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Developing Multiple Sources for Retirement Income

If you anticipate being rich - far beyond your income requirements - in retirement, read no farther. If you are concerned about maximizing the income available to you in retirement, then one of your considerations needs to be the impact of taxes. By having alternative sources of income that are taxed differently, retirees can tap into different sources of funds over the span of their retirement to minimize taxes, reduce the impact of down markets, and have more after-tax funds to spend.

Personal income taxes are typically the highest taxes investors will pay. The largest source of funds for most retirees are tax-deferred retirement accounts. While these funds provided tax deductions during your working years, they are fully taxable as personal income when withdrawn. Federal taxes will claim 22% to 37% of every deferred retirement plan withdrawal as well as interest and nonqualified dividends from taxable investment accounts. Pension payments are also fully taxable at personal income tax rates unless the recipient made after-tax contributions.

Depending on where one lives, state income taxes will take their share as well.

Social Security is not immune to personal income taxes. Depending on the recipient’s income, up to 85% of Social Security benefits can be subject to taxes. That includes survivor and disability benefits.

2024 Federal Tax Brackets

Tax Rate	For Single Filers	For Married Individuals Filing Joint Returns
22%	$47,150 to $100,525	$94,300 to $201,050
24%	$100,525 to $191,950	$201,050 to $383,900
32%	$191,950 to $243,725	$383,900 to $487,450
35%	$243,725 to $609,350	$487,450 to $731,200
37%	$609,350 or more	$731,200 or more

Standard deductions and Alternative Minimum Taxes will impact actual taxes. Net investment income tax (NIIT) factors in for some taxpayers. at a rate of 3.8%. In 2024, the 28% AMT rate applies to excess AMTI of $232,600 for all taxpayers ($116,300 for married couples filing separate returns). AMT exemptions phase out at 25 cents per dollar earned once AMTI reaches $609,350 for single filers and $1,218,700 for married taxpayers filing jointly.

Source: Internal Revenue Service, "Revenue Procedure 2023-34."

Capital gains from the sale of investments held more than a year in a taxable account, as well as qualified dividends, get more favorable tax treatment, leaving the investor with a higher after-tax, take-home amount than ordinary income.

Federal Capital Gains Tax Brackets

	For Unmarried Individuals, Taxable Income Over	For Married Individuals Filing Joint Returns, Taxable Income Over
0%	$0	$0
15%	$47,025	$94,050
20%	$518,900	$583,750

Source: Internal Revenue Service, "Revenue Procedure 2023-34."

Many retirees assume that they will need less income in retirement and will fall into lower tax brackets. But the sale of real estate, business ownership or high value personal property can push taxpayers into higher tax brackets. Required Minimum Distributions (RMDs) based on life expectancy, can also result in higher income than expected.

Reducing the amount of retirement savings lost to income taxes requires developing alternative sources of retirement funds long before you retire. Roth 401(k) and Roth IRA accounts, for example, are funded with after-tax dollars. Withdrawals after five years following the first contribution are exempt from federal personal income taxes as well as most state income tax structures. With no required minimum withdrawals, flexible use of these accounts for income can be used to lower taxable income.

With annuities, the portion of a withdrawal representing the initial principal is tax-free, while earnings are taxed at personal income rates (unless the annuity was purchased with pre-tax funds, in which case the full withdrawal is taxable).

Savings bond interest is taxable at ordinary income rates upon maturity.

Interest from municipal bonds issued by state, city, and county governments, is exempt from federal income tax and may be exempt from state tax. Profits from the sale of municipal bonds, however, have tax consequences.

Life insurance benefits are generally not subject to tax when received as a beneficiary. Surrendering a policy for cash may result in tax consequences.

Gains from the sale of the taxpayer’s primary home that meet specific ownership and use criteria can be excluded from income tax up to $250,000 ($500,000 for married couples). Excess value above the exemption amount is taxed as capital gains.

The goal of developing alternative sources of retirement income is to be able to modify income sources in response to changing circumstances and market returns to minimize taxes and optimize after-tax income.

All too often, investors focus on fees and returns, overlooking the fact that taxes may have a much greater impact on what is available to spend in retirement. If you have not thought about diversifying sources of retirement income, take some time to work with your financial advisor on what you might need in retirement.

The information presented here is an overview only. A number of factors including personal circumstances may affect tax consequences. Consult with your tax advisor before making any decisions.

Brian Carruthers

Brian R. Carruthers, CFP, CMT

BRIAN CARRUTHERS & ASSOCIATES

Your Conservative Advisory Firm Since 1990
301 Forest Avenue
Laguna Beach, California 92651-2115 USA
Telephone: 1-949-464-1900
www.gobcafunds.com
brian@gobcafunds.com