Delaying IRA distributions could have consequences

In the pursuit of retirement savings, individuals often strive toward maximum "pre-tax" retirement plan contributions and delay of traditional IRA distributions. Eventually, however, withdrawals must be made through the form of required minimum distributions (RMDs), generally starting by April 1 of the year after one reaches age 70½, and taxes must be paid. For some taxpayers, the strategy of delaying traditional IRA distributions could result in more taxes than expected.

Since every situation is different, this analysis is a bit tricky, but there are a few issues and planning concepts to think about. Remember to consult with knowledgeable tax and legal professionals who can help identify and implement appropriate strategies for each unique situation. Changes in tax law, the impact of inflation, IRA fees and costs, and risks of underlying funding vehicles may have a significant impact on the long-term value of an IRA.

RISING TAX RATES

As a starting point, let's just say that, generally, the more taxable income an individual has, the more tax they will pay. As their taxable income increases, they can be exposed to higher income tax brackets (currently in 2018 the income tax brackets are 10%, 12%, 22%, 24%, 32%, 35%, 37%). And those filing their tax returns as single taxpayers will move into the higher tax brackets sooner than those who file married, filing joint returns. Let's look at two hypothetical scenarios where tax surprises could be waiting.

For retirement plans and arrangements like traditional IRAs, 401(k)s, and 403(b)s, the owners or participants must begin distributions at some point – typically at age 70½. And it's easy to think the best strategy is always to wait as long as possible before taking withdrawals. However, if an individual defers as much as possible for as long as possible, when withdrawals are eventually "forced," they may end up paying tax on these withdrawals at higher income tax brackets. For example, if an individual had a $2,000,000 traditional IRA, the age 70½ required minimum distribution (RMD) would generally be almost $73,000. At age 80, the RMD on $2,000,000 would generally be more than $106,000. And at age 85, the RMD on a $2,000,000 traditional IRA would generally be more than $135,000. These large amounts of taxable income can create large amounts of tax.

The second scenario presents itself after the first death in a marriage. In the year after the year of death, the surviving spouse will most likely file as a single taxpayer and be exposed to the higher income tax rates. Depending on the age of the surviving spouse, the RMDs may temporarily cease or may be even higher than before the death. So, the tax situation might get worse after the first death.

ADDITIONAL TAXES AND COSTS

In addition to the increasing marginal income tax rates there are certain points – usually based on adjusted gross income (AGI) – at which other taxes and costs arrive.

Medicare Part B premiums – The cost of Medicare Part B premium depends on an individual's income. In 2018, a first-time Part B beneficiary in the first income band (modified adjusted gross income (MAGI) less than $85,000 single; $170,000 for married, filing jointly (MFJ)) has a premium of $134.00/month. If the MAGI were between $85,000 and $107,000 ($170,000 and $214,000 for MFJ) the 2018 premium would be $187.50/month – 40% more. This premium continues to escalate (there are five premium levels) until it reaches the highest level at $428.60/month for single individuals with MAGI over $160,000 ($320,000 for MFJ). Keep in mind that for this purpose, MAGI is modified adjusted gross income from two years prior to the premium year and is defined as AGI plus tax-exempt interest income.

The 3.8% net investment income tax (NIIT) – In 2013, an additional tax on net investment income became effective. For those filing single, once MAGI reaches $200,000 an additional 3.8% NIIT is assessed on certain amounts/types of investment income. For individuals filing MFJ, the threshold is $250,000. Interestingly, these threshold amounts are not adjusted for inflation, so it's expected that this NIIT will affect more taxpayers as time

passes. Keep in mind that for this purpose, MAGI is adjusted gross income plus the net foreign earned income exclusion (but also adjusted for certain deductions related to the foreign earned income).

PLANNING CONSIDERATIONS

The timing and sources of income are important when planning for retirement. The following strategies and considerations could play an important role in managing taxes.

Roth IRA – If the withdrawal is a qualified distribution, there is no income tax. Any conversions distributed – including those done as rollovers to Roth IRAs from employer retirement plans – may be subject to an additional 10% federal tax for early distributions. Ordering rules can work in your favor to help avoid taxes on distributions from a Roth IRA.

Social Security – Delaying Social Security in the early years of retirement might create an opportunity to remove money from retirement plans at lower income tax rates, since there will be no taxable income from Social Security. In addition to lower initial tax rates, this strategy would reduce the mandatory distribution amounts later on, since it would reduce the amount in the plan.

Deferred nonqualified annuities – Since nonqualified annuities don't have required minimum distributions, they may be appropriate for money that's not in a retirement plan. This could reduce taxable income and create opportunity to withdraw more from the retirement plans at lower tax rates, since the money in a deferred nonqualified annuity is tax-deferred, so it will not generate taxable income as some other financial vehicles might.

Health savings accounts (HSA) – Before starting Medicare, the health savings account allows pre-tax contributions, and tax-free distributions for qualified medical expenses. Pre-tax HSA deposits and their growth can be used to pay one's Medicare Part B costs in retirement without subjecting the distribution to income taxes.

As the amount of money in retirement arrangements increases, more individuals may end up with tax concerns in retirement. It's important to plan ahead in order to create the most efficient withdrawal strategy.

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