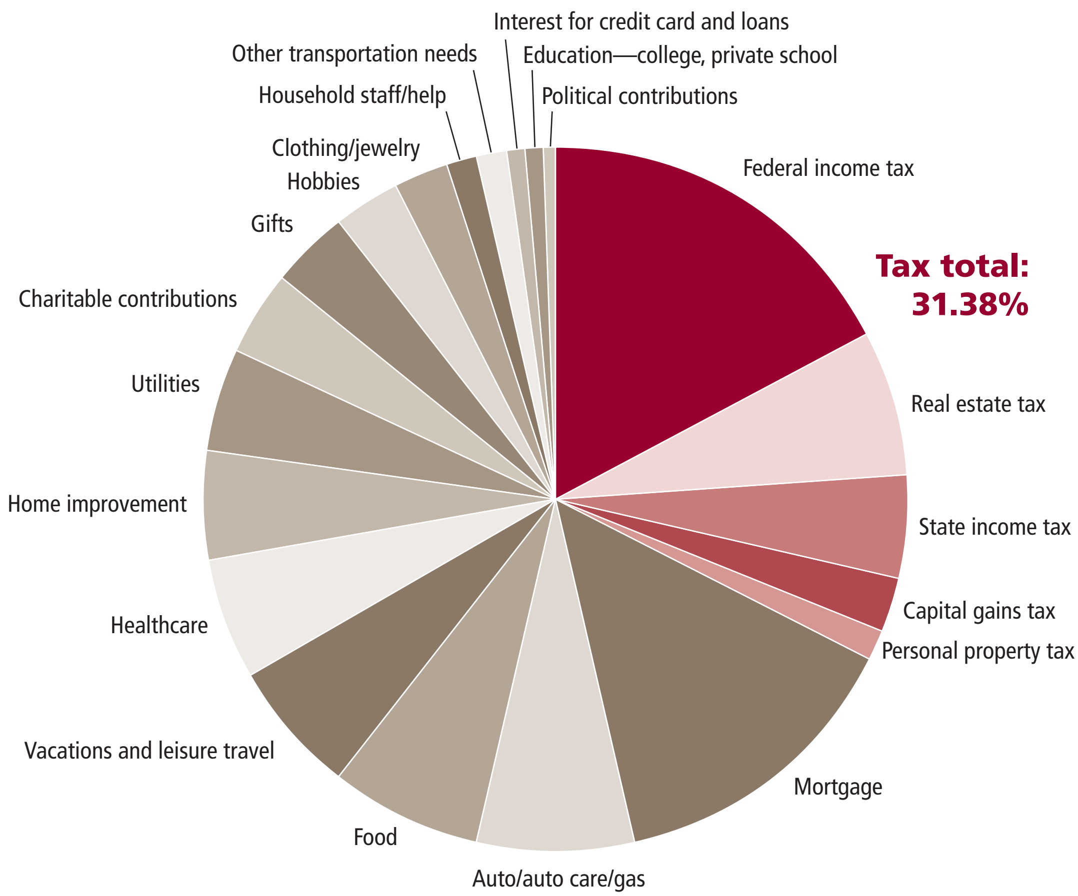
The underrated impact of taxes on retirement

Research study

Nearly one out of every three dollars spent by high-income retirees goes to taxes, according to a study by Lincoln Financial Group.

Most future retirees would not anticipate that taxes would be among their highest bills, but a recent study by Lincoln Financial Group (LFG) uncovered the startling reality of the impact of taxes in retirement.[1]

Exhibit 1: Overall spending in retirement



[1] Over 250 such individuals responded to an online survey developed by LFG with the Spectrem Group, which conducted the survey from October 5 to October 8, 2009.

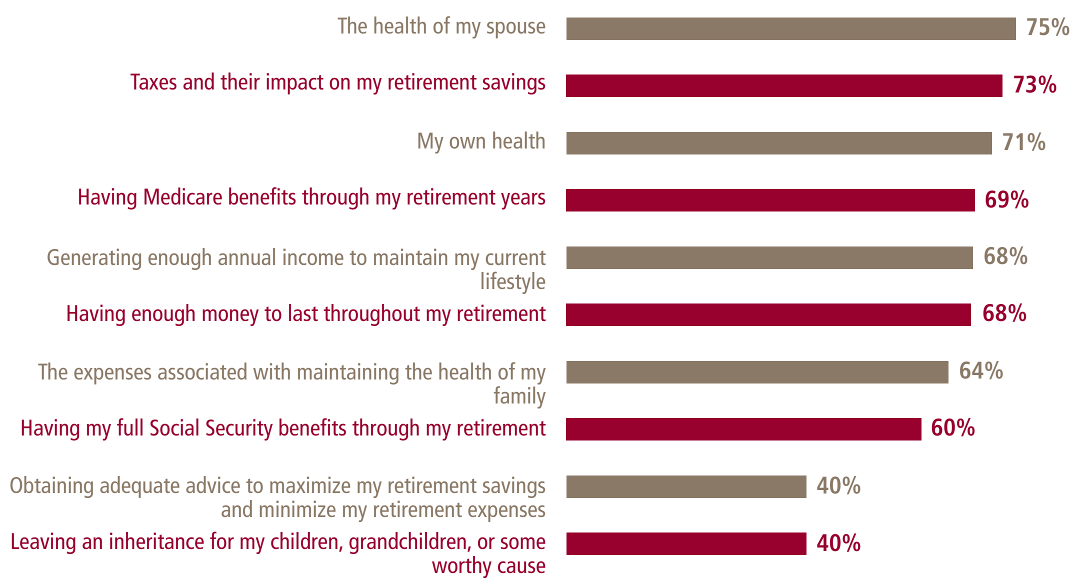
The LFG-sponsored research surveyed retirees between the ages of 62 and 75 with annual household incomes greater than $100,000. The results provide a snapshot of affluent retirees' concerns, expenses, income, and tax planning and illuminate gaps in individuals' understanding of why taxes matter in retirement.

Taxes represent the greatest expense incurred by this group. They are greater than many individuals planned for prior to retirement—and a growing source of concern. Also, many retirees are not very savvy about taxes. The survey's results also provide a foundation for taking action.

Retirees worry most about health, taxes, and income

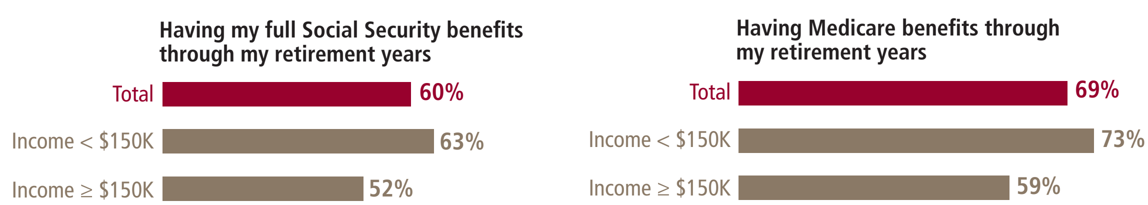
Health and taxes in retirement rank highest among retirees' concerns. Not surprisingly, the health of one's spouse and one's personal health rank high — first and third — among retirees' concerns (see Exhibit 2). Taxes rank second, beating out concerns related to income, expenses, and inheritance, which suggests that retirees are aware that taxes may significantly reduce their savings. However, the survey also demonstrates that retirees are less familiar with the specifics, such as how much their taxes amount to or how to reduce tax burdens.

Exhibit 2: What expenses concern retirees?



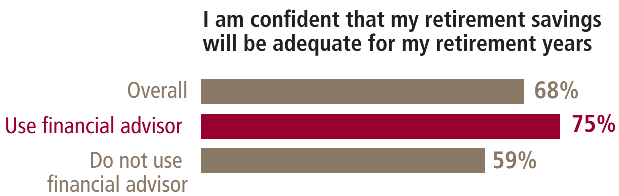
Despite annual household incomes over $100,000, the majority of respondents worry about collecting their government benefits. Sixty percent expressed concern over Social Security benefits being reduced throughout their retirement (see Exhibit 3). This concern increased to 69% with regard to Medicare, which may reflect fears about healthcare costs.

Exhibit 3: Level of concern over government benefits



A majority of respondents, 68%, feel confident that their savings will be adequate for retirement (see Exhibit 4). As expected, confidence increased with wealth and income. Working with a financial advisor also contributed to confidence. Only 59% of retirees without financial advisors feel confident. Confidence rises to 75% for retirees who work with a financial advisor.

Exhibit 4: Confidence in retirement savings

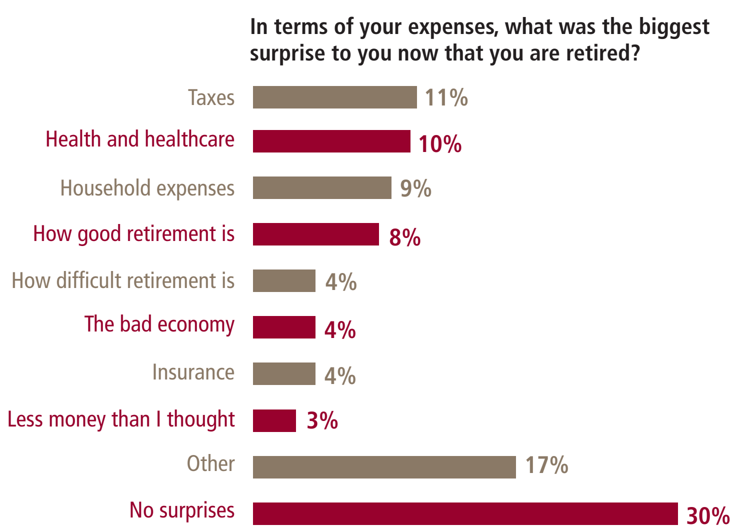


Income < $150K	64%
Income ≥ $150K	76%
Wealth < $1M	57%
Wealth ≥ $1M	81%

Income and expenses: Taxes are biggest surprise

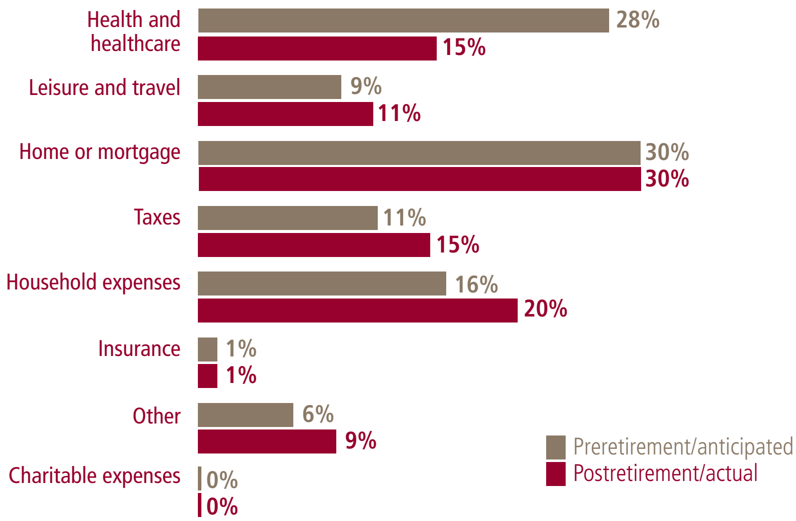
The importance of taxes stands out in responses to questions about income and expenses (see Exhibit 5). While respondents overestimated the costs of healthcare in retirement, they tended to underestimate the expense of taxes.

Exhibit 5: Largest surprise in retirement



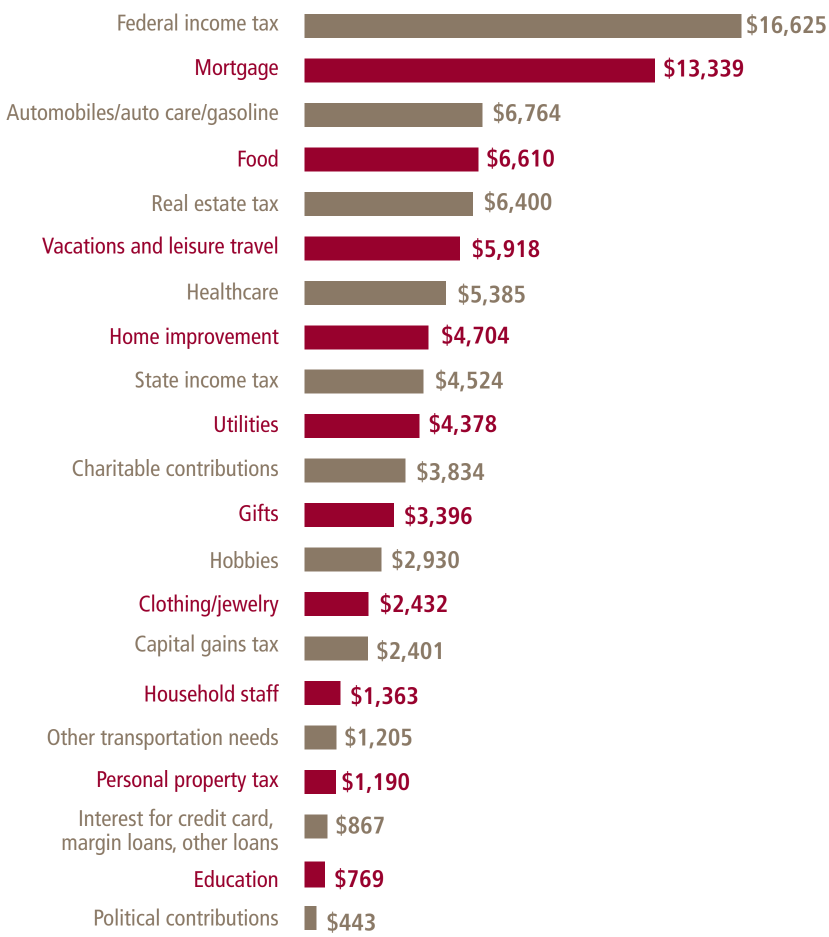
The survey examines the gap between anticipated and actual expenses in retirement (see exhibit 6).

Exhibit 6: Anticipated vs. actual expenses



Prior to retiring, many respondents had underestimated the impact of taxes. The combination of federal and state income taxes is the retirees' greatest expense, representing 20% of annual expenditures (see Exhibit 7).

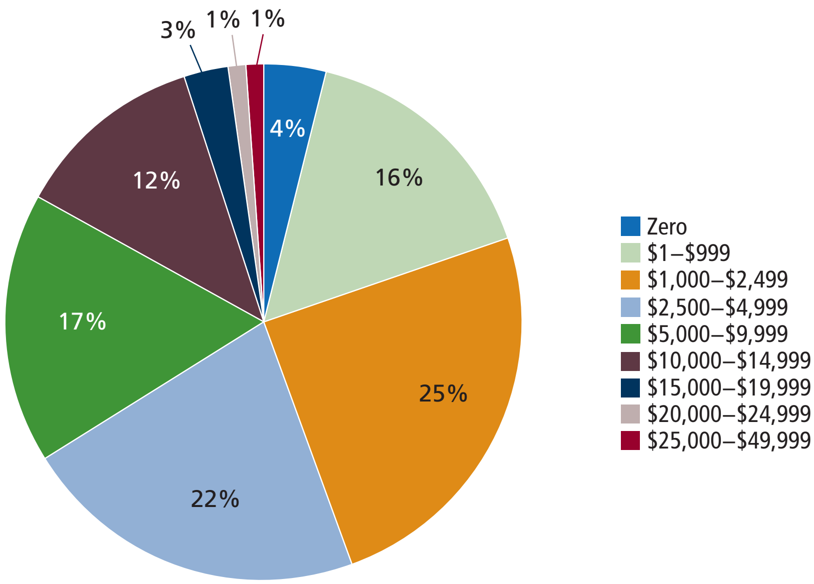
Exhibit 7: Average of annual expenditures



Note: This includes respondents who indicated they do not spend money in all of the listed categories.

Respondents had dramatically overestimated the level of expenses they would pay in retirement for health and healthcare. While 28% had thought it would be their largest expense as retirees, only 15% found health and healthcare to be their largest expense in retirement. In reality, 67% of respondents spent less than $5,000 on healthcare (see Exhibit 8). This difference may result from the relatively young age of the retirees—62 to 75.

Exhibit 8: Annual expenditures on healthcare



Finally, with respect to income, the most common sources for respondents included Social Security (81%), salaries (65%), and income from pension plans (58%) (see Exhibit 9). The next four sources—income from investments, retirement plans, IRAs, and annuities—are subject to market movements. One reason these income sources are so prominent may be that market declines have spurred even high-income retirees to maintain some type of employment. Fifty percent of the respondents have one person in the household who is retired and one who works full time. This mix of retirees and workers explains the high salary level (see Exhibit 10) among those drawing salaries.

Exhibit 9: Sources of annual income

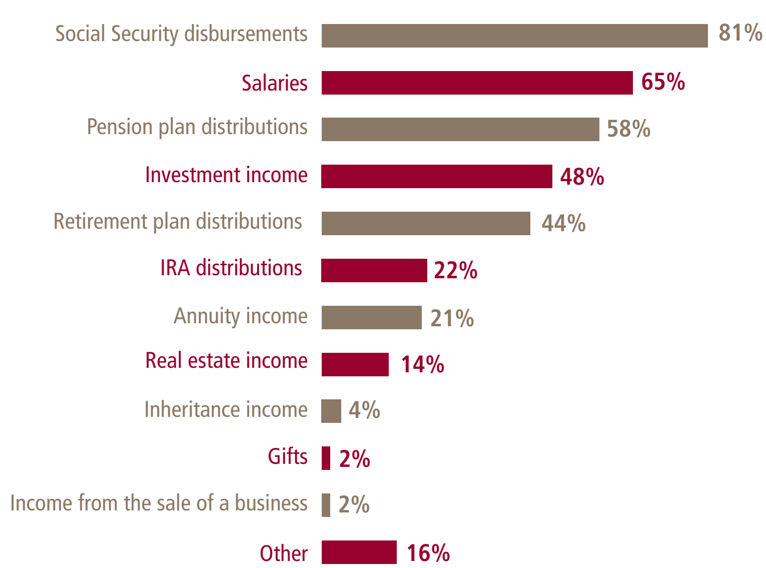
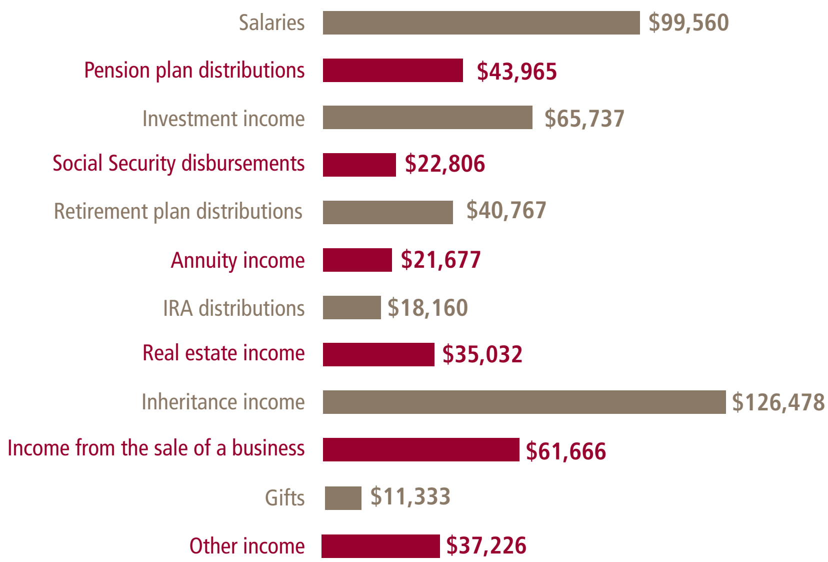


Exhibit 10: Amount of annual income by source

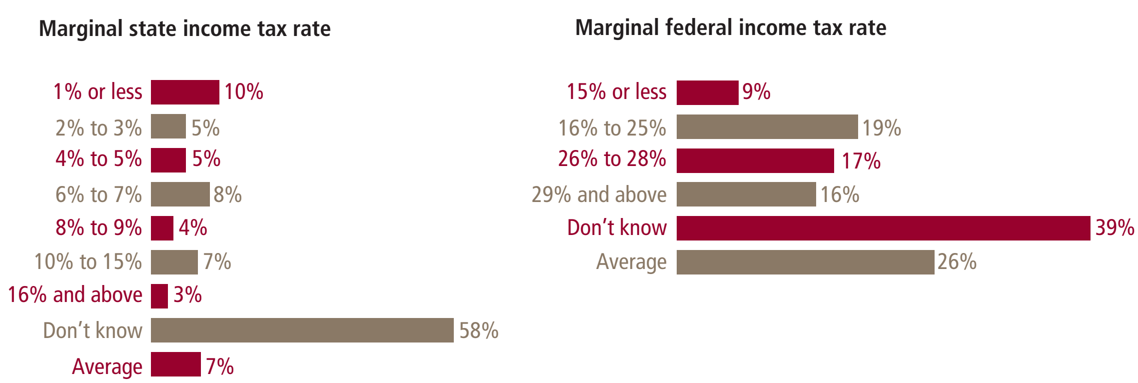


Tax planning falls short

One key finding of the survey is that many of the respondents do not maximize their tax planning opportunities. In fact, they display a surprising lack of knowledge of some tax topics, though they have a strong interest in learning more about tax planning and new opportunities that may exist within Roth IRAs.

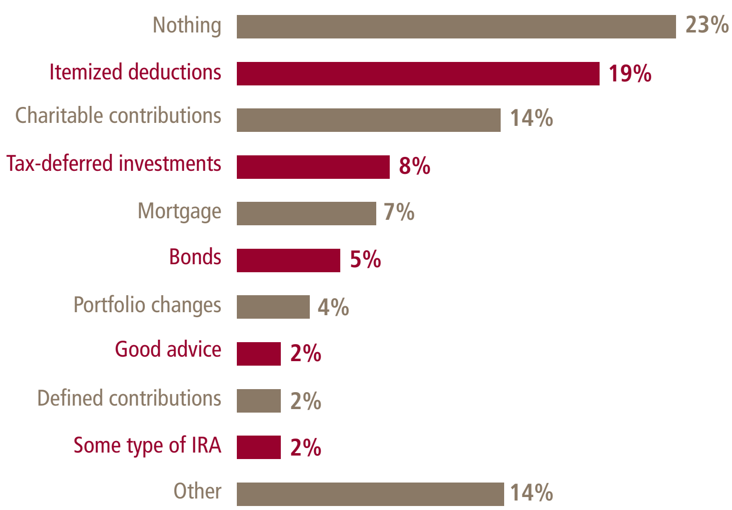
Despite the significant impact that taxes have on respondents' income, a surprising portion of the retirees were unfamiliar with the specifics of their tax status. Even though the respondents' average marginal rates are 26% and 7% for federal and state taxes respectively (see Exhibit 11), nearly 39% of respondents do not know their federal tax rates. More than half (58%) do not know their state tax rates.

Exhibit 11: Familiarity with marginal tax rates



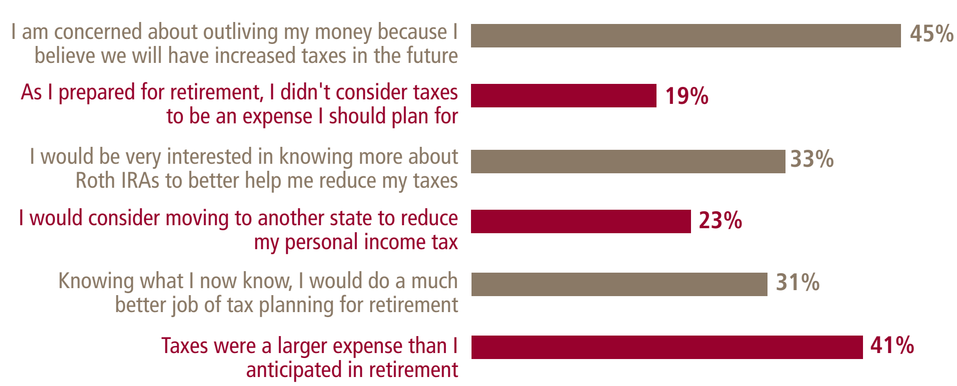
Retirees' lack of familiarity with tax rates is reflected in the weakness of their tax planning. Nearly one-quarter currently do nothing to minimize their taxes (see Exhibit 12). Only 19% itemize deductions, and 14% make charitable contributions as their primary method of reducing taxes. Only 2% identify some type of IRA as their primary way to cut taxes.

Exhibit 12: Primary tactics for reducing taxes



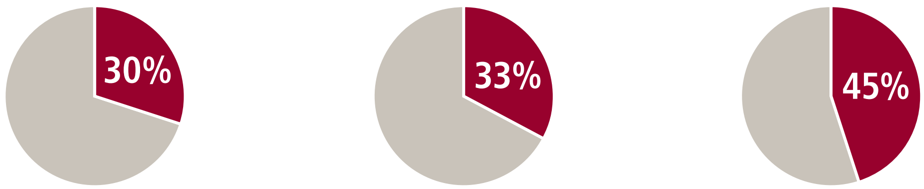
Many retirees worry about taxes and feel dissatisfied with their preretirement tax planning. Forty-five percent of respondents are concerned about outliving their money because of future tax increases (see Exhibit 13). Nearly one-third indicated that, in retrospect, they wish they had focused more on tax planning for retirement. Over 40% said taxes are a greater expense than they anticipated.

Exhibit 13: Attitudes about taxes in retirement



High-income retirees are not very familiar with Roth IRAs as a way to reduce taxes and save for retirement (see Exhibit 14). This lack of familiarity is not surprising given that historically high income made many of them ineligible for Roth IRAs under the original rules. However, they now have new opportunities based on Roth conversion rules that took effect in 2010.

Exhibit 14: Roth and retirees



Only 30% are familiar with the new Roth IRA conversion rules.

Only 33% have had a conversation with an advisor about Roth IRAs.

45% would establish a Roth IRA with their primary advisor/ financial institution if they saw value in doing so.

Lessons for retirees

For retirees, taxes matter significantly. This survey shows that approximately one out of every three dollars spent in retirement goes to taxes. As noted earlier, one-quarter of respondents do nothing to minimize their taxes, and many are not even familiar with their state or federal tax rates. So, the first step is understanding the ways that taxes are detrimental to their retirement lifestyles.

In the meantime, retirees can benefit from the following actions:

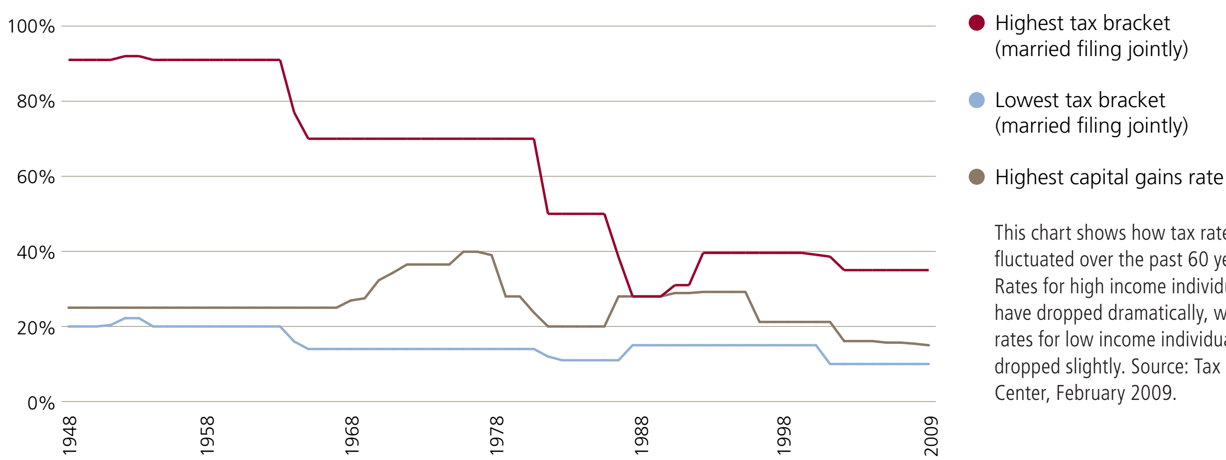
1. Examining the outlook for tax increases and other demands on their retirement savings
2. Becoming aware of the sources of taxation
3. Using strategies to break their cycle of spending on taxes

Each of these actions requires more in-depth consideration.

Outlook for tax increases and other demands

While taxes are detrimental to retirees' ability to spend, taxes are currently low by historical standards (see Exhibit 15). Rate increases are a possibility given the size of government budget deficits and spending. If tax rates increase, retirees will lose even more to taxes. When planning, it is important to consider the tax and market environments now and in the future.

Exhibit 15: Tax rates are at a historic low



This chart shows how tax rates have fluctuated over the past 60 years. Rates for high income individuals have dropped dramatically, while rates for low income individuals have dropped slightly. Source: Tax Policy Center, February 2009.

Another factor increasing the tax burden is that even high-income retirees are working longer than expected. Indeed, 65% of respondents have some sort of salary. It is not clear whether these respondents are working out of necessity or by choice. Some may be making up for investment portfolio balances reduced by the market volatility of 2008–2009. In any case, salaries would be subject to any future tax increases, thus increasing the percentage of retirement expenses going to taxes.

Investment portfolio declines may also boost the percentage of retirees who take distributions from their retirement plans. In the survey, only 44% of retirees ages 62 to 75 receive income from retirement plan distributions. But if their portfolios do not recover from losses, they may need to tap their retirement accounts earlier than they originally planned. This need is particularly true for the 35% who indicated they have no salary. Again, those distributions will be taxed at higher rates.

Addressing all sources of taxation

Federal taxes are not the only issue. Place of residence does matter for taxes. For example:

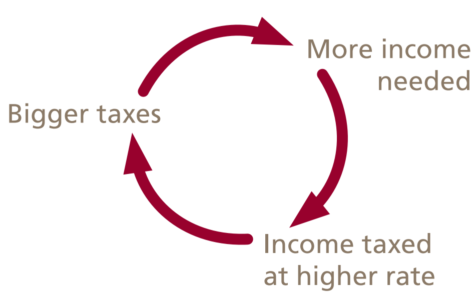
- 45 states have a sales tax
- 41 states have an income tax
- 17 states impose an estate tax
- 14 states tax Social Security benefits

The tax spending cycle

Additionally, other sources of taxes exist: city wage taxes, real estate taxes, personal property taxes, and capital gains taxes. In addition, the cost of health and long-term care also varies dramatically by state. Simply stated, a major driver of taxes and retirement expenses is both where you live and where you die.

Taxes are the greatest expense for the retirees in our research study. And as tax rates increase, a vicious cycle begins. More income (salary, retirement plan distributions, etc.) is needed to maintain retirees' lifestyles. Next, their increased income is taxed at higher rates. And so on.

1. Bigger taxes
2. More income needed
3. Income taxed at higher rate



Break the tax cycle with help from an advisor

There are tax and retirement planning strategies to help reduce the impact of taxes, depending on retirees' unique goals and circumstances. Financial advisors and tax professionals are two key resources for finding ways to reduce tax liability. A few broad areas that retirees can discuss with them include:

- Learning about local and state tax policies
- Reviewing withdrawal strategies
- Reviewing the product allocation and account types used in a retiree's portfolio
- Evaluating their portfolio's asset allocation
- Reviewing a retiree's estate

These areas provide excellent starting points for a conversation with a financial advisor. Professional advice can help individuals select, prioritize, and take action on appropriate strategies. As the research from Lincoln Financial Group showed, retirees who use a financial advisor feel more confident about their retirement funding.

Conclusion

It is important to recognize the possibility that taxes matter more after retiring than they do before. Taxes should become part of the conversation that retirees, both current and future, have with their tax advisors and investment professionals. Remember, when it comes to taxes and retirement, informed clients get the best advice.

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