BUSINESS

Road to Retirement: Saving taxes in after you're done working

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It's tax season, and as tax bills come due, many investors wonder what they can do to reduce the taxes they pay on their investment returns. This is particularly true for retired investors, where every dollar paid in taxes is one you can't use to support your lifestyle.

These days, many retirees have sizeable amounts of money saved in retirement accounts, like IRAs. And most retirees quickly learn that once they reach age 70.5, they have to start taking distributions from those IRAs. As the funds come out, they are taxed. These distributions start modestly at age 70.5, but then increase significantly as investors age.

Photograph by Ellen Jaskol
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One primary strategy to reducing taxes in retirement is to think about what sort of assets you keep in your IRA accounts. In a nutshell, if you can keep your slower growing, ordinary income assets in your IRA, you are likely to reduce your overall tax burden in retirement.

To see how this strategy can help, you have to understand what are called the required minimum distribution rules ("RMD"). These are the rules that determine how much you have to take out of your IRA each year. The rules are based on your age and your account value.

The minimum distribution number is a percentage that you have to distribute each year. At age 70.5, the first year you have to take money, the minimum distribution percentage is 3.65 percent. That means you look at your IRA account value at the end of the prior year, and multiple it by 3.65 percent. That is the amount you have to take out and pay tax on. You then follow this procedure every year going forward.

As you age, the RMD percentage moves from about 3.65 percent at 70.5 to 5.35 percent at 80, and 8.8 percent at 90. If you live long enough, you will essentially be required to empty your IRA and pay tax on all that money.

While you have no control over the first part of the RMD formula (the percentage you have to take out), you have some control over the second part, meaning how much is in the IRA. All else being equal, the less of your retirement assets you have in your IRA, the lower your RMD will be because the percentage is applied to a smaller account balance. And if you are distributing less from your IRA, you are paying less in taxes.

Here is an example of the basic strategy: Let's assume you are going to have half your money in stocks and half in bonds in retirement — this just makes the example easier. We'll also assume at 65 you have $100,000 in stocks and $100,000 in bonds; and you have $100,000 in an IRA and $100,000 in a taxable account.

Since over the long term stocks generally grow faster than bonds, should you place the stock or bond investments in your IRA? In many cases, you would be better off investing the IRA funds in bonds and the taxable account in stocks. Why, because the bonds are the slower growing, ordinary income assets.

Let's project forward 20 years to see how this might play out. Assume your stocks grow at 7 percent and your bonds at 3 percent. After 20 years, you'd have about $387,000 in stocks and $181,000 in bonds. Now you are 85 and your RMD percentage is 6.76 percent. Well, if the stocks are in the IRA, you'll need to take out $26,161.

But if the bonds are in the IRA, you'll only have to take out $12,236. Since you are taking out about 54 percent less, your taxes will be 54 percent less.

Moreover, you may recall that stocks that are held outside of retirement accounts are taxed as capital gains. For stocks held over one year, the base capital gains tax rate is 15 percent. Now, if you hold those same stocks in an IRA, the gains are taxed as ordinary income when distributed from the IRA. And that rate is often higher than the long-term capital gains rate. So there is a secondary benefit to keeping more stocks outside of the IRA. Not only are you reducing your minimum distribution, but you are also probably reducing the tax rate applied to gains on those stocks.

The bottom line is to the extent you have control over what assets to hold in your IRA in retirement, it often makes good tax sense to allocate more of your slower growing, ordinary income assets to the IRA.

Taxes are tricky, so you should consult with your tax adviser for guidance. But in general, you may find this strategy is helpful in reducing your long-term tax rate in retirement.

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