Strategies for Managing Post-Retirement Bracket Creep

July 2, 2020

by Kimberly Foss

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We've all quoted the mantra to our clients before and during tax season: "Defer income, accelerate deductions." It's generally good advice, of course. If clients can push income past the end of the year, they won't have to pay taxes on it this year, and a deduction taken now is of more immediate benefit than one in the future.

But especially for HNW retirees, this tried-and-true proverb needs a caveat or two. Those who have been methodically and faithfully contributing as much as they can to traditional IRAs, 401Ks, and other tax-favored plans, can find themselves in a higher tax bracket in retirement once their required minimum distributions (RMDs) kick in, even if they wait until age 72, as allowed by the 2019 SECURE Act. Especially in future years, as more people enjoy longer lifespans, it could be possible to live for 20, 30 or more years in retirement in a higher tax bracket than when they were still working full-time. Your advice to your client's needs to reflect this changing reality.

So, what should you do?

Well, as with most things in financial planning, it starts with some in-depth conversations with your clients, and you want to invite their tax advisor – conversations that ideally need to begin several years prior to your client's retirement. The goal is to project current and future income and analyze all sources of retirement income, including tax-qualified and taxable accounts and Social Security. Once you've gathered the necessary information, you'll be in a position to help your client decide which of several available strategies will help them find the "sweet spot": carefully balancing income for maximum tax efficiency, both now and after they stop working.

For example, you might decide that it makes sense for your client to convert some of their traditional tax-deferred accounts to Roth accounts. This will entail paying taxes on a portion of the funds, but insures tax-free income in later years, when RMDs begin. What you must determine is whether, in your client's particular situation, it makes more sense to pay taxes on the money in their current bracket or in the bracket they're likely to be in at age 72 or later, especially if it is likely that their other income will cause part of their Social Security income to be taxable (for some wealthy retirees, up to 85% of Social Security benefits can be taxable).

Another strategy involves shifting the traditional order in which retirement accounts are tapped for income. The usual advice is to spend down taxable accounts first, allowing the tax-deferred accounts to continue to compound tax-free. But depending on other sources of income, this could put some HNW retirees in the position of having "too much" income in later years, especially if they defer Social Security benefits to age 70. All this together could shove them into a higher tax bracket from which they may never escape. Instead, it may make more sense to take income from the deferred (traditional accounts) earlier in retirement, before the onset of RMDs takes away flexibility.

A third idea, applicable to clients who are still working but approaching retirement, is to contribute to a Roth, rather than a traditional account. This means that they will be paying taxes on the funds contributed now, rather than deferring taxes until after retirement. When the analysis reveals that these individuals are likely to be in a lower tax bracket now than in the future, paying the taxes "up front" may pave the way for a more tax-efficient income stream in later years.

Your clients have a certain number of "tax buckets"; some are based on lower rates, and some are based on higher ones. The ideal equilibrium fills as many of their lower-rate buckets as possible and avoids the higher-rate ones. Do your clients a favor: Analyze their situations to develop tax-efficient strategies that will keep their "income buckets" flowing freely.

Kimberly Foss, CFP®, CPWA®, CFT-I™ candidate, is president and founder of Empyrion Wealth Management, an RIA with offices in Roseville, CA, and New York City. Her book, Wealthy By Design, is a New York Times bestseller*. She has*

been a commentator for NBC, ABC, Fox News and The Wall Street Journal. *You can reach her at kimberly@empyrionwealth.com*