Retirement income planning

How to manage tax liabilities in retirement

Wealth Management

Why tax efficiency matters

As you prepare financially for retirement, you may envision having time—and money—for activities that are meaningful to you. While the financial independence you achieve in retirement does include freedom to choose how you spend your time, the reality is that what you spend for day-to-day living may not change much.

Indeed, your living (essential) expenses (i.e., food, housing, health care, etc.) may stay about the same. Yet many retirees say the biggest surprise about retirement is how much goes to taxes.

Fact is, many high income retirees can expect to pay more in taxes in retirement. However, this should come as no surprise, given that taxes may reduce your income by about a third before you retire.

If reducing your tax burden has been a concern for you during your working years, it may become an even higher priority in retirement. Because when you need your money to last the rest of your life, carefully managing your tax liabilities takes on special urgency.

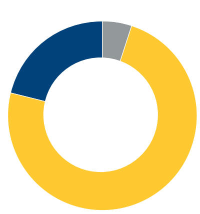
What can you do?

Addressing the following investment considerations with your financial advisor may help minimize your taxes. Which may mean more income for you—and a higher probability of enjoying financial security throughout your retirement.

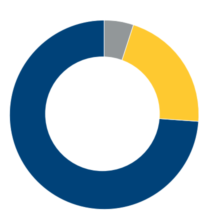
Step 1: Asset allocation and investment selection

First your financial advisor will help you choose your ideal asset allocation. If you visualize your portfolio as a pie chart, asset allocation is how you divide your money among various asset classes (or categories) such as stocks, bonds, cash and other investments.

Some slices may need to be bigger, some smaller. That is because asset classes have different advantages and tradeoffs. Some offer greater potential for growth or income, but with greater risk of losing value. And some offer less risk of losing value, but with less potential for growth or income.



Conservative



Aggressive

Since every investor is different, to determine an asset allocation appropriate for you, your financial advisor will talk about your financial circumstances, goals, risk tolerance and time horizon—as well as your cash flow, liquidity and investment return requirements.

Then they can offer recommendations from a broad range of investment strategies and products.

Like the different "risk and return" potential of asset classes, different investments may offer more favorable (or less favorable) tax treatment. Your financial and tax advisors can help you choose investments offering optimal after-tax return for your unique situation. For example, choosing taxable bonds versus tax-free municipal bonds.

Step two: investment placement

The next step is to determine where you want to place these investments, by understanding the tax treatment of different accounts.

Taxable investment accounts (such as standard brokerage accounts) are subject to tax on interest, dividends or capital gains in the year that it is distributed.

Tax-deferred investment accounts (such as traditional IRAs, qualified retirement plans and non-qualified annuities) grow tax deferred and are not taxed until distributions are taken.

Tax-free investment accounts (such as Roth IRAs and life insurance) grow tax-free and are not taxed at distribution, provided certain qualifications are met.

Some investments are better placed in taxable accounts while others should be placed in tax-deferred or tax-free accounts. The table below summarizes guidelines to consider for placement of different investments.

Non-qualified (taxable)

- Passively managed
- Low turnover
- ETF/Index funds
- Qualified dividend stocks
- Long-term capital gains
- International stocks (FTC)
- Tax-exempt bonds
- Master limited partnership (MLP)
- Single premium immediate annuities
- Life insurance

Qualified (tax-deferred)

- Actively managed
- High turnover
- Small cap
- Short-term capital gains
- Non-qualified dividends
- Taxable bonds
- International bonds
- Preferreds
- REITS
- Option strategies
- Deferred annuities

Roth (tax-free)

Same as qualified, but especially:

- High turnover
- High growth stocks
- Option strategies
- Certain hedge funds
- Variable annuities
- Deferred annuities

Step three: managing distributions

The final step is to determine which accounts to pull income from each year. Since the order of distributions may have tax consequences, you generally have three approaches.

1. Taking entire distributions from your taxable account first may result in a lower tax bracket in earlier years. However, it may lead to higher required minimum distributions (RMDs) at age 73 and potentially higher taxes in later years.
2. Taking distributions solely from your tax-deferred account first may require you to take a larger amount earlier in retirement (because of taxes due) but may help lower future RMDs.
3. Taking a portion from both taxable and tax-deferred accounts provides flexibility to efficiently distribute assets throughout retirement.

Optimum results happen when you withdraw funds in a way that produces the most favorable overall income tax treatment. Not just for the current year, but over the course of your lifetime.

Harvesting strategies

In a paper published in the Journal of Financial Planning (March 2006), Jonathon Guyton describes guidelines he developed on how best to harvest assets from a portfolio to generate retirement income. In general, he found that it's important to try and avoid selling assets that are down in value and when possible to harvest in the following order:

1. Income from interest and dividends distributed first
2. Asset classes with positive returns
   — Begin with equities
   — Then fixed income
3. Cash holdings
4. Assets with negative returns
   — Begin with fixed income
   — Then equities

Rebalancing

Along with the decision rules to avoid selling assets when they are down, it's also important to maintain the overall asset allocation through rebalancing. As you are generating income through the sale of assets with positive returns (selling high), you will also want to consider purchasing those assets with negative returns (buying low) to maintain the original asset mix.

Your tax bracket may also offer general guidelines for optimizing tax efficiency when managing distributions.

Brackets	Strategies
10% or 15%	Draw from tax-deferred assets to receive maximum benefit of lower relative tax bracket. This may also help reduce future RMDs.
25% or 28%	Use tax-free assets to avoid higher income tax rate. For taxable assets, take advantage of lower capital gains rates by selling high-basis assets first and harvesting losses.
33%, 35% or 39.6%	Use tax-free and/or Roth assets

When to deviate from guidelines

While the previous guidelines will make sense most of the time, there will be instances when you may want to deviate from these guidelines depending on the your individual situation.

1. Majority of your assets are in tax-deferred accounts
   — Spending early or converting to Roth may help to minimize RMDs in the future
2. Years where you may be paying little to no taxes
   — In years where you may have large deductions (i.e., medical expenses), it may be an opportune time to distribute from an IRA or convert to Roth to pay 10–15% in taxes now instead of 20–30% in the future.

Selling assets at a loss (tax-loss harvesting)

— The harvesting strategies information did not take into account the effect of taxes, so in some cases it may make sense to sell assets at a loss to help offset gains.

Important caveats

Every client situation is different. So please discuss distribution strategies with your professional tax advisor.

You may also want to consider your heirs' potential income tax brackets when making estate planning choices regarding assets you transfer to them through taxable, tax-deferred and tax-free accounts. Please include your tax advisor and attorney in this discussion.

Keep more of what you earned

Reducing your tax bite may mean having more money to enjoy the retirement you want. Contact your financial advisor today. They can work with RBC Wealth Management specialists and your other professionals to help you effectively manage your investment income tax liabilities.

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