

Developing a “tax smart” retirement income strategy

People are living longer, and this is expected to continue. In fact, the U.S. Census Bureau (February 2020) estimates that the average life expectancy will increase an additional six years by 2060. While a longer life can influence how people think about the future, it can also add to the challenges of retirement planning and the need to create a sustainable source of lifetime income.

But longevity is not the only challenge to retirement income. Market risk and inflation may erode savings in retirement. In addition, relying on Social Security for guaranteed income may be a problem as the program’s future solvency is in question. Taxes are another risk. With federal marginal rates on certain income as high as 40.8%, combined with state income taxes, more than 50% of income for some individuals may be subject to taxation.

Yet while taxes can have a negative impact on savings, investors using a tax-efficient retirement income strategy may mitigate this effect. As always, you should consult your financial representative to determine what may be best for your individual needs.

Effect of taxes on the success of an income plan

A historical analysis of different tax scenarios illustrates the survivability over various time periods of a diversified portfolio of stocks, bonds, and cash when the portfolio is taxed at different rates. Not surprisingly, the portfolio with the highest tax bracket had the shortest survivability.

Historical success rate

	20 years	30 years	40 years
No taxes	97%	79%	60%
15% tax rate	86%	61%	42%
25% tax rate	75%	49%	21%

This hypothetical illustration is based on rolling historical time period analysis and does not represent the performance of any Putnam fund or product, which will fluctuate. This illustration uses the historical rolling periods from 1926 to 2022 and a portfolio composed of 60% stocks (as represented by an S&P 500 composite), 30% bonds (as represented by a 20-year long-term government bond (50%) and a 20-year corporate bond (50%)), and 10% cash (as represented by U.S. 30-day T-bills) to determine how long a portfolio would have lasted given a 5% initial withdrawal rate adjusted each year for inflation. A one-year rolling average is used to calculate performance of the 20-year bonds. Past performance is not a guarantee of future results. The S&P 500 Index is an unmanaged index of common stock performance. You cannot invest directly in an index.

Predicting taxes in retirement is difficult

Planning for future taxes is difficult. There is always some level of uncertainty around public policy, tax reform debates, and how income will be taxed. It is impossible to predict what lawmakers will do in the future regarding tax law.

That said, there are some fair assumptions that can be made about the future of taxes. It is reasonable to believe that taxes will rise in the future. The United States continues to deal with rising federal budget deficits and underfunded government entitlement programs such as Social Security and Medicare. Federal tax receipts will likely continue to be an important part of the solution to future fiscal imbalances.

Even if the tax rates remain the same, individuals cannot predict what their personal tax rate will be in retirement. Many investors assume that their tax rate will fall when they are no longer working. But some retirees could face similar or higher tax rates in retirement.

Several factors can move individuals into higher tax brackets. Retirees may experience increased tax liability by:

- Drawing income from tax-deferred retirement accounts
- Realizing large capital gains
- Losing popular tax deductions such as the mortgage interest deduction when the house is paid off, or losing tax credits for dependent children
- Earning income as more retirees continue working in retirement

Tax treatment of various types of retirement assets

Type of asset/account	Taxability
Traditional retirement accounts (e.g., pensions, IRAs, 401(k)s)	Taxable at ordinary income rates when distributed
Roth IRAs and 401(k)s	Contributions made with after-tax dollars; not taxed when distributed
Taxable investment accounts	<p>Capital gains and dividends Taxed at a maximum 23.8% rate</p> <p>Other income Taxed at ordinary income rates</p> <p>Return of principal Not taxable</p>
Social Security	May be partially taxable at ordinary income rates

“Tax diversification”: An approach to strategically plan for taxes in retirement

Investment diversification is often expressed by the adage, “Don’t put all your eggs in one basket.” This philosophy can also be applied to taxes.

Being mindful of the tax status of assets in retirement, and how funds are allocated among them, is an important aspect of planning when considering potential tax exposure in the future. One of the challenges many retirees face is that a disproportionate percentage of their overall savings is held in tax-deferred retirement accounts that can be taxed at a rate as high as 37% upon withdrawal.

Retirees who have a large majority of their savings in traditional retirement accounts could be in for a surprise when they have to pay taxes. In fact, of the \$10 trillion currently held in Individual Retirement Accounts (IRAs), only 10% is held in tax-free Roth accounts.

Creating tax diversification means allocating assets over time across taxable, tax-deferred, and tax-free sources.

Tax diversification

Taxable	Tax-deferred	Tax-free
Savings accounts and CDs	Employer-sponsored retirement plans	Roth IRA and Roth 401(k)
Brokerage accounts	Traditional IRAs	Municipal bond funds
Mutual funds	Annuities	529 plans

Tax diversification offers several distinct benefits

- Flexibility to draw income from different sources depending on your tax situation and changes in overall life circumstances
- May help your portfolio last longer
- Allows you to hedge your portfolio against the direction of tax rates, which could be higher in the future

A sound tax diversification plan may include the following elements:

Allocate assets by tax status

In general, consider placing a larger percentage of your stock holdings outside of retirement accounts and a larger percentage of your fixed income holdings inside retirement accounts. With respect to stock investments, allocating a greater proportion of your buy-and-hold or dividend-paying investments to taxable (i.e., non-retirement) accounts may increase your ability to benefit from a lower tax rate on qualified dividends and long-term capital gains.

Look at holding a larger percentage of taxable (i.e., non-retirement plan) fixed income assets in municipal bond funds¹

Municipal bonds are free from federal and, in some cases, state income taxes, and are particularly advantageous for investors in the highest tax brackets. The higher the taxpayer’s ordinary income tax bracket, the higher the tax-equivalent yield of the municipal bond compared with taxable bonds.

Utilize a Roth IRA/401(k) strategy

Consider funding a Roth 401(k) account, rolling over a retirement plan distribution to a Roth IRA, or converting a traditional IRA to a Roth IRA. Remember that distributions from a Roth IRA or 401(k) are not taxable if requirements are met.

Tax legislation opened the door to Roth IRAs and Roth 401(k)s

Economic Growth and Tax Relief Reconciliation Act (EGTRRA)	Introduced Roth 401(k) plans for employee salary deferrals.
Tax Increase Prevention and Reconciliation Act (TIPRA)	Eliminated the modified adjusted gross income requirement for converting a traditional IRA to a Roth IRA. Effective 2010, Roth IRA conversions are available to all taxpayers regardless of income.
Small Business Jobs Act of 2010	Allows Roth conversions inside 401(k) plans.

Implementing a tax-efficient withdrawal strategy

When it comes time to withdraw funds for retirement income, the conventional wisdom is that retirees should take money from accounts in the following order:

1. Taxable
2. Tax deferred
3. Tax free

The motivation behind this conventional wisdom is to preserve tax-deferred assets for as long as possible. However, depending on an individual's tax situation, the conventional wisdom may not be the best course of action.

For example, if you have substantial unrealized capital gains on taxable assets, it may be better to withdraw funds from tax-deferred or tax-free (e.g., Roth IRA) accounts first. By doing so, you may be able to preserve all or a significant amount of your taxable assets, which could then be passed to your heirs with a "stepped-up" cost basis (i.e., the market value of the assets on your date of death rather than their original cost).

Similarly, it may make sense to time the withdrawal of funds from tax-deferred accounts for years when you're likely to be in a lower marginal tax bracket compared with your pre-retirement tax bracket. These years could occur early in retirement before required minimum distributions (RMDs) from retirement accounts begin (normally age 73),

or later in retirement when medical expenses may be higher. Drawing from tax-deferred accounts when your tax rate is low will allow you to enjoy the full benefit of the lower rate.

The table below summarizes various retirement situations and the corresponding withdrawal strategies that may be optimal from a tax standpoint.

Tax-efficient withdrawals

If the retirement situation involves:	Then consider the following:
Lower marginal tax rate	Draw from tax-deferred assets to maximize use of lower relative tax bracket, which may help to reduce RMDs at age 73
Higher marginal tax rate	Use tax-free or taxable assets to avoid higher income tax rate and/or take advantage of lower capital gains rates
Significant capital appreciation in a taxable account	If a legacy goal exists, preserve taxable assets to take advantage of "stepped-up" cost basis at death
Working in retirement	Avoid tax-deferred assets, which will increase overall income (higher income could trigger taxes on Social Security benefits)

Maximizing the use of tax brackets

A related strategy is to draw income from different tax sources as you gradually transition from lower to higher tax brackets. That is, draw enough income from tax-deferred sources such as traditional IRAs or 401(k)s to reach the limit of the 12% income tax bracket (\$44,725 for single filers). This approach maximizes use of the relatively low 12% tax bracket for ordinary income. This also reduces the balance of tax-deferred accounts, which lowers required minimum distributions in the future.

As more income is needed, consider drawing from other sources (taxable or tax-free) to avoid increasing ordinary income, which is subject to higher tax rates.

Tax bracket*	Single filers	Joint filers	Strategy
10%	\$11,000	\$22,000	Tax deferred
12%	\$44,725	\$89,450	Tax deferred
22%	\$95,375	\$190,750	Taxable
24%	\$182,100	\$364,200	Taxable
32%	\$231,250	\$462,500	Tax free
35%	\$578,125	\$693,750	Tax free
37%	—	—	Tax free

* 2023 federal tax rates.

IRS provides clarity on rolling over after-tax retirement assets

For 401(k) participants with a mix of pretax and after-tax funds in their retirement plan, planning may be easier following a recent announcement from the Internal Revenue Service.

The IRS issued Notice 2014-54 in September 2014 that provides clarification on how to distribute these funds. Participants are now able to transfer after-tax funds directly to a Roth IRA tax free if a triggering event exists (termination of employment, attaining age 59½, death, disability). Any pretax funds can be transferred to a traditional Individual Retirement Account (IRA).

Prior to the notice, it was difficult for taxpayers to segregate post-tax and pretax funds into a Roth IRA and traditional IRA respectively.

Consider this example:

- Plan participant has \$200,000 in a 401(k) plan
- Assets within the plan consist of \$150,000 (75%) in pretax funds and \$50,000 (25%) in after-tax employee contribution
- The participant could opt to roll over the \$150,000 in pretax funds to a traditional rollover IRA while directing \$50,000 of after-tax contributions to a Roth IRA

The IRS further notes that any partial distributions are deemed to consist of a pro rata portion of pretax to after-tax dollars. Using the same example, let's assume the participant chooses to roll over just \$100,000 from their plan to an IRA. In this case, \$75,000, or 75%, would be considered pretax and could be rolled over to a traditional rollover IRA, while \$25,000, or 25%, could be directed to a Roth IRA.

This guidance opens doors for plan participants who may wish to fund more retirement savings to Roth accounts, particularly when the plan does not offer a Roth 401(k) option. Knowing that they are able to directly roll over after-tax retirement plan assets to a Roth IRA, participants may be more likely to use this option if it is allowed in their plan. And, unlike contributions to a Roth IRA, there are no income requirements limiting after-tax contributions inside a retirement plan.

Plan participants deciding the most efficient way to distribute their retirement plan assets should consult with an advisor or tax expert to determine an appropriate strategy.

Sound planning is the key

The goal of achieving lasting retirement income is more challenging today than in the past. However, through a combination of fundamental and advanced strategies, your advisor can help you meet this challenge head on by developing a plan that links inflation protection with sustainable, tax-efficient withdrawals.

¹ Treasury bills are guaranteed as to the timely payment of principal and interest and are exempt from state and local income taxes whereas municipal bonds are free from federal and in some cases state and local taxes. Funds that invest in bonds are subject to certain risks including interest-rate risk, credit risk, and inflation risk. As interest rates rise, the prices of bonds fall.

For some investors, investment income may be subject to the federal alternative minimum tax.

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