SPIA paying $61,000 a year for five years and $68,300 goes into a deferred income annuity (DIA) for income of $16,592 per year for five years.

The annual income for the first year of the second term is $117,336 ($61,000 + $16,592 + $39,744 in Social Security). Of that amount, $70,719 is taxable. That includes $33,782 (85% of the Social Security benefit), $61,000 from the qualified annuity, and $2,937 from the non-qualified annuity—minus the $27,000 standard deduction. At current rates, the federal tax bill will be $8,098. The couple's net income would be $109,238 ($117,336 – $8,098).

Front-loading federal taxes

The tax-delaying strategy described above would backfire, Parker pointed out, if federal income tax rates rise considerably over the next two or three decades in response to the higher national bills for Social Security and Medicare that will come with an aging society. So he proposed an alternate strategy that would frontload rather than backload the couple's federal tax liability.

This alternative ("Option 2") uses Roth conversions to bring taxes forward. A conversion of a traditional IRA to a Roth IRA means satisfying the tax liability on the IRA assets while allowing them to continue to grow tax-deferred.

Under this strategy, the clients fund their income for the first five years of retirement by applying $314,621 to the purchase of a period certain SPIA that would pay $65,220 a year. Simultaneously, they would convert $65,000 in qualified money to a Roth IRA. With a taxable income that high, 85% of their Social Security benefit ($30,600) would be taxed as ordinary income.

Their first-year federal tax would be $21,158 on taxable income of $133,820 ($65,220 + $65,000 + $30,600 minus $27,000 standard deduction), of which $65,000 would remain invested in the Roth IRA. Their after-tax first-year spending would be $80,062 minus the tax cost of the Roth conversion (about $10,000).

The couple would follow a similar strategy each year for each of the first ten years of retirement. Over those ten years, they would have paid about $200,000 in federal income taxes (compared with $49,000 in the tax-backloading strategy).

In the 11th year, their qualified assets would equal zero (instead of $1.235 million in the tax-backloading strategy), having either been spent as income or converted to Roth IRAs. Federal taxes after age 75 would be negligible, and beneficiaries would not receive qualified money, with its implicit tax bill.

In the second (tax-frontloading) strategy here, Parker said, one of the goals was to minimize Medicare taxes. For individuals with incomes under $170,000, the monthly Medicare premium is currently $135.50 per month. The Medicare premium rises with wealth, to a maximum of $460.50 per month for those with annual incomes of $750,000 and higher in retirement. Presumably $5,526 a year wouldn't be onerous a premium for the rare person with a post-age-65 annual income of $750,000; that's 4% of $18.75 million.

To *download* a copy of Parker's PowerPoint slides, click **here**.