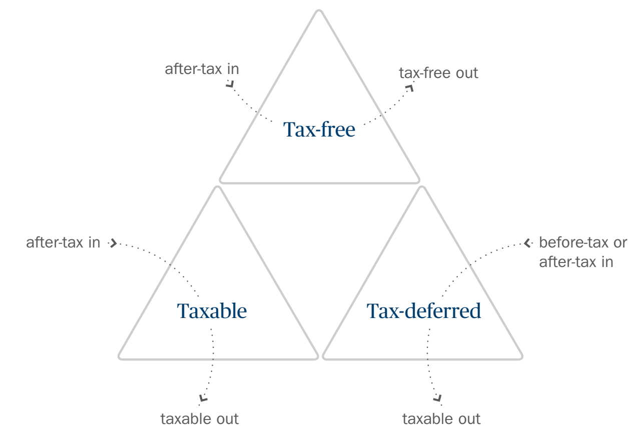
Ameriprise Financial

Tax diversification strategies for tax-efficient income in retirement

To build assets for the future, investors seek to create diversified portfolios with a mix of investments that match their time horizon and their risk tolerance. To help control the impact of taxation on their portfolios, investors often have accounts that fall into three different types of tax treatment:



1. **The tax-deferred account.** This bucket includes savings vehicles funded with pre-tax contributions (such as 401(k) or IRA) or, in some cases, after-tax dollars. Tax-deferred earnings and contributions are not taxed until withdrawn. Amounts withdrawn prior to age 59½ may also be subject to a 10% early withdrawal penalty. Generally, distributions from qualified accounts are required to begin at age 70½.
2. **The taxable account.** This bucket consists of accounts funded with after-tax money for taxable income, such as interest when earned, dividends when paid or capital gains/losses when realized. Examples include checking accounts, savings accounts, and brokerage accounts.
3. **The tax-free account.** This bucket consists of savings vehicles funded with after-tax money (with the exception of Health Savings Accounts (HSAs)). Earnings can be tax-free, provided certain conditions are met. Examples include Roth 401(k), Roth IRA, HSAs, cash value life insurance, and interest on municipal bonds (subject to possible capital gains taxes at sale or maturity).

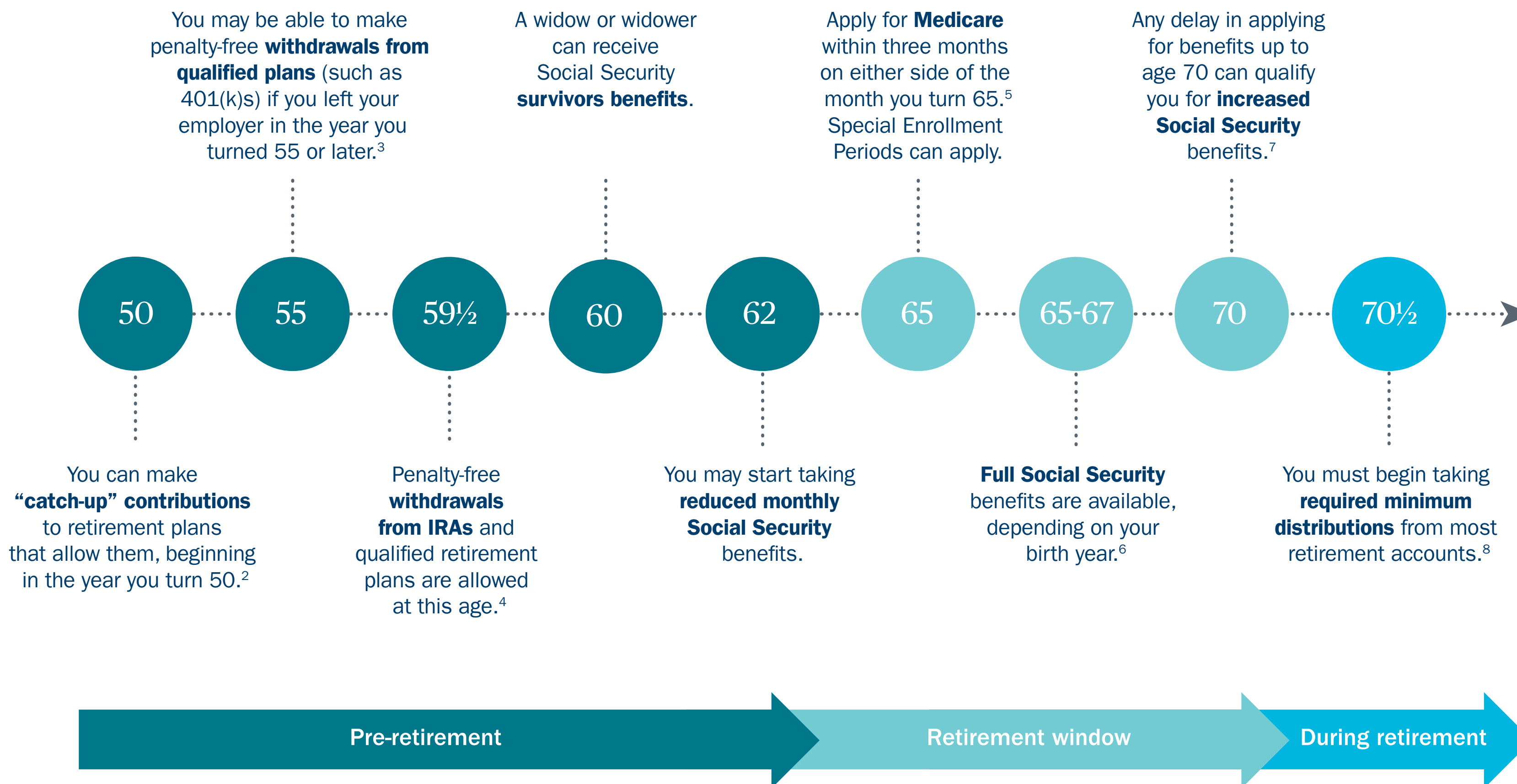
Saving into diverse tax vehicles — tax deferred, taxable and tax-free — on the journey to and through retirement may help you maintain more control over how and when your retirement assets are taxed when you retire.

This can extend the life of your portfolio up to three years longer[1] and provide flexibility if market conditions, life events and/or tax rates change throughout your retirement journey.

Diversification does not assure a profit or protect against loss.
Ameriprise Financial, Inc. and its affiliates do not offer tax or legal advice. Consumers should consult with their tax advisor or attorney regarding their specific situation.

Decision timeline

There are important age milestones at which you can or must make decisions that can impact your income, your taxes or both in retirement.



Pre-retirement

Retirement "Window"

During retirement

Pre-retirement

Principle

Consider taking tax deductions to the greatest extent possible during peak earning years, when your marginal tax bracket may be at its highest. Strive to save money in taxable and tax-free investments in addition to your savings in tax-deferred accounts during these accumulation years to add flexibility when you reach retirement.

Retirement plan contributions

Lay the foundation for your financial future by saving money in your workplace retirement plan. Many employer plans offer a match that will help you accumulate more money for retirement.

A **traditional 401(k) plan** allows you to accumulate tax-deferred so your assets can grow faster.

With a **Roth 401(k) plan**, any growth is tax-free so even though you don't get an immediate tax deduction, your income will be tax-free in retirement (if all requirements are met). A Roth 401(k) plan may be appropriate if you think you may be in a higher tax bracket in the future.

A pension is an employer-funded retirement plan that pays a fixed monthly income in retirement. Many employers no longer offer pension plans or have replaced them with a cash balance pension plan that works more like a defined contribution retirement plan.

Non-deductible IRA or after-tax 401(k) contributions

Consider making after-tax contributions to your IRA and/or 401(k) and convert it to a Roth IRA. The after-tax funds that you convert to a Roth IRA are not taxable, but any earnings that are converted will count as income. The rules that determine the earnings that are related to your after-tax contributions are different for 401(k)s and IRAs and can be complex, so be sure to talk to your Ameriprise advisor and your tax advisor before going ahead with the strategy.

Non-qualified savings for retirement

Stocks, bonds, mutual funds, and cash are all resources you can use in retirement. In addition, many employers offer the option of accumulating assets in non-qualified, deferred compensation plans.

Health Savings Accounts

Consider contributing to a health savings account (HSA), a tax-advantaged medical savings account available to individuals enrolled in a high-deductible health plan. You can deduct contributions, earnings grow tax free, and withdrawals are tax free if they are used for qualified medical expenses. The unused account balance rolls over each year to be used in the future.

Life insurance

Life insurance provides protection while offering the opportunity to build cash value. Because it's flexible, you can adjust benefits as your needs change. Review your life insurance coverage to see if you have prepared for the unexpected and have the protection you need.

Annuities

Annuities are long-term insurance solutions that offer lifetime income and tax-deferred growth potential.

50

Catch-up contributions

A catch-up contribution allows people age 50 or older to make additional contributions to their 401(k) accounts or IRAs. If you are in a modest tax bracket, consider making catch up contributions to a Roth 401(k) to provide tax-free income in retirement.

55

Age 55 exception to the 10% early distribution penalty

If you retire or otherwise separate from service, you can take distributions from your 401(k) plan during or after the year you turn age 55 without a 10% penalty. (This rule does not apply to IRAs.)

59½

In-service distribution

You may be able to take an in-service distribution from your 401(k) plan while you're still employed and roll it to an IRA and periodically convert portions to a Roth IRA for tax-free distribution in retirement. You'll pay tax on the amount of pre-tax contributions and earnings you convert to a Roth account, but depending upon where you are in your career or if tax rates rise in the future, you might be better off paying taxes at today's rates. Some 401(k) plans permit you to convert your pre-tax account to a Roth account inside the plan. It's worth considering before 2026's scheduled tax increase.

Retirement "Window" – Your retirement age through age 70

Principle

The "Retirement Window," i.e. the time between employment ending and Required Minimum Distributions beginning, is generally a time when you have lower marginal tax rates. If you have lower rates, this may be a good time to sell a business or vacation home, diversify your portfolio, or make strategic withdrawals from your tax-deferred accounts. Thoughtful planning during this window may extend your retirement dollars.

62-70

Social Security

You can begin receiving reduced monthly benefits as early as age 62. Full Retirement Age (FRA) may be between age 66 and 67 depending on your date of birth. If you delay taking your benefits they will increase 8% per year between FRA and age 70.

The amount of Social Security that is subject to income tax increases as your income increases. At most, 85% of Social Security retirement benefit may become taxable.

The Social Security website, ssa.gov, is an excellent resource that can also help you think about when to claim your benefits.

Net Unrealized Appreciation

If you have "highly appreciated employer securities" in your qualified plan, you may be able to convert some plan assets from being taxed as ordinary income (when received by the participant) to being taxed at long-term capital gain rates. Consult your tax advisor before making decisions.

Roth conversions

Consider converting money, periodically until age 70, from IRAs and 401(k)s to Roth IRAs during the Retirement Window. This may also provide flexibility in managing taxes and potentially higher healthcare costs later in retirement. You will pay income tax on conversions of pre-tax contributions and earnings, but once the money is in the Roth, you won't owe on it again and the growth is tax-free (if conditions are met). Drawing from tax-free assets may allow you to realize cash flow yet control your tax bracket.

Medicare high-income surcharge

Medicare beneficiaries whose income exceeds $85,000 ($170,000 for married couples filing jointly) pay an income-related monthly surcharge which applies to both Medicare Parts B and D. In 2019 a new top surcharge tier was added for very high-income beneficiaries, defined as individuals with Modified Adjusted Gross Income of $500,000 or more ($750,000 for married couples filing jointly). High-income surcharges are based on your income two years prior.

Health Insurance pre-65

Those who retire before age 65 and plan to purchase health insurance through the exchange market should balance the level of taxable income you target with the level that affects subsidies on health insurance. In some cases a modest increase in taxable income can result in a significant increase in health care premiums.

Capital asset sales

Capital assets are assets that would produce a capital gain or loss at sale. Examples include real estate investments and stocks. Since the zero-percent capital gain rate still exists for filers at certain income levels (for example, married filing jointly with taxable income not exceeding $78,750), retirees may want to consider using their first full year of retirement (assuming income falls below the limit) to create a net long-term gain that may have little or no tax. If the long-term income exceeds $78,750 but falls below $488,850, the long-term capital gain still has a favorable rate of 15 percent tax on the gain. Married couples with taxable income exceeding $488,850 are subject to the new 20 percent rate on long-term capital gains.*

* Data as of 2019.

A Roth IRA is tax free as long as investors leave the money in the account for at least 5 years and are 59 1/2 or older when they take distributions or meet another qualifying event, such as death, disability or purchase of a first home.

During retirement

Principle

Withdraw assets or income in retirement from tax-deferred, taxable and tax-free buckets to supplement income already coming in, such as Social Security Income, pension distributions, interest/dividends, and Required Minimum Distributions (RMDs). Then“layer” cash flow across the tax brackets to help reduce overall taxes and increase cash flows on taxable amounts.

70½

Required Minimum Distributions

Individuals are required to withdraw prescribed sums from IRAs and 401(k)s (including Roth 401(k)s each year. Distributions of pre-tax contributions and earnings are taxable (unless they are qualifying Roth distributions) Roth IRAs are not subject to lifetime RMDs and heirs can get tax-free income from Roths.

Qualified Charitable Distributions

If you’re 70½ or older and charitably inclined, you can transfer up to $100,000 from a traditional IRA tax-free to charity each year. It will count as your RMD without being added to your adjusted gross income. You can deduct a QCD regardless of whether or not you are itemizing, which is a big advantage for many people given the increased standard deduction. Plus, keeping your RMD out of your adjusted gross income could help keep your income below the threshold for being subject to the high-income surcharge for Medicare parts B and D, or hold down the percentage of your Social Security benefits subject to taxes.

Distribution Recommendations

1. Look at your Social Security, pension income, and interest and dividends plus RMDs, to see what your base tax rate is for the year. Then decide which tax buckets to choose from.
2. Create taxable income to fill the 0% tax bracket (if not already filled by RMDs).
3. Take long-term capital gains to take advantage of lower tax rates available below certain income levels (see previous page for details).
4. Spend “tax-paid” assets, such as cash, a maturing bond in a bond ladder (i.e., spend principal), or sell a high-basis (low-gain) asset, or offset a capital gain with a loss or a capital loss carry-forward, if one exists. This strategy should create cash flow with minimal taxes.
5. If you have tax-deferred assets such as a 401(k) or IRA, consider taking taxable distributions while you are in a lower tax bracket. Minimizing the average marginal tax rate on these withdrawals can increase the longevity of your portfolio.[1]
6. If you have assets that you won’t need during retirement, consider whether repositioning those assets in a life insurance policy might be right for you. This will eliminate future taxes on the amount your heirs receive, creating a larger benefit to them and potentially offsetting income taxes due on the distributions of any tax deferred assets they inherit.
7. Take cash flow from tax-free assets, such as Roth IRA qualified withdrawals, tax-free withdrawals from a non-Modified Endowment Contract life insurance policy or Health Savings Account (HSA), if appropriate.

Tax Bracket Management

37%
35%
32%
24%
22%
12%
10%

Tax-Free
- Roth IRAs
- Life insurance
- Tax-exempt interest income

Tax-Deferred
- IRAs, 401(k)s, 403(b)s
- Non-qualified Deferred Annuities

Taxable
- Interest income
- Long-term capital gains
- Qualified dividends

[1] 2015 *Tax-Efficient Withdrawal Strategies*, Financial Analysts Journal, Volume 71, Number 2.

[2] Internal Revenue Code 219(b)(5)(B).

[3] Internal Revenue Code 72(t)(2)(A)(v).

[4] Internal Revenue Code 72(t)(2)(A)(i).

[5] See www.medicare.gov/sign-up-change-plans/how-do-i-get-parts-a-b/part-b-sign-up-periods.

[6] See www.ssa.gov/planners/retire/retirechart.html for your full retirement age.

[7] See www.ssa.gov/planners/retire/delayret.html.

[8] Roth IRAs are not subject to lifetime RMDs. In addition, some 401(a) and 403(b) accounts may not be subject to RMDs if actively employed. See Internal Revenue Code 401(a)(9)(A)(1) and 401(a)(9)(C)(1)(1).

Most annuities have a tax-deferred feature. So do many retirement plans under the Internal Revenue Code. As a result, when you use an annuity to fund a retirement plan that is tax-deferred, your annuity will not provide any necessary or additional deferral for that retirement plan. But annuities do have features other than tax deferral that may help you reach your retirement goals. You should consult your tax advisor prior to making a purchase for an explanation of the tax implications.

Investment products are not federally or FDIC-insured, are not deposits or obligations of, or guaranteed by any financial institution, and involve investment risks including possible loss of principal and fluctuation in value.

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