Harvest the Gap in Your Income Tax Rate
By Gary Case

When preparing for retirement, and during retirement, it pays to understand your income tax bracket when you consider from which to draw. Our federal income tax system is graduated—that is—the first tier of income is taxed at the lowest rate (10%), the next tier a higher rate (15%), and so on up to 35%. State income tax works the same way, but has only two tiers in Idaho. For you purists, I'm ignoring income tax credits for this discussion.

When drawing income during retirement, a good general principle is to draw income from taxable accounts early in retirement, allowing IRA's, 401k's, and such qualified plans (QPs) to grow tax deferred. However, eventually tax deferred funds must be withdrawn and taxes paid (with the exception of Roth IRA's and certain annuity payout options). It pays to look forward to determine if drawing money now from QPs, either for income or to convert to a Roth, will benefit you. The benefits could include lowering the amount of required minimum distributions (RMD) when you reach age 70 ½ (thus reducing taxes owed later). Often minimum distributions can cause "bracket creep," forcing higher income tax rates in order to satisfy the RMD. Another income tax play could be to sell appreciated assets such as stocks and real estate, paying long-term capital gains rates, which are generally lower that regular income tax rates.

You may want to postpone taking Social Security income, which can help in two ways. First, delaying Social Security until your full benefit age will increase your monthly income for the rest of your life. Secondly, the delay can give you leverage to reposition your QP money to reduce taxes later. Social Security can become taxable, either 50% for "tier 1" income levels ($25,000 for joint filers) or 85% for "tier 2" income levels. See your tax advisor or financial planner for the details of calculating how much of your Social Security may be taxable.

You can "harvest" unused lower tax bracket income by calculating how much income you can take and not move to the next higher bracket. By taking that extra income from QPs or appreciated assets, you may well lower your future income tax burden. You may even be able to engineer high and low income and deduction years to enhance your opportunity to pay less tax! Consult your tax advisor or financial planner to evaluate your options.

Gary Case, CFP®, Cornerstone Financial Planning, 917 2nd Street South, Nampa, 466-1971, is a Registered Representative of Cambridge Investment Research, a Broker/Dealer (Member NASD/SIPC) and Investment Advisor Representative of Cambridge Investment Research Advisors, Inc., a Registered Investment Advisor. Cambridge and Cornerstone are not affiliated.