The Importance of Age-Based Tax Planning

Part 9 of 12
In today’s world, more and more of the responsibilities of preparing for retirement seem to fall upon each of us as individuals. As you prepare, you will unfortunately find that income taxes do not stop when you stop working. It is for this reason that tax planning is an integral part of your overall retirement strategy.

Evaluating Your Financial Strategy
Staying abreast of all of the tax-advantaged strategies available to you as you age will help you to maximize your retirement savings. Wealth Managers can guide you on a path to achieving financial success by helping you take advantage of appropriate age-based tax planning opportunities.

Be Aware Of Important Milestones
As you’re nearing or are in your 50s, it is important to be aware of certain milestones that create opportunities for you to maximize your savings opportunities. Here are those important milestones to remember in order to fully maximize your savings:

- **Age 50** – Catch-up Contributions Allowed For Both 401(k) & IRA.
- **Age 55** – Some 401(k) Distributions Allowed
- **Age 59 ½** – IRA & 401(k) Distributions Allowed
- **Age 62** – Social Security Eligibility Begins
- **Age 65** – Medicare Enrollment Begins
- **Age 70** – Maximum Social Security Benefits Achieved
- **Age 70 ½** – Required Minimum Distributions
- **Ages 60 – 70** Roth Conversion Opportunities

Taking Advantage of Catch-up Contributions - Age 50
In 2001, Congress passed a law to help workers make up for lost time if they feel that they are behind in their retirement savings. This provision allows workers age 50 and older to make contributions to their retirement plans in excess of the limits younger workers are allowed.

At age 50, you may contribute up to the regular 401(k) limit — $18,000 for 2015 — and if you reach that limit, you may also make a catch-up contribution of an additional $6,000. Giving you a total of $24,000 you can set aside. Setting aside an extra $6,000 each year into a tax-deferred retirement account can have a big impact on the eventual balance of the account.

Additionally, individuals at least 50 years old may also make catch-up contributions of $1,000 to their IRAs. This amount is in addition to the regular contribution limits for both traditional and Roth IRAs, currently $5,500.

Catch-up contributions are a smart way to make up for lost time in retirement planning. Of course,
catch-up contributions only come into play if you maximize the elective deferral amounts in your 401(k) or reach the contribution maximums in your IRAs. Aiming to do so is a good starting goal. However, be sure that you have the information that you need to leverage this tool wisely – consult an experienced Wealth Manager to learn how to make catch-up contributions work for you.

Penalty Free 401(k) Distributions  
– Age 55

Normally, you are not allowed to take distributions from a 401(k) until you reach age 59 ½. However, there is a special provision in 401(k) plans for people who leave their employer after age 55 but before age 59 ½. This rule allows you to take withdrawals from the plan that are exempt from the early withdrawal penalty of 10%.

Be aware should someone suggest you roll funds from your 401(k) to an IRA without first explaining the age 55 provision to you. Once you move funds from your 401(k) to your IRA, the age 55 penalty-free withdrawal provision no longer applies, and you’ll have to wait until age 59½, or pay the penalty.

Penalty Free IRA Distributions  
– Age 59 ½

Under IRA tax rules, the earliest you can begin withdrawing funds from your IRA without penalty is at age 59 ½.

However, that doesn’t mean you must, or even should, withdraw money. Many people wrongly assume they must start drawing down their IRA once they become eligible. Nevertheless, if you are still earning an income at 59 ½, the best tactic may be to leave your IRA alone and let it continue growing.

A great source of information regarding IRA accounts is IRS Publication 590. It offers a detailed explanation of IRA regulations, including those pertaining to distributions. Free copies are available by visiting the IRS website at http://www.irs.gov.

Social Security Eligibility  
– Age 62

Social Security benefits are another integral part of your retirement planning. It is important to understand the procedures and other details of filing. The Social Security Administration offers a wealth of information on this subject online at http://www.socialsecurity.gov/retire.
How and when to begin taking Social Security Benefits can be a difficult decision. Please feel free to visit our website to check out the seventh article in this series that discusses Social Security benefits at length – www.rfawealth.com/articles.

Medicare Enrollment – Age 65
Medicare is the health payer program of the United States Government that helps provide payment coverage for health and medical care. It was first enacted in 1965 to help those who could not afford health or medical care in their retirement years. Today, millions of American citizens age 65 and older receive Medicare assistance.

Medicare Initial Enrollment Period
For most people, enrolling in Medicare Part A is automatic. However, there are instances where you may have to manually enroll in Medicare Part A and/or Part B during your Initial Enrollment Period (IEP) which is the seven-month period that begins three months before you turn 65, including the month of your 65th birthday, and ending three months later.

Some situations where you would need to enroll in Medicare during your initial enrollment include:

1. **If you are not yet receiving Social Security retirement benefits.**
   If you are not yet receiving retirement benefits and are close to turning 65, you can sign up for Medicare Part A and/or Part B during your Initial Enrollment Period.

2. **If you do not qualify for retirement benefits.**
   If you are not eligible for retirement benefits from Social Security, you will not be automatically enrolled into original Medicare. However, you can still sign up for Medicare Part A and/or Part B during your Initial Enrollment Period.

Medicare General Enrollment Period
If you do not enroll during the IEP when you are first eligible, you can enroll during the General Enrollment Period. The general enrollment period for original Medicare is from January 1st through March 31st of each year. *Keep in mind that you may have to pay a late enrollment penalty for Medicare Part A and/or Part B if you did not sign up when you were first eligible.*

Health Savings Accounts – Age 65
Health Savings Accounts (HSA) are tax-advantaged medical savings accounts available to taxpayers in the United States who are enrolled in a deductible health plan. The funds contributed to an HSA account are not subject to federal income tax at the time of deposit. HSA accounts can be used to pay for qualified medical expenses at any time without federal tax liability or penalty.

Any distribution from an HSA used to pay for medical expenses is tax free. Once you reach 65, HSA distributions used to pay for non-medical expenses are subject to income taxes but avoid the 20% penalty that applies to those under age 65 who use the money for non-medical reasons.
Required Minimum Distributions (RMD) – Age 70 ½

While the primary benefit of most IRS sanctioned retirement accounts is their tax deferred status, this benefit does not last forever. You must begin taking your taxable withdrawals no later than April 1st of the year after you turn 70 ½. Subsequent annual withdrawals are then due by December 31st each year thereafter. If you postpone your initial distribution to the first quarter of the year after you turn 70 ½, then you will have two distributions in that second year.

There are many details that accompany the start of these distributions but one is certain. Failure to comply with this requirement carries a full 50% penalty of the required amount not withdrawn.

As an investor, the tax burden created by these withdrawals can be quite an eye opener. By planning in advance, there may be ways available to minimize the impact of the taxes that your Required Minimum Distributions generate.

For example, it may be advantageous to systematically draw down your IRA in the years prior to you turning 70 ½ in order to reduce the size of the account and in turn, the required distribution. Often, this can be accomplished by employing the Roth conversion strategy outlined in the upcoming section.

Using Roth IRA Conversion Opportunities – Age 60 to 70

An important point to remember is that regardless of when you choose to remove funds from your traditional IRA, those funds are reported as ordinary income in the year in which they are received. However, converting at the right time can help you to minimize those taxes.

For many, converting traditional IRA holdings to a Roth IRA helps reduce the amount of your RMDs as well as allow those funds to continue to grow TAX EXEMPT!

The Advantages of a Roth Conversion

There are two distinct advantages to using Roth conversions as an effective retirement strategy.

1. **Tax Exempt Earnings** – Going forward, those funds deposited into the Roth IRA will grow *tax exempt* rather than *tax deferred*.

2. **Decrease Future Required Distribution Amounts** – By decreasing your traditional IRA balance prior to beginning your RMDs, you have reduced the amount they will be required to be removed from the account both in the initial year and subsequent years as well of your RMD.
When to Consider a Roth Conversion

1. **When you are in a low tax bracket.**
   If your current tax rates are historically lower than in the past, this alone may be reason enough to convert now as opposed to being hit with possible higher rates in the future. However, more importantly, is whether you expect your individual income (including RMD) to be higher in the future.

2. **When you are in a low income period.**
   Because conversion results in increased taxes in the near term, doing so may make the most sense in lower earning periods. Also, for those without taxable income, converting an amount lower than your standard deduction would allow you to not pay taxes on your converted amount.

3. **As you consider estate planning.**
   Often, an elderly client may not be in need of his or her IRA money. By converting his or her traditional IRA funds now, they may be in a lower tax bracket than if the beneficiaries need funds. The Roth conversion may be taxed at a lower rate than their heirs would be at a later time.

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**How it Works — A hypothetical example**

In order to examine the advantage or disadvantage of converting funds from a traditional IRA to a Roth IRA, we assume a current income tax rate of 25% and a 6% average annual return.

As you can see from the table below, a future retirement tax rate equal to or higher than the current tax rate favors the Roth conversion. In contrast, a lower future tax rate favors leaving the money in a traditional IRA. Additionally, the longer the time horizon, the greater the advantage (or disadvantage) of the conversion. Note that the Roth conversion has a slight advantage even if the future tax bracket remains the same. That’s because we assume current taxes will be paid from taxable accounts and the full conversion amount will go into the Roth. If taxes were paid from the IRA at the time of conversion, then there would be neither an advantage nor a disadvantage, regardless of how long the time horizon, assuming the future tax rate is the same.

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<th>Future tax rate</th>
<th>Time horizon (years)</th>
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<tr>
<td>15%</td>
<td>($118)</td>
<td>($142)</td>
<td>($171)</td>
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</table>

1 Table shows the difference between the projected future value of the Roth minus traditional IRA. Note that we also subtract an opportunity cost from the Roth projection, assuming the conversion tax paid from taxable accounts would have been invested with a return of 6%, but would lose some return to ongoing taxation, as well as a 15% long-term capital gain tax on the adjusted cost basis at liquidation.

Roth IRA Conversion: Does It Make Sense by Rande Spiegelman - April 3, 2015
Age Based Tax Strategies
The biggest challenge in retirement is making your funds last a lifetime.

Just as a builder uses a blueprint to construct a home, a retiree should have a similar plan for achieving his or her own retirement goals. By being aware of those important dates along the way, it insures that you are taking full advantage of those tools available to you.

Using your retirement plan assets in a strategic way so as to minimize income tax should also be an important part of your overall strategy. It should allow you to preserve as much of your retirement savings as possible.

So watch for those important dates!

About RFA
Reilly Financial Advisors is a fee-only Registered Investment Advisor, aimed at helping our clients both define and achieve their individual financial goals through four unique service offerings:

1. Wealth Building – for those still accumulating their investment portfolios
2. Wealth Management – for those who have amassed their savings and have specific needs associated with their wealth
3. Wealth Legacy – for those who have accumulated a significant amount of wealth and face unique wealth transition needs
4. Corporate Retirement Services – tailored solutions for plan sponsors and participants

RFA, founded in 1999, services clients around the United States and in more than a dozen countries worldwide. As an independent advisor, we are able to provide our clients with the highest level of Fiduciary services which allows us to make investment decisions based solely in the best interest of our clients. Our goal is to be our client’s first point of contact for all of their financial needs, serving as a trusted financial partner for the long term.