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Why You Need to Think About Your Retirement Taxes Now

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You probably spend a lot of time diversifying your investments, but it's also important to diversify the taxation that comes with your savings. (iStockPhoto)

It may seem extreme to plan today for the taxes you'll pay 20, 30 or even 40 years from now, but financial planners say smart workers do just that. "Taxes are likely to be one of, if not the largest expense in retirement," says Jeff Fosselman, a senior wealth advisor at Relative Value Partners in Northbrook, Illinois.

After decades of deferring tax on your retirement savings, the tax bill becomes due in retirement. You need to plan ahead if you want to minimize the taxes you will pay during your retirement years.

Income tax is due on retirement account withdrawals. Paul Markowich, a certified financial planner and executive vice president at Firstrust Financial Resources in Philadelphia, says too many seniors face a "tax torpedo" in their later years. They may have saved all their money in traditional IRA or 401(k) accounts, which have taxable withdrawals that will cut into your spending power.

"All too often, people have this thought in their mind that they'll be in a lower tax bracket," says Charlie Harriman, a financial planner with Cloud Financial in Huntsville, Alabama. However, that may not be the case for people who save a significant amount. Plus, Harriman notes the tax code could be completely different decades from now, and it is possible tax rates will rise.

Traditional 401(k)s and IRAs require participants to begin taking a taxable required minimum distribution, known as an RMD, each year after they reach age 70 ½. "The RMD is something people gloss over," Markowich says. However, for someone with a significant nest egg, that RMD – and its associated taxes – can be quite large.

Tax diversification is often overlooked. Workers often spend a great deal of time diversifying their investments, but it's equally important to diversify the taxation that comes with a person's savings. "If pre-tax money is all your savings, then you're going to be floored at how much you'll pay in taxes [in retirement]," Markowich says.

Pre-tax money includes funds put into traditional 401(k)s and IRAs. Those contributions are tax-deductible while you are working, but are subject to regular income tax when withdrawn in retirement. When finance experts talk about tax diversification, they recommend workers also have money available that will not be subject to income tax in retirement, such as investments in Roth accounts or cash value life insurance.

Fosselman says workers may also want to consider how to maintain some tax deductions going into retirement. "I work with a lot of people now who keep their mortgages," he says. "They think their investments will earn more than what they pay in interest, and they like the income tax deduction [for mortgage interest]."

Options make Roth accounts accessible. Roth accounts are a relatively new retirement savings option, and older workers may already have a significant amount of money stored in traditional 401(k)s and IRAs. Others may make too much money to contribute to a Roth IRA, which the IRS limits to those with a modified adjusted gross income of less than $132,000 ($194,000 for couples) in 2016.

In both cases, workers may assume they are destined to pay taxes in retirement, but there are ways around them. Those with a traditional IRA can convert it to a Roth account at any time. Doing so requires a person to pay taxes on the converted amount, but Harriman says that may be preferable to waiting until retirement when tax brackets could be vastly different.

Converting to a Roth IRA is also a way for high earners to get the benefits of tax-free withdrawals in retirement. These workers may be able to contribute to a traditional IRA and then convert it to a Roth account, a process known as a backdoor Roth IRA. "It's a silly nuance in the law," Fosselman says. "I can contribute to a traditional IRA on day one and convert to a Roth on day two."

Even if workers decide not to convert to Roth accounts, they may find it's in their best interest to calculate and plan for the amount of taxes they will have to pay in retirement – even if it will be decades before they are sitting on the beach, drink in hand.