Retirement and Taxes:
What You Need to Know Now

Including changes based on the Tax Cuts and Jobs Act of 2017

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Taxes are a critical piece in retirement planning, yet most financial advisors avoid discussing the topic for several reasons. First and foremost, they fear violating federal regulations or industry standards that limit who can provide "tax advice."

The result? Advisors and firms are reluctant to talk taxes or incorporate tax-related tools, even if these tools help deliver better financial advice through the consideration of the likely tax consequences of various strategies. The topic of taxes is like the elephant in the room - many financial advisors know taxes have a significant impact on their clients, but due to uncertainty surrounding the scope of their duty to clients and the possibility of compliance issues for addressing taxes, they ignore or gloss over the topic of taxes.

Lumping anything tax-related into "tax advice," however, is a disservice to the client.

Under the current suitability standard and definitions of "tax advice," financial advisors may already have a duty to understand, consider and explain the tax consequences of various strategies.

So, let's turn our gaze toward that elephant in the room. **What exactly is tax advice?**

"Tax advice" is quite poorly defined by the legal, accounting and financial services industries.

Is tax advice informing a client that selling a stock with a gain will result in tax consequences? Or comparing the after-tax return of a municipal bond to a corporate bond? If you helped a client decide whether to save into a traditional IRA or a Roth IRA, would you be giving tax advice? You could even argue that advising a client on which account to draw from at different points in retirement could be tax advice.

Federal law (26 U.S. Code § 7525**) defines tax advice as** “advice given by an individual with respect to a matter which is within the scope of the individual's authority to practice described in subparagraph (A)”. Subparagraph (A) defines a "federally authorized tax practitioner" as any individual who is authorized under Federal law to practice before the Internal Revenue Service if such practice is subject to Federal regulation United States Code."

For financial advisors the definition of "tax advice" has taken on a broader meaning than originally intended.

The standard financial services disclosure - used by financial advisors when meeting with clients - simply intends to explain that the financial planner's advice does not constitute tax advice, as defined by law. In other words, the tax-related considerations that may have entered the financial advisor's process are not tax advice by definition. Unfortunately, the language of the ubiquitous disclosure has made advisors and many compliance departments overly leery about discussing the tax implications of various actions that are central to the duties of a financial advisor.

Individuals should seek tax advice to ensure that in the event their actions, with respect to their tax returns, create tax penalties, they may pursue relief from the penalties due to their reliance on tax advice.

Although the requirements for abatement of penalties are beyond the scope of this article, in general, a taxpayer must be able to demonstrate that they had reasonable cause for underpayment and good faith in compliance with tax law overall. If a client wants tax advice - meaning an opinion from a federally authorized tax practitioner who could prepare returns and defend the client in front of the Internal Revenue Service, and potentially qualify for abatement if the advice was incorrect - the proper source would be a Certified Public Accountant (CPA), Enrolled Agent or attorney.

In contrast to the stance taken by many in the financial services industry, the Certified Financial Planner Board of Standards states in its "Financial Planning Competency Handbook:"

“A competent financial planner can evaluate multiple years of prior 1040s and supporting documents to inform present tax-planning decisions and identify planning opportunities and areas of concern for the current and future periods.”

The handbook actually provides descriptions of tax-related capabilities for entry-level, competent, and expert financial planners related to a wide variety of financial situations - from the purchase of investments, life insurance and annuities to pension distribution options, work and self-employment income and others.

Non-CFP® financial advisors may be tempted to consider these capabilities irrelevant to their practices and choose instead to use the tax advice disclosure as a means to avoid the time and effort involved in using tax-related tools and developing related knowledge. Many of these advisors are registered representatives of broker-dealers, who are subject to rules of the Financial Industry Regulatory Authority (FINRA). FINRA rule 2111 "requires that a firm or associated person have a reasonable basis to believe a recommended transaction or investment strategy involving a security or securities is suitable for the customer. This is based on the information obtained through reasonable diligence of the firm or associated person to ascertain the customer's investment profile."

The rule further states that the customer's investment profile "includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objective ... "(emphasis added).[1]

The application of the suitability rule as it regards taxes was demonstrated in a recent arbitration.

FINRA Awards $50,000 to Client After Advisor's Tax Oversight

An advisor in Florida suggested that an 82-year-old woman's daughter and power of attorney withdraw her mother's IRA CD to help pay for the mother's care. The transaction created a $9,000 tax bill. The daughter brought the case to arbitration and was awarded approximately $52,000 in damages, including triple damages and the classification of the incident as "exploitation of an elderly person" under Florida state law-even though the advisor didn't actually sell anything (1).

(1) http://www.finra.org/industry/suitability

Although the case is nonpresidential, it may shed light on the duty of an advisor to discuss potential tax consequences. If this judgement can occur under a suitability standard, it is reasonable to expect that this sort of case may become more common under the new fiduciary rules, which require a more comprehensive understanding of a client's overall situation.

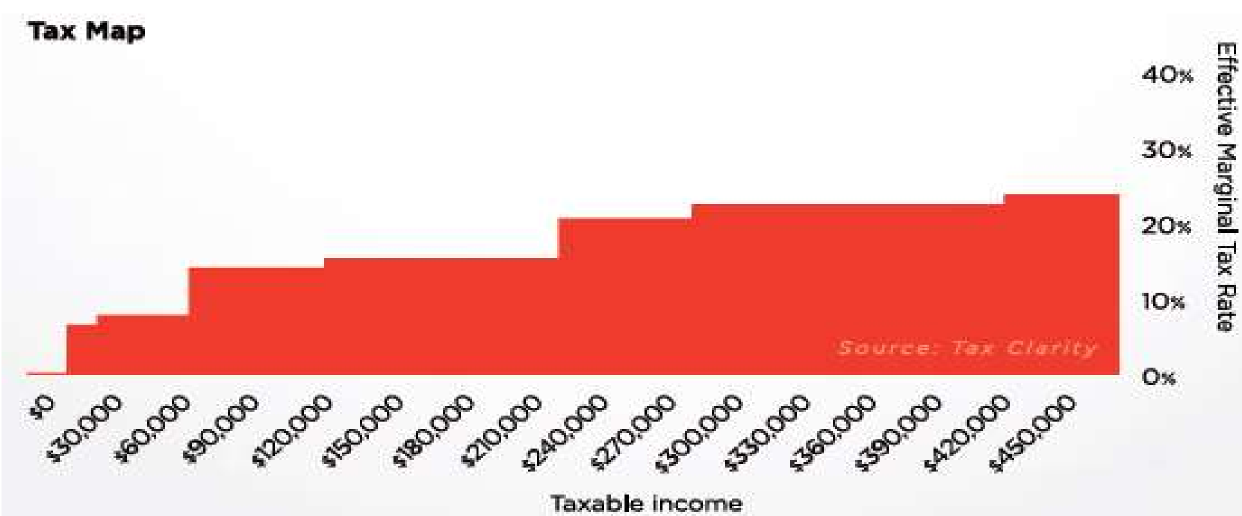
The first step in addressing the elephant in the room - to fulfill the advisor's fiduciary duty - is to explain to clients what is and what is not tax advice and recommend that clients consult with a CPA or Enrolled Agent prior to any transaction that may have significant tax implications. But it's not the only step.

The next step is understanding that the interactions of various tax provisions can increase an individual's overall tax liability and, in turn, diminish the sustainability of their retirement income. In retirement, it is not uncommon to see one extra dollar that's harvested from the wrong account at the wrong time snowball into $3.70 of income subject to tax. Financial advisors who understand this snowball effect and can explain it to their clients will differentiate themselves from those advisors who are simply out to sell product.

The federal income tax system in the United States is progressive, meaning individuals or couples with lower levels of "taxable income" pay a lower rate than those with higher levels of taxable income. Most advisors have seen federal income tax tables that look something like this:

Rate	Single Filers	Married Filers	Head-of-household Filers
10%	$0 to $9,525	$0 to $19,050	$0 to $13,600
12%	$9,526 to $38,700	$19,051 to $77,400	$13,601 to $51,800
22%	$38,701 to $82,500	$77,401 to $165,000	$51,801 to $82,500
24%	$82,501 to $157,500	$165,001 to $315,000	$82,501 to $157,500
32%	$157,501 to $200,000	$315,001 to $400,000	$157,501 to $200,000
35%	$200,001 to $500,000	$400,001 to $600,000	$200,001 to $500,000
37%	$500,001+	$600,001+	$500,001+

The illustration below represents these tables graphically. This is called a Tax Map, because it visually identifies where a client's ordinary income places them on the landscape of tax rates. Moving from the left to right at the bottom, as taxable income increases, the dollars that fall into each taxable range are taxed at the corresponding amount (on the Y axis at right).



For example, a married couple, filing jointly in 2018 with taxable income of $10,000 would be taxed at a 10% rate, resulting in a tax bill of $1,000.

If you had no real-world experience with tax rules, you might think this means you simply add up all of your taxable income and multiply it by the appropriate rates in the table. For example, if a married couple has an income of $40,000 of Social Security benefits and $15,000 of IRA withdrawals, this so-called "intuitive tax calculation" would add up to $6,219 in taxes. The American tax system is not that simple.

"Intuitive Tax Calculation" for $40,000 of Social Security and $15,000 of IRA withdrawals

Income bracket		Tax rate		Taxes
$0 -19,050	x	10%	=	$1,905
$19,050 -55,000	x	12%	=	$4,314
Total	"Intuitive" Tax		=	$6,219

The "Taxable Income" Challenge

The challenge with income tax lies in the definition of taxable income.

Taxable income represents a highly complex set of interactions between different rules related to different types of income.

This creates a very difficult landscape for advisors and clients to navigate when constructing financial plans.

Counter to the example above, a couple with $40,000 of Social Security benefits and $15,000 of IRA withdrawals, would pay no federal income tax in 2018.

How could that happen? First, you need to determine how much of the Social Security benefit is treated as taxable income - and how much is tax-free. That calculation requires several steps:

1) Determine the provisional income by taking 50% of the Social Security benefit and adding the IRA withdrawal (2).

[2] If the client had additional incomes through the year, such as taxable interest, nontaxable interest, dividends or capital gains, those amounts would also be included. We include only the IRA withdrawal here for simplicity of the example.

2) Apply the thresholds for taxability and multiply the amounts over the thresholds by 50%, and 85% respectively.

3) Compare the result to the maximum taxable Social Security amount, which is 85%(3) of the full benefit amount. The lesser of the two is the taxable portion.

In this case, the taxable portion of the Social Security benefit is $1,500.

Now, add that to the taxable IRA withdrawal, which was $15,000.

The total taxable income is $16,500.

Taxable income must be reduced by any deductions. The standard deduction for a married couple for 2018 is $24,000, plus an additional $2,600 if both are 65 or older. Our total deductions and exemptions are $26,600.

Total taxable income		$16,500
Minus deductions and exemptions	-	$26,600
Net taxable income	=	-$10,100

Finally, apply the corresponding tax bracket to the result. How do you do that? There is no bracket that dips into the negative.

Many advisors might consider taking an extra $10,100 out of the IRA. Conceptually, a negative $10,100 result would mean a client could add $10,100 of taxable income without paying tax, right? Here's what would happen if you added a $10,100 withdrawal from the client's IRA:

Taxable Social Security benefits		$6,935
Taxable IRA withdrawals	+	$25,100
Taxable income	=	$32,035
Minus deductions and exemptions	-	$26,600
Net taxable income	=	$5,435

In the second case, an additional IRA withdrawal of $10,100 created additional taxable income of $15,535.

[3] The thresholds for married filing jointly are $32,000 (50%), and $44,000 (85%).

If a client had only Social Security benefits, they would be entirely tax-free, but once you begin to add other types of income, Social Security benefits begin to become taxable. In this case, each dollar over $12,000 withdrawn from the IRA causes $1.50 to appear on the tax return, having an outsized negative impact on the client's tax situation.

Another example of this phenomenon is capital gains. If a married couple over age 65 had only long-term capital gains and qualified dividends on their return with no other income in 2018, they could actually take $103,800 of capital gains and qualified dividends and pay zero federal income tax[4]! The reason is because any long-term capital gains or qualified dividends that occur while the client's adjusted gross income (AGI) is under $77,200 receive a 0% tax rate. In other words, one additional dollar of capital gain or qualified dividend may or may not be taxable depending on what is on the return.

Not only does the tax code preserve certain types of income that are only taxable based upon the other income on the return, but it also preserves the phase-out of some deductions based on other income on the return.

For example, let's look at the medical expense deduction, because it is quite common for retirees. Historically, the threshold for deductibility of medical expenses has been a moving target, recently to the extent they exceeded 7.5% of Adjusted Gross Income (AGI), then the tax law changed so they were deductible when they exceeded 10% of AGI. The Tax Cuts and Jobs Act of 2017 (TCJA) reduces that threshold back to 7.5% for 2017 and 2018. In other words, if you have $50,000 of AGI, only amounts above $3,750 of medical expense would be deductible. So, if a client has a $15,000 medical expense, he is allowed to deduct $11,250. However, he has to get that money from somewhere, so he withdraws it from his IRA. And that move has two major consequences. First, the IRA withdrawal pushed his AGI up by $15,000 to $65,000 - 7.5% of which is $4,875 - meaning he is only able to deduct $10,125 of medical expenses rather than the $11,250 that he could have deducted prior to making the withdrawal.

Overall, the $15,000 IRA withdrawal caused him to have to pay taxes not just on the $15,000, but also on an additional $1,125 of deduction that was lost because of another tax rule - a phase out of itemized deductions for income over certain thresholds. In other words, he pays 1.075 times the tax rate on the extra withdrawal.

[4] Based on 2018 brackets.

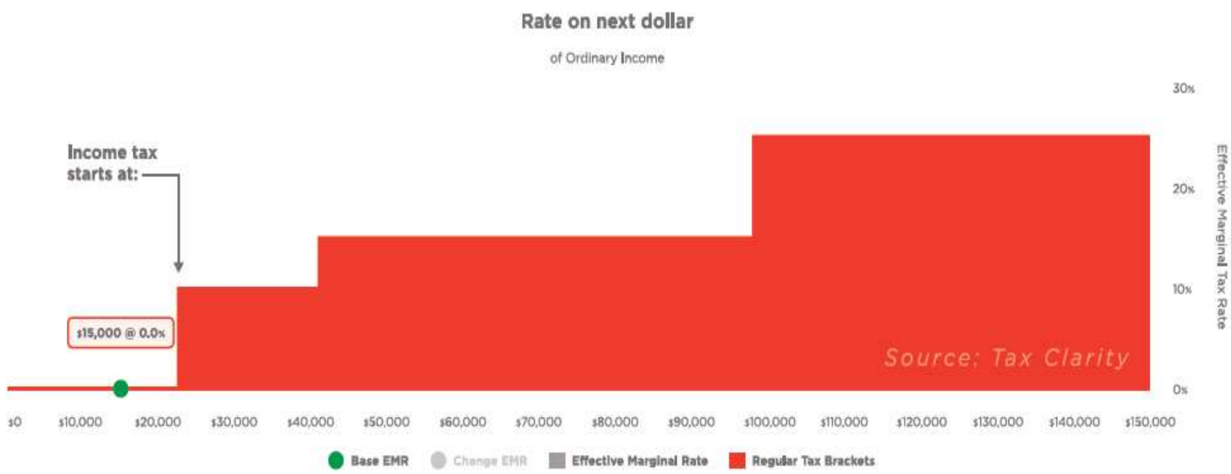
These examples are just the beginning; there are several more that you should be aware of. Sometimes you will see interactions in which an individual has capital gains, ordinary income and Social Security. In the absence of each other, it is possible that neither the gain nor the Social Security would be taxable. But when an individual has capital gains and also is collecting Social Security benefits, it means that a portion of Social Security becomes taxable. The amount at which it's taxed can vary, from 50 to 85 cents. Once Social Security enters the equation, a client must figure out his or her "provisional income," or how much Social Security is taxable. ("Provisional income" includes half of a client's Social Security benefits, plus all other taxable income, including dividends, realized interest and realized capital gains, plus nontaxable interest earnings, such as from municipal bonds.)

In this scenario, when you include the capital gain in the provisional income calculation, 50 or 85 cents of a Social Security dollar becomes taxable, which makes the capital gain taxable. The combination of Social Security with ordinary income, such as IRA withdrawals and capital gains, can create a "snowball" effect where the resulting tax on one additional dollar of income recognized is far greater than what is expected.

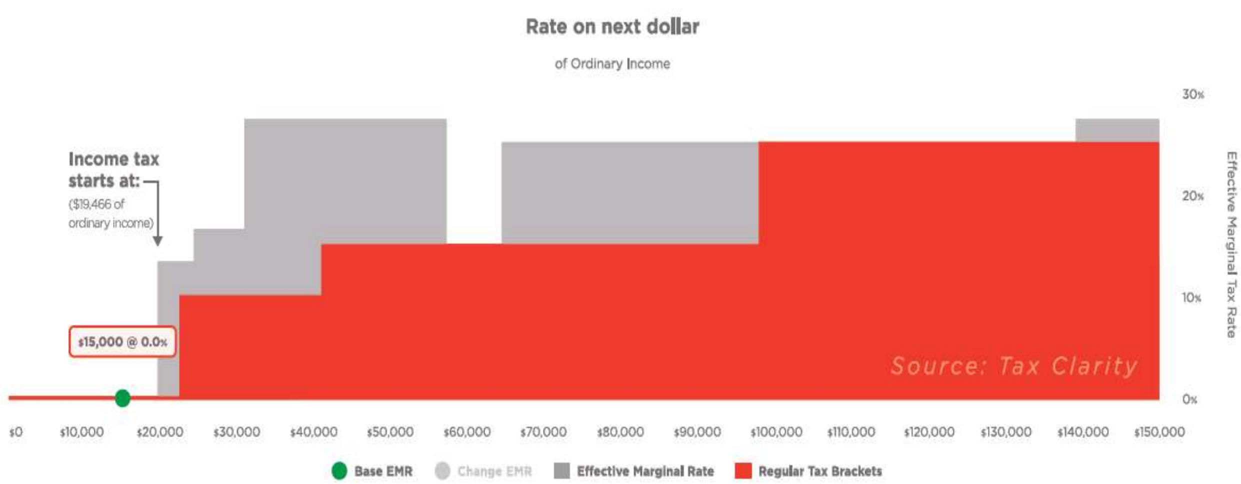
Individually capital gain, IRA withdrawal and social security income may not be taxable, but when you put them all together taxes snowball.

THE EFECTIVE MARGINAL RATE

When you add $20,000 of capital gains into the mix, the Tax Map changes significantly. Although the capital gain itself is not taxable because the client's AGI fell below the threshold for taxable capital gains, $378 of federal income tax was created because the capital gain created additional taxable Social Security and used up part of the deductions and exemptions. And that caused a small amount of ordinary income tax.



Now, add a Social Security benefit in the mix. Remember: Social Security is not taxable as ordinary income by itself and only becomes taxable as ordinary income in the presence of other income. The following Tax Map displays the consequences of adding Social Security income. The gray shows the "effective marginal rate," which is the rate that would actually be paid on the next dollar of ordinary income.



For this particular individual, IRA withdrawals begin to create income tax once they reach roughly $21,750. The effective marginal rate in this range is 15%, which is created by one dollar of IRA income causing $0.50 of Social Security to also become taxable -and both the IRA and Social Security are taxed at 10%. The next step up is 18.5%, where one dollar of IRA withdrawal brings $0.85 of Social Security into the calculation, and both are taxed at 10%. The third step, during much of the range in which the client may expect to be in the 10% or 12% bracket, one dollar of IRA brings in $0.85 of Social Security, and both are taxed at a 12% rate. In other words, on each additional dollar of IRA withdrawal, the client is actually creating an additional tax of 22.20 cents (a 22.2% effective marginal rate).

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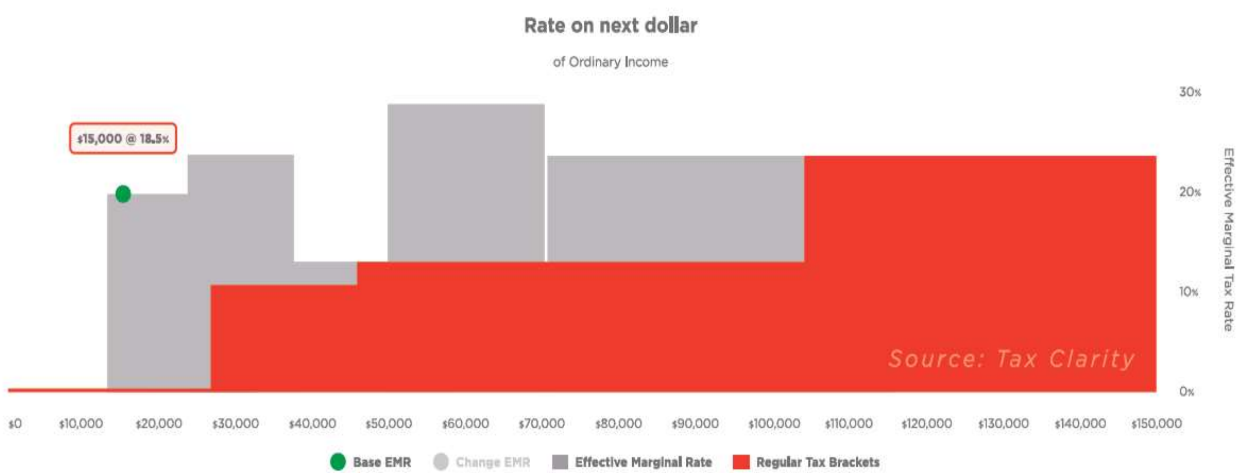
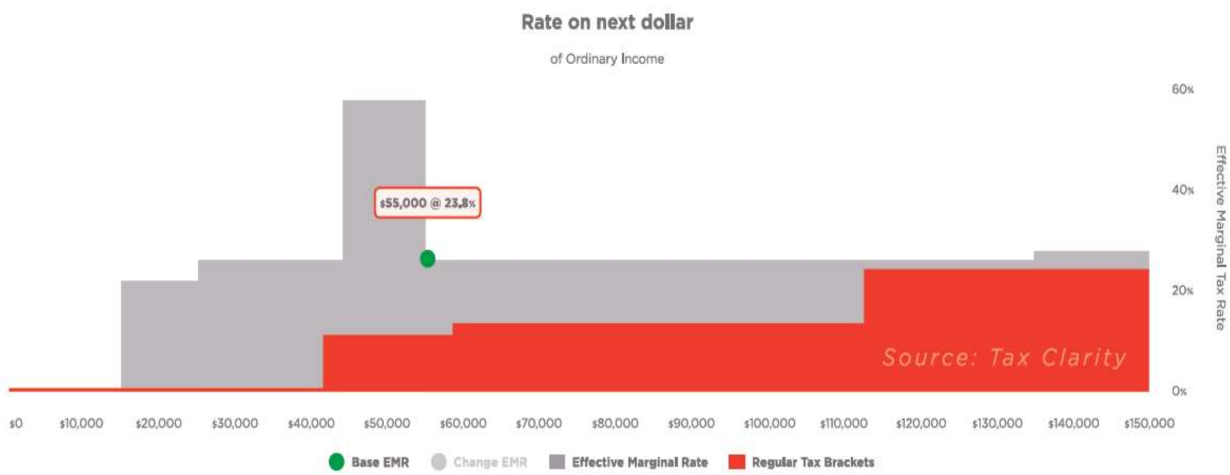
You now have a 27% rate that would be paid between approximately $49,750 and $70,000 of IRA withdrawals. An additional dollar of IRA withdrawal in this range brings a dollar of capital gain that would have come through at a 0% rate into a 15% rate (and the IRA dollar itself is taxed at a 12% rate), so each additional IRA dollar withdrawn in that range faces a 27% effective marginal rate.



For one final example, assume a couple is married filing jointly, both over 65, with combined Social Security benefits of $75,000, with $15,000 of capital gains, and $55,000 of IRA withdrawals. Assume further, the couple has a $50,000 medical expense this year. Here is the Tax Map:



Notice the intuitive Tax Map (in red) shifts well to the right due because the couple has the large deduction for medical expenses, but the effective marginal rate of 20.35% still begins at only $14,750. The 20% rate occurs because one additional dollar of IRA withdrawal creates 85 cents of taxable Social Security and also phases out 7.5 cents of tax deduction because the IRA withdrawal triggers taxable Social Security, which then causes both the IRA dollar and the 85 cents of includible Social Security to increase the threshold for deductible medical expenses.

The most noticeable spike on this Tax Map is on the last ten thousand dollars of withdrawals from the IRA. In this range, each additional dollar of IRA withdrawal brings 85 cents of a Social Security dollar into taxable range, which then pushes $1.85 of capital gains out of the 0% bracket and into the 15% bracket. In this range, the one dollar actually created over 53 cents of federal income tax. Of course, for retirees, it is not uncommon to see IRA withdrawals, capital gains or dividends, Social Security benefits, and medical expenses at the same time.

Individuals need to understand the value of tax-sensitive retirement income strategies by visualizing a snowball - one additional dollar, harvested from the wrong place or at the wrong time, can drag another dollar or more into the tax calculation, creating tax impacts dramatically higher than what the taxpayer would expect.

The fiduciary rule - because it requires more advisors to act in the best interest of their clients - will create an environment in which ignorance of the tax implications of retirement advice will no longer be tolerated. As we've shown, the tax conse-quences of interactions between multiple income sources can be so significant and unexpected that advisors acting in the best interest of their clients cannot ignore the topic of taxes.

Multiple studies - including research sponsored by Vanguard, Morningstar and others - have confirmed that tax-efficient strategies may add between 23 basis points (Morningstar asset location and withdrawal sequencing) and 145 basis points[5].)

Advisors will no longer be able to hide behind disclosures stating that they "do not provide tax advice." They will need to understand, evaluate and explain the consequences of various income and withdrawal strategies and to document how their advice was in the best interest of their clients. They will be forced to equip themselves with tools that thoroughly consider a client's overall financial situation, including the tax implications of various strategies.

To have a professional review your personal situation and answer any questions you may have please contact us at https://www.uswealthgroup.com/contact.html.

5- Vanguard 70 basis points for implementing a spending strategy and 75 basis points for asset allocation