Tax Planning for Retirement: The Long Game

Tax planning for retirement is different from the strategies you deploy to minimize taxes while working. You'll be using your investments for income, and the way they are taxed is different depending on the type of account you hold assets in. In addition, at age 72, you'll begin taking required minimum distributions from your tax-deferred accounts, and these amounts can quickly push you into higher tax brackets.

Does it matter? According to research done by Morningstar, tax planning can add up to 4% to retirement income.

In Retirement, Asset Location is Just as Important as Asset Allocation

Asset allocation is creating diversification in an investment portfolio by placing assets into several different asset classes that may perform differently given the same set of market circumstances. It helps to smooth volatility, which can potentially increase returns over time. The classic 60/40 portfolio that combines 60% equities and 40% bonds is an example of asset allocation.

The goal of the asset allocation is to keep part of the portfolio invested in higher risk, potentially higher growth stocks to fund future income needs, and 40% invested in lower-risk, income-producing bonds for current income. But in creating an asset allocation, thinking about where the assets should be held – their location — can make a big difference to how their returns are taxed.

Asset location isn't an investing strategy. It refers to the type of accounts where you keep your assets. Most retirees usually have at least two of the three types:

1. Tax-deferred investment accounts. These are 401(k) and IRA accounts where money was saved during working years. Contributions were made with pre-tax dollars, and the taxes must be paid when the funds are withdrawn in retirement. Withdrawals from these accounts are taxed at ordinary income rates.

2. Taxable investment accounts. These are regular brokerage accounts that are funded with post-tax money. Withdrawals from these accounts aren't taxed as income. The capital gains tax schedule applies instead.

3. Tax-free accounts. These are Roth 401(k) and IRA accounts that were funded with post-tax dollars. Contributions grow tax-free, and withdrawals in retirement are tax-free.

Where does the tax savings come in? It comes from selecting the account type to correspond with the tax profile of the returns of the asset. Matching up types of investments with the correct type of account can lower overall tax liability. For example:

• Individual equities and stock fund returns largely come from price appreciation, which is taxed at the capital gains tax rate. Holding them in a taxable account makes sense, as you're taking advantage of the lower rate.

• Bonds and bond funds that throw off income are taxed at ordinary income rates, so holding them in a retirement account that will be taxed as income is a good choice.

Thinking Through Which Account to Pull From When Can Also Lower Tax Bills

Generally, you want to withdraw from your taxable account first, as the capital gains rate is lower. Then you move to your tax-deferred accounts and finally to any tax-free accounts. Since the money grows tax-free, you want to keep it growing for as long as possible.

There are some situations where you might change the order:

• If your income level is high enough that drawing money from a taxable or tax-deferred account will push you into another tax bracket, you want to withdraw just enough to stay in the lower bracket and then augment with income from the tax-free account.

• Once you hit age 72 and required minimum distributions begin, you'll need to withdraw funds from your taxable account.

If You Didn't Set Up a Roth While You Were Working, You Can Convert Now

Roth accounts have income limits, so for many investors, if they didn't set one up earlier in their career, most of their savings is in a traditional 401(k) or IRA account. These accounts can be converted into a Roth IRA, and there are no income limits on the conversion. You will have to pay the taxes before you invest in the account.

Converting to a Roth IRA will allow you to have more control over your income, which can help you avoid taxes on Social Security and the Medicare IRMAA surcharge on part B and part D premiums.

Converting some or all of your traditional retirement account to a Roth IRA also means you can avoid or minimize RMDs. Because you've already paid the taxes, Roths don't have RMDs.

Converting requires planning – you'll be getting an income bump, so you need to figure out how to stretch it out over a few years and when to do it. The best time is usually early in retirement, before social security and Medicare.

The Bottom Line

A good retirement tax planning strategy can save a significant amount of money over your entire retirement, which means you'll have more income for longer. You'll need to switch your asset allocation around to build out an asset location plan, but once it's in place, you'll see the impact on your plan.