



Retirement Taxes: Simplify, Diversify, Plan

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Everyone hopes for a tranquil retirement. Henry David Thoreau's famous advice for achieving the uncomplicated life was, “Simplify, simplify.” He complained in *Walden* that our lives were being “frittered away by detail” and urged people to reduce the number of things demanding their attention.

Thoreau could get away with that more easily than we can. He lived for a time in a cabin at Walden Pond and had little interest in accumulating the creature comforts and financial security that occupy much of modern life. He once observed that wealth was the ability to experience life fully.

Unfortunately, Thoreau never had to figure out required minimum distributions.

Thoreau Never Had to Plan for a 30-Year Retirement

Life in 1850s Massachusetts was considerably simpler than retirement in 21st-century America. Modern retirees may live for decades after leaving the workforce and must manage Social Security, Medicare, pensions, IRAs, 401(k)s, annuities, investment accounts, property, insurance, and federal and state taxes.

Thoreau himself died in 1862 at only 44. He never had to wonder whether his nest egg would last into his 80s or 90s, budget for Medicare premiums, or decide when to withdraw money from an IRA. He did, however, have one memorable encounter with taxation.

Thoreau spent a night in jail after refusing to pay a poll tax as an act of protest against slavery and the Mexican-American War. Someone—traditionally described as an unidentified relative or

acquaintance—paid the tax, much to Thoreau's annoyance, and he was released. Today's retiree cannot count on a mysterious benefactor showing up to settle matters with the IRS.

Retirement Does Not Mean Retirement From Taxes

When the paycheck stops, income taxes do not necessarily stop with it. Retirement income can arrive from several sources, and each can be treated differently. Social Security may be partly taxable. Traditional IRA and 401(k) withdrawals generally produce taxable income. Roth accounts can provide tax-free qualified distributions. Annuity taxation depends on how the annuity was funded and structured. Taxable investments have still another set of rules.

That complexity makes **tax diversification** almost as important as investment diversification. The objective is to enter retirement with money held in different types of accounts so that not every dollar you need produces the same tax consequence.

Some Social Security Benefits May Be Taxable

The original version of this article simply said, “You pay income tax on your Social Security benefits.” That was too broad.

Many people pay **no federal income tax on their Social Security benefits**. Whether benefits become taxable depends on Social Security plus other income.

The IRS calculation essentially looks at one-half of your Social Security benefits plus other income, including tax-exempt interest. For an individual filer, the first important base amount is **\$25,000**; for a married couple filing jointly, it is **\$32,000**.

As income increases beyond the applicable thresholds, some benefits can become taxable. At higher income levels, **up to 85 percent of Social Security benefits may be included in taxable income**. That does not mean there is an 85-percent tax on Social Security. The taxable portion is simply included with your other taxable income and taxed at the rate that applies to you.

That distinction is important when deciding where retirement spending money should come from.

Traditional IRAs Eventually Produce Taxable Income

Traditional IRAs generally provide their tax advantage on the front end. Depending on income and participation in an employer retirement plan, contributions may have been deductible when they were made, and investment earnings grow tax-deferred.

Eventually, however, the IRS expects its share. Withdrawals from a traditional IRA are generally included in taxable income except to the extent the account contains money that was previously taxed.

The old age-70½ required-minimum-distribution rule cited in the 2019 article has changed. Under current law, traditional IRA owners generally must begin taking **required minimum distributions, or RMDs, at age 73**.

The amount required each year is calculated under IRS rules using the account balance and applicable life-expectancy tables.

Traditional 401(k) Withdrawals Are Generally Taxable Too

Traditional 401(k) contributions are generally made with pre-tax dollars, allowing taxes to be postponed while the money remains in the account. When that money comes out in retirement, taxable distributions are generally included as ordinary income. Required-minimum-distribution rules also apply to traditional 401(k) accounts.

That creates an important planning issue. Someone with substantial traditional IRA and 401(k) balances may reach the RMD years and discover that mandatory withdrawals increase taxable income even when all of the money is not needed for current expenses. Tax planning therefore should begin before RMDs begin, not afterward.

Roth Accounts Turn the Tax Arrangement Around

A Roth IRA reverses the traditional IRA tax bargain. Contributions are made with after-tax dollars, so there is no federal income-tax deduction for making the contribution. In return, qualified withdrawals—including accumulated investment earnings—can generally be received tax-free.

There is another major advantage for retirement planning: **the original owner of a Roth IRA does not have to take lifetime required minimum distributions**. Current law also eliminates lifetime RMDs for original owners of designated Roth accounts in 401(k) and 403(b) plans. Beneficiaries are subject to different rules.

That makes Roth money potentially valuable late in retirement because it can remain invested until needed rather than being withdrawn simply to satisfy an RMD.

Annuities Have Their Own Tax Rules

Annuity taxation depends heavily on how the contract was funded. A nonqualified annuity purchased with after-tax money generally contains two components: your original investment and earnings. The original after-tax investment is not taxed a second time when properly returned to you, while taxable earnings are generally treated as ordinary income.

The calculation can differ depending on whether you take withdrawals, receive periodic annuity payments, or surrender the contract. An annuity held inside an IRA or other qualified retirement account is different because the retirement account itself already provides tax deferral.

The important point is that “annuity payments are taxable” is too simple a statement. **The source of the money matters.**

Early Withdrawals Can Be Expensive

The original article warned that taking money from an IRA before retirement could produce a 10-percent penalty. The basic principle remains, but the rules deserve more precision. Taxable distributions from many retirement accounts before age **59½** may be subject to an additional 10-percent federal tax on top of ordinary income tax.

But there are numerous exceptions involving circumstances such as disability, certain medical expenses, qualified higher-education costs, first-home purchases from an IRA within limits, qualified birth or adoption distributions, certain emergency expenses, and other situations established by federal law. The exceptions also differ depending on the type of retirement plan.

So it is better to call it an **additional tax that may apply**, rather than an automatic penalty on every early withdrawal.

Keep Some Money Readily Available

One of the simplest retirement strategies in the original article remains one of the most useful: maintain some readily accessible money outside retirement accounts.

Savings accounts, money-market deposit accounts, Treasury securities, CDs, and other relatively liquid holdings can provide money for unexpected expenses without forcing you to take a taxable retirement distribution at an inconvenient time.

Bank deposits within applicable limits can also have FDIC insurance protection. The trade-off is that interest from ordinary savings accounts and CDs is generally taxable as it is earned, and conservative holdings may produce lower long-term returns than investments carrying greater risk.

Their job, however, is not necessarily to produce the highest return. Their job may be to provide **liquidity and stability**.

Tax Diversification Gives You Choices

Investment diversification means not putting all your money into one investment. **Tax diversification** means not putting all your retirement money into accounts that receive identical tax treatment.

Imagine having retirement resources divided among a traditional IRA or 401(k), a Roth IRA, ordinary savings, and taxable investments. When an unusually large expense arrives, you may have several possible places from which to obtain the money.

Taking everything from a traditional IRA could increase taxable income. Taking qualified money from a Roth may not. Using existing cash savings may create no additional taxable income at all.

The point is not that one account is always preferable. The advantage is having **choices**.

Downsizing Can Have Tax Advantages

Selling a large house and moving to a smaller one can reduce property taxes, insurance, utilities, maintenance, and other retirement expenses. It can also release home equity for other purposes.

Federal tax law provides another potential benefit. A homeowner who meets the applicable ownership and use requirements may generally exclude up to **\$250,000 of gain** on the sale of a principal residence. Married couples filing jointly may generally exclude as much as **\$500,000** when the requirements are met.

Notice that this is an exclusion of **gain**, not an exclusion of the entire selling price. If you bought a house for \$200,000 and eventually sold it for \$600,000, the tax calculation concerns the gain after considering the home's adjusted basis and qualifying selling expenses—not the entire \$600,000 received at closing.

Paying Off the Mortgage Is a Different Decision

The earlier version connected paying off a mortgage with the home-sale tax exclusion. They are really separate issues. Whether paying off a mortgage before retirement makes sense depends on the mortgage interest rate, available cash, investment alternatives, taxes, risk tolerance, and the value you place on entering retirement debt-free.

The home-sale exclusion does not depend on whether the mortgage has been paid off. It depends primarily on ownership, use, and other IRS requirements. Eliminating a mortgage can certainly reduce monthly retirement expenses, but it should be evaluated as a **cash-flow and financial-security decision**, not as a requirement for obtaining the home-sale tax exclusion.

Simplify—But Diversify First

Thoreau's advice still has something to teach us. Retirement can be a good time to simplify. Consolidating scattered financial accounts, eliminating unnecessary expenses, paying down debt, reducing the burden of maintaining a large house, and organizing financial records can make retirement considerably easier to manage.

But simplicity does not necessarily mean putting every retirement dollar into one basket. A mixture of taxable, tax-deferred, and potentially tax-free resources can provide flexibility when deciding where the next year's spending money should come from.

The modern retirement version of Thoreau's advice might therefore be:

Simplify your financial life. Diversify the tax treatment of your money. And plan your withdrawals before the IRS plans them for you.

The Bottom Line

Taxes should not dictate every retirement decision, but neither should they be an afterthought.

Social Security, traditional IRAs, Roth IRAs, 401(k)s, annuities, savings, investments, and your home can all produce different tax consequences. The order and timing in which you use those resources can affect the amount of income tax you pay.

That is why retirement tax planning is not simply about finding deductions. It is about arranging your resources so that you have choices.

Thoreau wanted his affairs to be “two or three, and not a hundred or a thousand.” We may never get modern retirement finances down to three.

But with a little planning, we can at least keep them from becoming a thousand.

This article provides general information and is not individualized tax, financial, investment, or legal advice. Tax rules change and individual circumstances differ. IRS Publication 554, Tax Guide for Seniors, provides additional information for older taxpayers.