HEATHER SCHREIBER'S

SOCIAL SECURITY ADVISOR

Social Security Planning for Retirement

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Indirect Taxes Can Be Double Trouble for Seniors

Guest Expert

Brad Pistole, CFF®, CAS®

Trinity Insurance & Financial Services

Ozark, MO

Many people base their retirement planning on the principle that income — *and income taxes* — will drop once the paychecks stop. That's among the reasons for the popularity of pretax retirement accounts, where contributions save tax currently and future distributions may fall into low brackets.

That may be the case in some situations, but seniors face two complex financial demands: income tax on Social Security benefits as well as higher-than-standard premiums for Medicare. At our firm, we make a concerted effort to reduce these potential outlays for clients. Among the prime tools we suggest are Roth IRA conversions, especially before required minimum distributions (RMDs) begin at age 72, and qualified charitable distributions (QCDs) from IRAs, available after age 70½.

Rewards of Roth IRAs

We place a major emphasis on tax-free income in retirement because taxable income affects many different aspects of taxation and de facto taxation, including the tax on Social Security benefits and Medicare premium surcharges. Consequently, Roth IRA conversions are appealing.

After age 59½ and 5-year holding period, any distributions from a Roth IRA are free of income tax. That includes distributions of investment earnings! Not only will such distributions avoid income tax, they won't be counted as income for the purposes of taxing Social Security benefits or raising Medicare premiums.

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Note that there are some fine points to consider here. On the plus side, the five-year requirement really is only 4+ years: the countdown includes the year of a conversion plus the next four calendar years, so a December 2022 conversion will allow tax-free gain withdrawals as early as January 2027: 4 years and some days later. Also, Roth distributions are first-in, first-out. The day after a conversion, funds up to the taxable conversion amount may be distributed without any additional income tax.

As for the negatives, Roth IRA conversions don't provide a free pass from the age 59½ deadline. Roth IRA owners must wait at least five years after the conversion or until age 59½ before distributions of converted dollars avoid the 10% early distribution penalty. Of course, the penalty won't apply if any of the published exemptions legitimately can be claimed.

Gains Without Tax Pains

Assuming the timing hurdles are cleared, converting traditional IRAs to Roth accounts provide a totally tax-free future source of investment income.

Example: Al converted $100,000 from a traditional IRA to a Roth IRA and has seen the account grow to $150,000 in five years. Al can withdraw all of those gains, plus the amount invested, without triggering any income tax. Moreover, none of such "qualified distributions" from a Roth IRA will count as income for the purposes of assessing Medicare premiums or triggering income tax on Social Security benefits.

In addition, Roth IRA owners have no lifetime RMDs. Consequently, carefully converting a portion of traditional IRAs to Roth IRAs each year can reduce RMDs, beginning at age 72. Smaller RMDs (possibly in higher future tax brackets) may generate fewer taxable distributions and address concerns that RMD income will add to the taxation of Social Security and to Medicare premium increases.

Savvy Signals to Seniors

For all of these reasons, we talk a lot about Roth IRA conversions to people who are aged in their late 50s and early 60s. Such actions may minimize future taxable distributions from traditional IRAs and other tax-deferred accounts. We believe that it's best to execute these conversions as early as possible, ideally before age 63. Income Related Monthly Adjusted Amounts (IRMAA) of higher Medicare premiums have a two-year time lag (income reported at age 63 will determine age-65 premiums, for example) so high-income seniors might consider extensive Roth IRA conversions that won't show up for premiums at or after age 65, the usual starting age for Medicare.

Converting traditional IRAs to Roth accounts provide a totally tax-free future source of investment income.

It's true that Roth IRA conversions will raise taxes in the year of the conversion. However, astute planning may keep partial annual conversions in today's relatively low tax brackets. Once the funds are in a Roth IRA, those dollars may be available in future retirement years, tax-free, reducing the need to take non-required taxable distributions from retirement accounts, payouts that may have far-reaching adverse effects.

Besides Roth IRAs, where appropriate, we also suggest using Indexed Universal Life (IUL) insurance, perhaps choosing a policy that has an added long-term care (LTC) rider. IUL policies tend to be permanent contracts, so the cash value investment account might appreciate, tax-free. Using indexes that are linked to the stock market, such as the S&P 500, can enable IUL policies to offer some growth potential. In retirement, it's possible that policy loans, withdrawals and LTC benefits can flow to the policy holder, as tax-free cash. If done properly, such cash flow won't increase income tax on Social Security or Medicare premiums.

From Tax-Exempt to Taxable

We also remind people that tax-exempt interest income is included in the formula for calculating the tax on Social Security benefits. Thus, investment income from municipal bonds and muni funds may not truly be tax-free, for many seniors on Social Security. The other avenues mentioned — *Roth IRA conversions, permanent life insurance policies with cash value accounts* — may be better paths to untaxed cash flow in retirement.

As another aspect of this planning, for married couples we stress the importance of letting the higher wage earner defer his or her Social Security income as long as possible to ensure the largest payment available for both spouses for life, as the surviving spouse will collect the larger benefit. The way Social Security benefits are taxed, it is much better to have more income coming from Social Security and fewer dollars from taxable IRA distributions. Number crunching may reveal the wisdom of taking traditional IRA distributions while seniors are in their 60s, if that permits deferral of Social Security benefits until age 70, or nearly there.

Sweet Charity

In addition to the tactics I described, we spend a great deal of time talking to retirees about qualified charitable distributions (QCDs). Once people reach age 70½, they can make charitable donations directly from their IRAs to most charities as QCDs. Individuals in that age group who are charitably inclined definitely should take advantage of the QCD option.

Why is this case? Other IRA owners —*those who are younger* — can't directly contribute to charity from these accounts. Instead, they must withdraw money from their IRAs, creating taxable income. If they itemize deductions, charitable donations can be included.

On the other hand, when seniors use QCDs, there are no taxable distributions and no itemized charitable deductions. *What's better than a deduction?* An exclusion. Technically, an IRA withdrawal is included in adjusted gross income (AGI), which can impact various items on a tax return. An exclusion doesn't count anywhere, typically with a much better result, especially for taxpayers who use today's generous standard deduction rather than itemizing.

At age 72 and older, QCDs satisfy RMDS, even though no income is reported. Not having to report QCDs as income means that there is less chance of paying tax on Social Security benefits and less chance of paying extra Medicare premiums, versus taking steep RMDs from pre-tax IRAs.

Thus, QCDs comprise one more astute tactic that can enable seniors to limit taxable distributions, including RMDs, which will help hold down Social Security taxation and Medicare premiums. Individuals and married couples can use such strategies to trim the chance of being in a high tax bracket during their golden years, effectively saving the Social Security benefits they've earned and keeping Medicare premiums to a minimum.

Advisor Action Plan

- As clients age toward their 60s, explain that some recipients of Social Security benefits owe no

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Editors-in-Chief
Heather Schreiber, RICP®, NSSA®
Ed Slott, CPA

Copy Editor
Ryan Fortese

Graphic Design
Debbie Slott, D. Slott Design

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federal income tax, but others owe tax on up to 85% of the benefits received. Income, including tax-exempt municipal bond interest income, determines how much will be owed, if anything. Most people do not realize that "tax-free" municipal bonds may not be really tax-free, if the interest income affects their Social Security taxation, so this gets their attention.

- Point out that premiums for Medicare Part B (medical costs) and Part D (prescription drugs) can cost almost $500 a month more for some enrollees than for other enrollees in 2022; for married couples, the difference can be almost $1,000 a month. The difference is based on the amount of income reported for 2020.
- Suggest advance planning to control these outlays. Converting traditional IRA money to a Roth IRA can help hold down the future income on which Social Security taxation and Medicare premiums will be based.
- For clients ages 70½ and older, urge charitable donations be made via QCDs, directly to charity, in order to hold down the income that may lead to higher taxes on Social Security benefits and higher Medicare premiums. Informing eligible clients about QCDs (particularly those who are wealthy and charitably inclined) makes them very happy, especially when they realize this won't increase IRMAA surcharges. ■

Brad Pistole is a Certified Financial Fiduciary®, a Certified Annuity Specialist®, and the CEO of Trinity Insurance & Financial Services in Ozark, MO.

Brad has been a member of Ed Slott's Master Elite IRA Advisor Group℠ since 2010. He is a Million Dollar Round Table (MDRT) Top of the Table Lifetime Qualifier. He has authored two best-selling books on retirement planning, and he hosts Safe Money Radio five times a week on several stations in MO, AR, KS, and OK. In 2019, Brad was recognized with the Missouri House of Representatives Resolution by state representative, Lynn Morris, for outstanding achievements in the financial services industry.

Brad can be reached at (417) 581-9222 or at brad@guaranteedsafemoney.com.