THREE QUESTIONS TO START 2023 TAX PLANNING

Every January, retirees receive 1099s and learn how much income will be added to their tax returns. Now is a great time to review tax strategies.

A tax dollar not paid is a tax dollar saved. In retirement, tax management can affect portfolio sustainability. Every dollar that must be withdrawn from an individual retirement account (IRA) or distributed from other accounts to pay taxes is permanently removed from income and growth production. That dollar is no longer available to produce income or grow money for future needs.

Many retirees have multiple income sources which might include Social Security benefits, the rare pension, investments, rental real estate, employment, or other income. While Social Security benefit and pension amounts are predictable, other sources of income will vary from year to year. This makes tax management more challenging, as it requires careful calculation to maximize the client's growable funds.

For some retirees, the ability to use certain strategies to time and control the recognition of gains allows for better tax management options. These three questions can help you identify which clients might benefit most from starting to plan strategies early in the year.

Question 1: Would your retiree clients, age 70½ or older, prefer to make charitable contributions with dollars that are not included in adjustable gross income (AGI)?

Answer: For retirees with an IRA who are age 70½ or older, a qualified charitable distribution (QCD) can help manage adjustable gross income (AGI). This can be true whether a retiree has reached his or her required beginning date (RBD) and wants to manage required minimum distributions (RMDs) or not. A QCD allows a retiree to make a charitable contribution directly from his or her IRA to a 501(c)(3) public charity. Up to $100,000 per year can be given and each QCD counts as the retiree's RMD. If done correctly, this contribution is not included in the retiree's AGI. As most taxpayers, including retirees, use the standard tax deduction, this lessens the impact on AGI compared to the impact of recognizing income and taking the standard deduction amount.

Remember that the IRS considers the FIRST dollars distributed from an IRA to be the RMD. If a retiree does not want his or her RMD, the first dollars distributed for the year must be at QCD to reduce or eliminate the RMD. For a retiree who does use his or her IRA for annual retirement income, the timing is less critical. The QCD is simply not reportable income, regardless of when the distribution occurs.

Tip: Many retirees include charitable giving in their holiday list. December can be a great time to review giving plans as well as estate planning for the upcoming year.

Question 2: How might the ability to time and control recognition of gains help manage your retirees' 2023 tax bill?

Answer: For many retirees, unpredictable income means unpredictable tax bills. An increase in investment returns can mean a higher RMD as well as higher reportable income in nonqualified managed accounts and mutual funds. This also means higher 1099s.

Deferral from a nonqualified tax-deferred fixed or variable annuity can help some retirees better manage those 1099s. In years with good investment returns, the income from non-annuity sources may be all that is needed. The gains in the nonqualified tax-deferred annuity can stay in the contract and continue to grow tax-deferred until needed or until contract maturity.

Tip: Beneficiaries of nonqualified tax-deferred annuities can still elect a fixed life-expectancy distribution option, also known as a "stretch." This can make a nonqualified annuity an attractive legacy asset.

Question 3: Would tax-advantaged or tax-free income improve your retirees' ability to manage both 1099s and tax thresholds?

Answer: Early in the tax year is always a good time to consider this and weigh the options with your clients. Tax-advantaged income might come from a Roth IRA, municipal bonds or bond funds, or annuitized income from a nonqualified annuity. Each one offers a slightly different benefit.

- **Roth IRA.** A Roth IRA that has met the exception and holding requirements provides tax-free distributions when needed. In turn, this allows the retiree to use the Roth IRA selectively. An example could be using a Roth IRA distribution to cover an unexpected expense, like a major roof repair.

  An additional benefit is that Roth IRAs are not included in the modified AGI or provisional income calculations for Social Security and Medicare's income-related monthly adjustment amount (IRMAA), which can help make managing thresholds easier.

- **Municipal Bonds or Municipal Bond Mutual Funds:** Municipal bonds or municipal bond mutual funds can produce tax-free interest payments. Depending on the type of bond or fund, the interest may be federal tax-free or federal and state tax-free. Remember that this type of income is included in the calculations for both taxable Social Security benefits and Medicare's IRMAA.

- **Annuitized Income from a Nonqualified Annuity:** The tax treatment of annuitized income from a nonqualified tax-deferred annuity is different. This income is eligible for exclusion ratio tax treatment, which means each payment is a combination of return of premium and credited interest or gains. This makes the taxable amount both lower and more predictable.

Each of these tax-advantaged strategies can help retirees reduce taxable income on their 1099s and keep more dollars working for future growth and income.

Tip: A "just-in-case" future income strategy can allow retirees to both manage taxes and create additional predictable income if needed. A tax-deferred annuity with an income benefit or partial-annuitization can accomplish this goal too, albeit in different ways.

The start of a new year is a great time to begin the "tax conversation" with clients. Reach out to retirees as soon as they receive their 1099s to discuss what changes might improve their tax outcomes for 2023. Start the planning process today!

Additional Resources and Links

How to Save on Charitable Giving During Retirement

2023 Medicare Parts A & B Premiums and Deductibles–2023 Medicare Part D Income-Related Monthly Adjustment Amounts

Tax-Deferred Annuities: Three Tips and a Trap

For more information about retirement planning, please contact our Retirement Strategies Group at RSG@PacificLife.com or (800) 722-2333, ext. 3939.
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