SONMORE FINANCIAL

2024 Tax Planning Guide for Retirement

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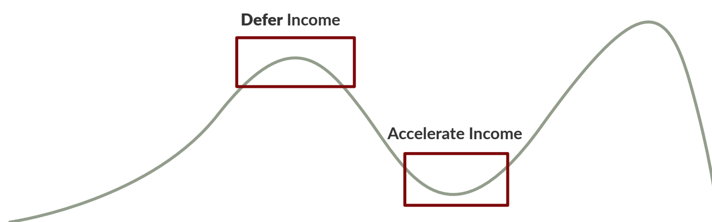
6 Tax Planning Steps That Can Improve Your Retirement

Preparing for retirement can be overwhelming. There are many things to consider in an ever-changing environment, so it's a good idea to focus on what you can control. Consider these six tax planning steps to help prepare you for retirement.

A common tool we use with clients is the image of your taxable income over time on a graph.



During your high-income years, your goal might be to defer income to later years, when you estimate your taxes may be lower. During your low-income years, your goal might be to accelerate income.

This simple framing helps to outline strategy for many of the tax topics we address in this guide. If you have an abnormally high-income year, you might do more pre-tax contributions and try to bunch charitable contributions into that year through a Donor Advised Fund. If you have a lower-than-normal stretch of years, as is common to see for retirees from the time they retire until they get to age 73, and have RMD's, then you might accelerate income by either making Roth contributions and/or converting funds from pre-tax to Roth. You may also tax gain harvest in some of these years.

1 Take Advantage of Your Tax-Advantaged Accounts

There are three main tax-advantaged accounts: Employer sponsored retirement plans like a 401(k) or 457, individual retirement accounts (IRAs), and health savings accounts (HSAs).

Company or employer-sponsored retirement plans like a 401(k) allow you to make contributions on a pre-tax or a Roth basis. For tax year 2024, you can contribute up to $23,000 if you're under 50 years of age and $30,500 if you're over age 50. Some employer plans allow you to make after-tax contributions, where individuals can contribute roughly an additional $40,000 on top of the normal contribution limits. These after-tax contributions can then be rolled over into your Roth IRA in what's referred to as an In-Service Rollover. Both of these options can be appealing for someone with the income ability to make the higher contributions who is also trying to max out their retirement savings as they approach retirement.

Below is a chart illustrating how various contribution types are taxed:

CONTRIBUTION TYPE	IN	GROWTH	OUT
Pre-Tax	You receive a **deduction** from income **for the contribution** amount.	The funds **grow tax- deferred.**	Every dollar that comes out of a pre-tax account will be **taxed at Ordinary Income rates.**
Roth	**No deduction** from in-come is received.	The funds **grow tax-free.**	There is **no tax on distributions.**
After-Tax	**No deduction** from in-come is received.	The funds **grow tax- deferred.**	The portion allotted to **gains** is **taxed at Ordinary Income rates** *unless rolled over into a Roth*
HSA	You receive a **deduction** from income **for the contribution** amount.	The funds **grow tax-free.**	There is **no tax** on distri-butions if used for health care expenses.

457(b)s and 403(b)s have some unique and powerful features that are not possessed by 401(k)s.

403(b) employees that have completed at least 15 years of employment with an organization are eligible to make special 403(b) catch-up contributions. The special catch-up contribution amount is the lesser of the following:

- $3,000
- $15,000, reduced by:
  - The total amount of prior special catch-up contributions
- $5,000 multiplied by years of service, minus all deferrals made by the employee to the organizations plan.

The special 403(b) catch-up formula imposes a lifetime limit of $15,000 of elective deferrals. If you are age 50+ this could allow you to contribute up to $30,000 a year into your 403(b) for several years.

457(b)s have a similar Special Catch-Up Contributions feature. In this case 3 years prior to normal retirement age the participant may contribute $23,000 for 2024 plus the lesser of:

- $23,000, or
- The basic annual limit contributions not used in prior years before age 50. Meaning the amount by which contributions where not maxed out in prior years.

Effectively, this could allow a participant to contribute $46,000 for tax year 2024 and is a great opportunity for those who want to crank retirement savings right before heading into retirement.

IRA contributions can also be pretax or Roth, however they are subject to income limitations for the latter. Contributions are limited to $7,000 if under age 50 and $8,000 if over age 50. If your income is too high for a Roth IRA, you may be eligible to do what is called a back door Roth contribution.

Health savings accounts (HSAs) have triple tax benefits: you get to deduct contributions, get tax-free growth, and get tax-free distributions if used for medical expenses. The HSA has the most tax-efficient features of any account, even more so than a Roth IRA or 401(k). Additionally, you can save up receipts so you can take HSA distributions in future years based on past health expenses. If used correctly, the dollars that flow through the Health Savings Account would never be taxed. 2024 HSA contribution limits are $8,300 for families and $9,300 if over age 55.

2 Accelerate Income or Defer Income

As it relates to retirement accounts, your goal should be to pay taxes at the lowest rate possible between now and in the future (see chart from intro). We know what tax rates are today, so by estimating your future income accurately, we can project your future tax rate. If we have a reasonable basis to believe that you will be taxed at a lower rate in the future, then it may be tax-advantageous to make pre-tax contributions today. If you believe that you will be in an equal or higher tax bracket in the future, then you might consider doing Roth contributions today.

If your income is low enough, you may even consider doing Roth conversions. Oftentimes, we see retirees' taxable income drop from the time they retire until the time they start drawing social security and taking required minimum distributions from their IRA. We commonly call these the gap years, because if you graph your taxable income, it looks like a gap. These years can be great opportunities for Roth conversions.

Regarding Roth 401k contributions, many people are under the impression that it is impossible to make Roth contributions to their 401(k). In reality, this is dictated by the plan design. It is worth checking with your plan administrator to see if this feature is available to you. Additionally, Roth 401(k) contributions are not subject to income limitations.

3 Setup a Donor-Advised Fund

Do you donate to charity now? If so, you might consider establishing a donor-advised fund. This gives you more control over when you receive the tax benefit for the contribution and when the charity receives the funds.

There are a couple ways in which this can become tax-advantageous:

a) You can frontload charitable contributions for future years in a strategy called bunching. If done correctly, this can provide a tax savings. By bunching contributions into one year, you can get above the standard deduction in that year or get a larger deduction in an abnormally higher income year.

b) If you are currently donating cash, you might consider donating appreciated stock from a non-retirement account. Since the capital gain would be taxable to you if you were to sell it, it's advantageous to instead gift appreciated stock. That's because the gain in the stock is not taxable, nor is it taxable to the nonprofit, when gifted. Additionally, you can pick the stock positions that have the largest gains to make this strategy even more tax-efficient.

On the next page is a visual of the potential savings generated by bunching. Note that the total amount being donated to charity is the same. The only difference is "when" it happens.

Potential Savings Generated by Bunching

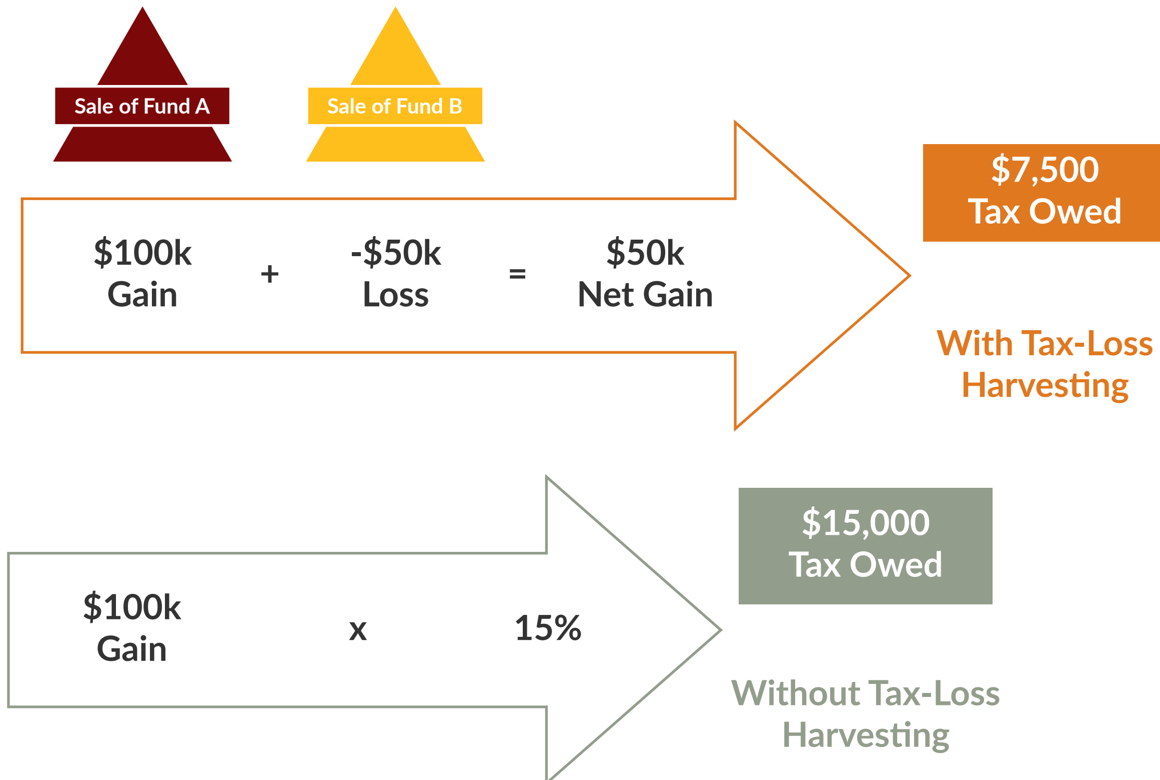
Year	No DAF – Take Standard Deduction	Use DAF to Group Itemized Deductions
2024	$29,200	$39,000
2025	$29,200	$29,200
Total Deduction	Total After 2 Years - $58,400	Total After 2 Years - $68,200
	Difference	**$12,800**

This information is provided for illustrative purposes only.

The column on the left shows a person who has $4,000/yr in state and local tax, $5,000/yr in mortgage interest, and $15,000/yr in charitable contributions, but does not generate enough in itemized deductions to justify itemizing over taking the standard deduction in a single year. However, if they instead choose to make two years' worth of charitable donations in one year to a Donor-Advised Fund, they can take the benefit in a single year and take the standard deduction in the year following. As depicted by the column on the right, this strategy results in $12,800 more in deductions for making the same amount of charitable donations. If someone did this in the 24% marginal tax bracket, the total tax savings over 2 years would be $3,072. This also allows the donor to make donations from the Donor-Advised Fund to the charity of their choice in whatever frequency is desired.

4 Harvest Your Non-Retirement Account

This may sound counterintuitive, but remind yourself that a non-retirement account doesn't have tax-efficient features like an IRA or 401(k). When you have positions that have a loss, it can be tax-advantageous to realize that loss, so you can use the loss to offset gains in other positions. If you do not have a gain to offset this year, then you can offset it in future years or use up to $3,000 a year in realized losses to offset your income. This tax-loss harvesting process helps improve your after-tax return. Additionally, if you have taxable income under $94,050 (if filing Married Filing Jointly) or $47,025 (if filing Single) you can realize Long Term Capital Gains and pay zero tax. This can help reset cost basis and allow you to withdraw funds in the future or in the same year and pay less or no tax. When used correctly, a non-retirement account can be much more tax-efficient than imagined and can function as an incredible bridge fund for early retirees.



This chart is for illustrative purposes only.

Sonmore Financial also rebalances our clients' investment portfolios twice a year, so they can stay on track with their target level of asset allocation and mitigate undesirable risks in their holdings.

5

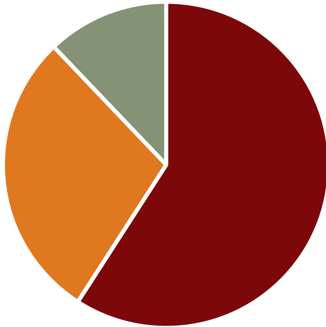
Maximize Your Premium Tax Credit

For those who retire prior to Medicare eligibility, one of the things that may be top-of-mind is obtaining healthcare that is affordable. The Premium Tax Credit can help achieve that.

Essentially, the Premium Tax Credit ("PTC") is a government subsidy used to make health insurance plans more accessible. However, income must fall between a certain range. The lower the income, the greater the subsidy. By pulling different levers and implementing tax-efficient distribution strategies, we can make taxable income lower and thus maximize the amount of Premium Tax Credit received without having to dramatically cut down on spending.

As an example, if you pull $10,000 from your IRA, this does not have the same tax effect as taking $10,000 from a non-qualified account or $10,000 from a Roth.

Total Portfolio - $850,000



■Pre-Tax ■Roth ■Non-Qual

This chart is for illustrative purposes only.

Hypothetical PTC Modified Adjusted Gross Income (MAGI) Target: $36,000

Net Cost of Living Income Target: $50,000

	Inefficient Distributions	Efficient Distribution
Pre-Tax	$54,000	$29,200
Roth	$0	$13,250
Non-Qualified	$0	$9,050
Standard Deduction	$29,200	$29,200
Taxable Income	$24,800	$0
MAGI	$54,000	$29,200
Tax Liability (Fed + AZ State)	$3,050	$0
Net Income	$50,300	$51,500
Effective Tax Rate	5.65%	0%

The possible scenarios that could be explored are endless. For the purpose of simplicity, two are depicted above. The column on the left depicts the least efficient scenario possible. A taxpayer whose filing status is Married Filing Jointly has living expenses of $50,000 net of tax but needs to stay below $36,000 to receive the maximum health insurance subsidy. A distribution of $54,000 is made from their Pre-Tax IRA to fulfill living expenses, but they are now over the PTC Income Target.

The column on the right distributes an amount equal to the standard deduction from their Pre-Tax IRA and 5.3% from their Roth. Since there is no taxable income at this point, the taxpayer could realize up to $94,050 in Long Term Capital gains and still pay zero tax, but gains are included in MAGI (which is the important figure when qualifying for PTC). In this scenario, they realize $9,050 but use tax loss harvesting to have a net gain of $0 and are able to meet living expenses and stay far below the PTC MAGI Target.

6 Increase Your Home Cost Basis

When approaching retirement, many often consider upgrading or downgrading their home, or perhaps purchasing a vacation home. When considering the disposition of one's personal residence, it is crucial to know about Section 121. Section 121 allows homeowners to exclude up to $500,000 ($250,000 if filing Single) in capital gains from the sale of their personal residence if the following criteria is met:

- They have owned the home for at least 2 of the last 5 years.
- They have lived in the home for at least 2 of the last 5 years.

These are the main qualifications, although they may not be the sole requirements. With real estate prices having surged for many people approaching retirement, it is more and more likely that people have a gain that is approaching, or in excess of, that $500,000 limit. If you are in excess of that limit, you want to create a log of all of the home improvements you have done to your home over time. This will help to increase your cost basis, so your gain will be smaller. Additionally, if you were planning to move either way and you are closing in on your $500,000 gain, you might consider accelerating that goal of moving sooner rather than later if that would fit your current and future lifestyle.

	Home Improvements Not Considered	Home Improvements Considered
Purchase Price	$150,000	$150,000
Fair Market Value	$750,000	$750,000
Home Improvements	$0	($50,000)
Adjusted Basis	$150,000	$200,000
Realized Gain	$600,000	$550,000
Gain Exclusion	($500,000)	($500,000)
Taxable Gain	$100,000	$50,000
Tax	$15,000	$7,500

This chart is for illustrative purposes only.

In the column to the left, a taxpayer purchased a home 10 years ago for $150,000, currently worth $750,000. Throughout the 10 years, they made home improvements such as a new roof, kitchen remodel, and backyard improvements. However, they neglected to add this to their cost basis, and thus, when they sold their home this year, they were able to exclude $500,000 in capital gain with another $100,000 unable to be excluded. They paid 15% long-term capital gains tax on the gain, resulting in a $15,000 tax bill.

In the example to the column above, assume the same cost, home value, and amount of home improvements. The only difference is that the taxpayer to the right kept records of their home improvements and made sure to add those home improvements to the cost basis of their home, resulting in a total taxable gain of $50,000. Thus, they ultimately paid half the tax that the taxpayer on the left column had to pay.

Next Steps

As you can see, there are a lot of moving parts as you approach retirement. The considerations above are small but actionable steps you can take to better control your retirement experience and maximize your retirement income, whether you're fast approaching the golden years or have 30 years to go.

At Sonmore Financial, we specialize in advising retirees and pre-retirees who are 50+ and retired or planning to retire within the next 7-10 years. Our retiree clients prioritize their financial independence, are ready to work less and enjoy life, and want a cohesive financial plan from a full-service wealth management firm that helps them delegate all of their retirement planning and investment management needs.

If you feel your retirement is too important to be doing it by yourself and want to delegate the heavy lifting to an expert, we offer a no-obligation, no-cost second opinion:

- Get started by clicking **here**,
- Email us at **info@sonmorefinancial.com** to discuss, or
- Call us to chat about it at **480-439-0500.**

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About the Author

Matthew Benson is the owner of Sonmore Financial in Chandler, Arizona, and a CERTIFIED FINANCIAL PLANNER™ serving Arizona's retirees and pre-retirees, aerospace business executives, and East Valley technology professionals. Matt specializes in tax-efficient investing, helping Sonmore's clients maximize their retirement, college savings or donating to a worthy cause. Matt often lends his expertise to leading media outlets, having been featured in Bloomberg, Forbes, MarketWatch, USA Today, and CNBC.

Sonmore Financial is a fee-only, financial planning firm that acts as a true fiduciary for its clients. Our goal is to help our clients create an efficient financial plan that provides them the opportunity to retire early. Many of our clients never "retire" in the traditional sense of the word, they simply graduate to spending time with their grandkids, building a strong family legacy, or consulting other professionals in their field. You're a good fit if:

- You are 50+ and retired or planning to retire within the next 7-10 years.
- You have at least $500k+ in investable assets (not including real estate).
- Financial independence is important to you.
- You want a cohesive financial plan from a full-service wealth management firm.
- You want to maximize your financial assets for your family's future.
- You're ready to work less and enjoy life.

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