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Protect Your Retirement Nest Egg with Smart Tax Planning

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When presidential power changes hands, wealth managers have their Spidey sense triggered as changes to tax code and investment regulation are often on the horizon. Indeed, the Biden administration has some bold propositions, such as an increase in the top tax rate and the proposal to tax capital gains as income.

And while provocative presidential promises are often followed by bartering and compromise, it's important to understand any potential changes as they happen, especially if you're approaching retirement and need to preserve as much of your retirement savings as possible. Protecting your nest egg is essential.

Retirement planning is an important piece of your overall financial health and advisors spend much of their time making sure clients are minimizing their tax burden. Tax planning is much different than tax preparation. Tax planning is a year-round process where investments, cash, and other vehicles are strategically positioned to maximize tax savings.

Tax planning isn't tax evasion - that's illegal. But there's no need to overpay the government and many of the tax strategies discussed in the following pages will help retirees or high net worth individuals protect their assets from unnecessary taxation.

Income Taxes In 2021

If you receive income in the United States, you'll be subject to income taxes. Income tax varies depending on the amount of income you make annually.

For most people, taxable income is your weekly (or bi-weekly) paycheck. Your employer automatically removes the income taxes for you, along with Social Security taxes, state and local taxes, etc. The federal income tax is usually the biggest hit to your paycheck, especially if you're a high earner in one of the top brackets.

What counts as taxable income in the United States? Any type of compensation you receive for work or services like wages, bonuses, or tips. In addition, gains from investments, rental property income, or sales of assets, like a home are counted as income and taxed appropriately. Even certain types of unearned income like debt forgiveness, alimony, Social Security payments, and other types of government assistance are taxable.

The United States currently has seven tax brackets and the income levels for each one usually change annually to reflect inflation. The federal tax system is progressive, meaning only income over a certain amount is taxed at a higher level.

For example, if your income is $150,000 annually and the tax bracket cutoff is $140,000, only $10,000 if your income will be taxed at the highest level. The first $9,950 you make will be taxed at 10%, and so on throughout the different brackets. Here are the 2021 federal income tax brackets:

2021 Tax Rate	Single Filers	Married Filing Jointly
10%	$9,950 or less	$19,900 or less
12%	$9,951 to $40,525	$19,901 to $81,050
22%	$40,526 to $86,375	$81,051 to $172,750
24%	$86,376 to $164,925	$172,751 to $329,850
32%	$164,926 to $209,425	$329,851 to $418,850
35%	$209,426 to $523,600	$418,851 to $628,300
37%	Over $523,601	Over $628,300

Source: Infopedia, 2021

Your taxable income for the year is known as your Adjusted Gross Income, or AGI. This is your income minus any deductions you qualify for, which is then sent to the IRS. Your tax bill is determined based on your AGI, but there is a tweak to the system if you're a high earner.

The Alternative Minimum Tax (AMT) is a separate calculation that must be made for those with high salaries. Under AMT rules, any individual with an AGI over a certain threshold must calculate their tax bill under ordinary income tax rules AND the Alternative Minimum Taxable Income (AMTI) rules.

The higher total between these two calculations is the one that must be paid. For 2021, the AMT threshold is $73,600 for single filers and $114,600 for married people filing jointly. All income under the AMT threshold will be exempt from the AMTI calculation.

Types of Tax Deductions

The tax code is full of breaks and opportunities for Americans depending on how they've spent or utilized their income throughout the year. A deduction is an expense that can be "written off", or not factored into the AGI calculation. When filing your annual tax returns, deductions can be listed out in two different ways - standard and itemized.

The standard tax deduction is the same and doesn't take into account any expenses or income decisions you've made during the year. With the standard deduction, you don't get to claim individual deductions like mortgage interest or medical expense - you simply deduct the eligible amount from your taxable income and report it to the IRS.

In 2021, the standard tax deduction is $12,550 for individuals, $18,800 for heads of households, and $25,100 for married couples filing jointly. Taking the standard deduction means you won't need to worry about getting audited, but you could be losing cash if you have lots of deductions worth itemizing.

Itemized tax deductions take time and documentation, but could save you a lot of money if you meet the requirements. Unlike the standard deduction, each itemized deduction must be listed on your return and documented in case of an audit. You can't claim medical expenses that didn't occur - you MUST be prepared to prove each of your itemized deductions is legitimate. What qualifies as an itemized deduction? Here are some examples.

- **Mortgage Interest** - If you've taken out a mortgage on your home, you may be able to write off the interest you pay on that loan. If your mortgage originated after December 16, 2016, you can deduct the interest annually up to the first $375,000 of indebtedness (or $750,000 if married filing jointly). So, if you have a $500,000 mortgage with your spouse, you can deduct the interest paid on your 12 annual mortgage payments and the end of each year.

- **Property Taxes** - According to the Tax Cuts and Jobs Act of 2017, property owners can deduct up to $10,000 total in taxes paid on their properties each year.

- **Mortgage Insurance Premiums and Other Property -** Related Deductions - Also deductible are premiums paid on mortgage insurance and home equity loan interest provided the loan was used for home improvement purposes. Moving expenses are also often tax deductible.

- **Medical Expenses -** Certain conditions must be met, but many medical expenses can be itemized as deductions. For example, taxpayers can write 24 cents per each mile driven to doctor's offices or hospitals. Additionally, large medical expenses that consume 7.5% or more of a taxpayer's AGI can be written off. Medical expenses can only be written off in the tax year they occurred, so don't overlook this deduction.

- **Contributions to Charity -** The IRS doesn't want to hit people who donate money to charity. If you make cash donations to a qualified charitable organization, you can deduct these expenses from your tax bill (provided you aren't donating more than 60% of your AGI).|

- **State and Local Taxes -** Known as the SALT deduction, taxpayers can deduct up to $10,000 annually in taxes paid to state and local governments, but ONLY if they did not utilize the property tax deduction. Think of these two deductions as one singular write off. You don't get to deduct state and local taxes if you already took the $10,000 property tax deduction.

- **Retirement Account Contributions -** Taxpayers can deduct a maximum of $19,500 in 401(k) contributions and $6,000 in traditional IRA contributions for 2021. If you're 50 or older, you can add an extra $1,000 to these contribution limits, but understand that this tax break phases out quickly as you climb the income ladder.

Capital Gains Taxes

Income taxes are paid based on the brackets listed above, but what about capital gains taxes? First off, a definition - a capital gain is the profit made on an appreciating asset that's held for longer than one year. Capital gains are incurred from profitable sales of stocks, bonds, real estate, gold and jewelry, or any other type of asset that's value has increased from the time of purchase, including cryptocurrencies transactions.

A capital asset must be sold for the tax to be levied. This is known as a "realized" capital gain. If you have a stock portfolio that's up 50% on the year, those are "unrealized" capital gains because you haven't actually cashed in on the sale. Only realized capital gains can be taxed.

Capital gains are treated more favorably than wages, salaries, or other types of income. The thought process behind this is that capital assets are usually purchased with post-tax dollars, so taxing gains on those assets at the income level would discourage investment. Assets held for less than a year will still be taxed at the ordinary income level. But if you hold an asset for longer than one year and sell it, you'll be taxed at the following rates based on your AGI:

Rate	Single Filers	Married Filing Jointly
0%	$40,000 or less	$80,800 or less
15%	$40,401 to $445,850	$80,801 to $501,600
20%	$445,851 and over	$501,600 and over

Source: Infopedia, 2021

If you earn $550,000 annually, the difference between your capital gains rate and ordinary income rate is 17%, so it's highly beneficial to hold your stocks and bonds for at least a year to utilize the much friendlier capital gains rate.

Assets can also lose value over time. If capital gains taxes must be paid on profits, can capital losses be written off? Yes they can! A popular tax planning strategy is known as tax-loss harvesting while investors sell certain stocks for loss to counteract the taxable gains from selling winners.

If your losses are more than your gains for the year, you can deduct up to $3,000 in losses from your taxable income. You must keep losses and gains separate based on term. For example, a short-term capital loss of $5,000 cannot be written off against a long-term gain of $5,000. Only short-term gains can be used with short-term losses and vice versa.

Tax Strategies For High Net Worth Families

If your family has a high-net- worth and you're looking for ways to reduce your tax burden, consider the following strategies:

1) Don't Neglect Estate Planning

It might be an uncomfortable conversation, but always discuss an estate plan with your advisor so your assets can be efficiently divided up upon your passing. Not only do you need to decide what happens to your properties and retirement accounts, but you also need to determine who should receive power of attorney and lay out any advanced medical directives should you become incapacitated. You don't want to leave important asset decisions in the hands of the state.

2) Utilize Tax Efficient Trusts

A trust won't shield your assets from taxation, but it can prevent messy court situations or battles between heirs. Trusts can be used to hold assets so that beneficiaries receive them upon your passing without the intervention of courts or an executor. One example is the Qualified Personal Residence Trust (QPRT), which helps maximize tax savings under the estate tax exemption.

3) Take Advantage of Gift Tax Exemptions

Under current tax laws, you can give up to $15,000 per year to each of your children, grandchildren, or relatives if you like. Now, this isn't a completely tax-free gift. The recipient of the gift will have the $15,000 count as income on their annual return. But gifts are often sent to beneficiaries in lower tax brackets, who don't pay as much on the income as the original holder of the funds.

4) Understand Changes to Inherited IRAs

Passing retirement accounts down to heirs is a great way to avoid unnecessary taxation, but it's important to understand the new rules introduced by the SECURE Act. As of today, only Eligible Designated Beneficiaries can "stretch" an inherited IRA over their life expectancy. Anyone who doesn't qualify as an Eligible Designated Beneficiary MUST draw down the account within 10 years. In most cases, only spouses and minor children will count as Eligible Designated Beneficiaries.

Tax Strategies for High-Net-Worth Individuals

Here are some individual tax planning techniques for those with high incomes:

1) Max Out Your Available Tax-Advantaged Accounts

If you make too much to qualify for tax breaks on a traditional IRA (or open a Roth), you can still max out contributions to your 401(k) and other tax-advantaged accounts like Health Savings Accounts (HSAs), 529 Plans, and Coverdell ESAs. Utilize as many tax shelters as possible to reduce your burden.

2) Hold Your Investments As Long As Possible

Obviously, you want to hold investments for longer than 12 months to utilize the capital gains rate, but passing on stocks and bonds to heirs is also a good way to reduce your overall tax burden (provided the heirs are okay paying taxes on the investments at their current rate). Taxable events only occur upon the sale of an asset.

3) Buy Municipal Bonds

Munis won't make you rich, but they are a great way to preserve purchasing power while avoiding federal taxes. Most municipal bonds are only taxed at the state level, so high earners can park money into municipal bonds and avoid paying federal taxes on their gains.

4) Utilize a Backdoor Roth IRA Conversion

Anyone with an AGI over $140,000 cannot contribute to a Roth IRA, but that doesn't mean they can't open one. Thanks to a loophole in the tax code, high net worth individuals can make non-deductible contributions to a traditional IRA and then roll those contributions over to a Roth IRA. Once inside a Roth IRA, your assets grow tax-free and won't be subject to required minimum distributions.

How Impending Income Tax Changes May Influence Your Retirement

One of the propositions on the table for President Biden's 2022 agenda is raising the highest tax bracket. Under this proposal, the highest tax bracket will jump from 37% to 39.6%, which has caused many high earners to consider tax-advantaged accounts like HSAs and Roth IRA conversions.

Additionally, a proposal to raise corporate taxes from 21% to 28% could also affect retirement if public company earnings take a hit and stock prices decline.

While stocks don't necessarily move in conjunction with corporate tax changes, a hit to profitability could spook investors in 2022.

Will Capital Gains Taxes Change in 2021?

One of the scariest proposals coming out of the Biden Administration is a change in how capital gains taxes are levied. Under current rules, the maximum rate for capital gains is 20% (or 28% for collectibles). But Biden's proposal would basically eliminate the capital gains rate for investment income over $1 million, meaning any income from investments over that amount will be taxed at the ordinary income level of 39.6%.

Thankfully, this proposal isn't on the table for taxes in 2021, so investors and retirees have time to adjust their strategies and maybe take some gains off the table now and pay the more favorable rate. If the proposal does go through in 2022, high income investors could see their tax burden double.

43.4% Capital Gain Tax? 10 Things To Know

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