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5 Tax Gotchas in Retirement

By Debra Taylor, CPA/PFS, JD, CDFIA

If you are wealthy and reaching your distribution phase, your high-balance retirement accounts can create some burdensome tax situations, particularly when it comes to legacy planning. Here are five potential pitfalls you should be aware of.

Most people are very proud of their wealth. And why shouldn't you be? You've worked your entire life to build your investment accounts and often sacrificed a great deal. However, once you hit the retirement "spending" phase, the government changes the rules on you, and you could essentially be punished for decades of following the rules and scrupulously saving.

The saddest part is that most people don't know what awaits them, as they have never retired before and they aren't aware of the potential pitfalls that their accumulated retirement accounts can cause.

WHO IS MOST AT RISK?

Those with traditional IRAs of about \$2M face significant tax planning challenges, when you consider how much an account that size could grow over a decade or two.

This is especially important when you are trying to create a legacy for your family at the end of your life.

1. RMDs ARE FOR LIFE*

Depending on the year you were born, required minimum distributions (RMDs) start at age 73 or 75 and only increase from there. RMDs grow based on the IRA account size and they also increase as you age. So, at age 73 the RMD may be only about 4% of the account value, but that annual distribution grows to 6.25% of the account value at age 85, which would be added to a Social Security benefit and boost your tax bill.

The key remedy here is to start distribution planning well in advance of age 70 with an eye on keeping taxes as low as allowed by the tax code.*

2. BEWARE OF THE EXPIRATION OF THE TAX CUTS AND JOBS ACT OF 2017*

To make matters more pointed, the taxable income (generated from RMDs and everywhere else) could be taxed at an even higher tax rate after 2025, since the TCJA sunsets at the end of that year. If the TCJA is permitted to expire without any congressional action, then tax rates will be increasing across the board. In addition, the lifetime exemption for estate taxes will be cut in half, adjusted for inflation.

Neither of these changes will be good for wealthier people with large IRAs, because the highest tax bracket will increase to 39.6%. Other tax brackets will increase and will also kick in at lower amounts. For example, a hypothetical couple with \$300,000 of income is now paying taxes at the 24% marginal rate but would be paying in the 33% tax bracket if the TCJA expires. That's a big difference.

To be clear, the expiration of the TCJA is not the only tax policy risk that wealthier people are facing. There is serious additional tax policy risk, as income inequality is real, and so are budget deficits.

The only remedy here is to follow the tax legislation closely, and to position income and your estate for a possible repeal of the currently very favorable tax

backdrop. An ounce of prevention is worth a pound of cure.

3. BEWARE THE WIDOW PENALTY

Many couples file as "married filing jointly," which is an advantaged status for every tax bracket except the highest one. Once one spouse dies, then the surviving spouse is filing as "single," which uses tax rates at roughly half of the taxable income of the married filing joint tax bracket. However, the surviving spouse will typically have about 90% of the income, as the IRAs will go to them. The widowed person also can step into the higher Social Security benefits, which are often the deceased spouse's (thus giving up their own lower amount, which is typically not too significant). This shift in tax rates can amount to about an extra 10% a year in a tax-rate increase for the surviving spouse.

Not only that, but the widow penalty also affects IRMAA Medicare surcharges, often causing the widowed person to pay more in IRMAA surcharges as a single than the couple did while both were alive.

4. RECONSIDER LEAVING A LARGE IRA TO YOUR CHILDREN*

The government passed the SECURE Act in December 2019 to make it difficult for you to pass that large traditional IRA to your children. The SECURE Act requires the inherited IRA to be withdrawn over 10 years for most beneficiaries, often thrusting beneficiaries in their peak earning years into a higher tax bracket.

Previously, beneficiaries could deplete that IRA over their life expectancy, allowing up to 40 years (in many instances) of tax efficient withdrawals. No more. Further, in July 2024 the IRS and Treasury Department clarified that beginning in 2025, most non-spouse beneficiaries who inherit an IRA account must take annual required minimum distributions (RMDs) from the IRA starting the year after the death of the original owner. This RMD is in addition to the existing 10-year rule that the entirety of the inherited IRA must be distributed by December 31 of the 10th year following the death of the original owner.

The remedy here is to engage in smart distribution planning well before retirement. Draw down those traditional IRA accounts so the government has less to chase after as your accounts grow

5. ESTATE PLANNING IS GETTING TRICKIER AND TRICKIER*

Income taxes are not the only area of tax law that has become controversial. Estate taxes are also a hot-button issue, with both parties fighting over the ability for wealthy families to pass their wealth to future generations. There have been many proposals during the years, mostly curtailing popular estate planning strategies. In addition, the currently very generous lifetime exclusion of \$13.99 million is due to expire at the end of 2025.

All of this adds up to a real challenge to families who have \$6 million or more in assets. HNW estate planning often requires years of advance preparation, but new tax legislation is often passed with very little warning—and can be retroactive if Congress so chooses.

The remedy here is to have a good plan for retirement that focuses on potential tax liabilities.

**Always consult a tax professional before taking action.*

Debra Taylor, CPA/PFS, JD, CDFA, writes on tax and retirement planning for Horseshoehn, an independent organization providing insight into the critical issues facing financial professionals and their clients.