Taxes Can Be a Real Threat to Your Retirement

Unfortunately, you can't bank on the idea that your tax bill will go down in retirement. So, get a plan in place now.

When people are asked what the biggest threats to their retirement plans are, they offer a host of responses. The most common include outliving their wealth, health insurance costs, nursing home expenses and having to help their children or grandchildren financially. All of these can be major threats to retirement plans, but there's one big one people tend to forget: **taxes.**

Having no clear plan to deal with higher taxes is one of the most serious threats to retirement-minded people.

For years, you have probably been told that, when you retire, you will be in a lower tax bracket than when you were working. We are advised to invest everything we can in our 401(k)s or equivalent plans because we will get a nice deduction now, and, when we retire, we won't need as much income. Since we won't be drawing a salary, our tax burden will be reduced.

There are three major reasons why many Americans may not get a tax break when they retire:

1. Most people want to maintain their current standard of living when they retire, which requires almost the same amount of monthly income they enjoyed while they were working — and that comes with similar tax consequences. Although their expenses change (they no longer have to commute to an office, and perhaps they don't need as many suits or dresses anymore), retirees have a lot of extra time on their hands, and that time tends to get filled with things that cost money, like a new hobby or club. Perhaps you will start traveling much more after you retire because you finally have the time to visit new places. It all adds up.

2. Retirees typically no longer have all of those tax deductions they have grown to rely on. By now, most of their homes are paid for, so they no longer have mortgage deductions. Even if they still have a mortgage in retirement, usually, it is almost paid off, so there is little interest to deduct. Chances are the kids are grown and gone. Retirees are no longer contributing to 401(k)s, so those deductions are gone. A lot of people contribute to charities or their churches when they are working, but, after they retire, rather than writing checks, many start contributing their time by volunteering. This is admirable, but the IRS doesn't allow you to deduct your time. All of this being the case, almost all of your income is taxable during retirement.

3. Future tax brackets may be higher than they are today. Most people don't like to hear it, but our current individual tax brackets are about as low as they have ever been. As bad as things are now, the highest bracket we have ever seen stood at 94% during two years in the 1940s. Throughout the 1970s, the top federal tax bracket stood at 70%, and that did not include state or local income taxes. Our current top rate of 39.6% pales in comparison. But Social Security, Medicare and Medicaid remain unfunded liabilities that could lead to tax hikes. So could the national debt, which currently stands just under $20 trillion. With these threats continuing to loom, tax rates could end up much higher than they are today.

There are some things you can do now to help prepare for these possibilities. Plan now to have as much money as you can in tax-free accounts, such as Roth IRAs, Roth 401(k)s and certain **investment-grade insurance strategies**. If your company matches your 401(k) contributions, contribute to it up to the match and take advantage of the extra money. Consider converting your IRAs to Roth IRAs over time.

Create some options for yourself, and do it sooner rather than later. If you wait until you have to start your required minimum distributions (RMD) at age 70½, it might be too late to take advantage of some of the available options. In some cases, the RMDs alone can cause your Social Security benefits to be taxed. If you have to pay tax on your Social Security benefits, it will not only be irritating and frustrating, but you will have to come up with the money to pay the income tax. Typically, it comes from withdrawing additional dollars from your IRAs, which will also be taxed. At this point, you are basically stuck with nothing else to do but pay the increased taxes.
Having a plan to deal with your tax burden in retirement can be the difference between having a successful retirement and struggling to meet your monthly expenses. Consider creating a plan now, because our tax burdens may get worse after we retire.

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