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How To Get Tax Free Retirement Income In 2020

David Rae
CFP who writes about having a Wealthier Healthier and Happier Life.

Having more tax-free retirement income is reason to celebrate

Whether tax rates are high or low, I will hear people complaining about the taxes they get to pay. Let's be real; no one likes paying taxes. 2020 is an election year, and your vote could also affect your future tax bills. But with tax planning, there are a few ways to get more tax-free retirement income in retirement.

As a Certified Financial Planner, my job is to help people work toward reaching financial independence and a happier, healthier, and wealthier retirement. The larger your tax burden in retirement, the more retirement income-producing assets (cash, investments, real estate, 401(k), Cash Balance Pension Plans, etc.) you will need to have saved to fund your retirement. Marriage can make the tax benefits of these accounts even more valuable. You may have heard of the marriage penalty. Well, this refers to the often-higher tax bills that come to high-earners who happen to be married.

For example, if you are retired a retired couple and make more than $45,360, combined, 85% of your Social Security is taxable. With this in mind, it can be advantageous to plan ahead for where your retirement assets will be held and how you will take withdrawals to help minimize the tax bite throughout your retirement years.

Here are six ways you can potentially earn tax-free income in retirement.

Happy Birthday, hopefully, you will be getting some tax-free retirement income.

Contribute to a Roth IRA in 2020

Think of the Roth IRA as the starter retirement account. You can put in $6,000 per year ($7,000 if you are 50 or older). There is not a tax deduction for your contributions, but the money will grow tax-free and, most importantly, the money comes out tax-free during retirement. While this may seem significant to some, the problem is that most people will need to save substantially more the $6,000, per year, in order to reach their financial goals. Also, there are income limitations for who can contribute and how much. For example, only couples who earn up to a combined $206,000 each year and singles who make $139,000, or less, are able to contribute to a Roth IRA.

If you contributed $6,000, per year, from the time you were 22 until you reached the age of 65, and earned a 10% return each year, you would have more than $3.25 million. If you worked a little longer and saved until age 70, that number would jump to more than $5.25 million. That’s the magic of compounding interest at its best, which you could then turn into tax-free income. By the way, all of this money could be used tax-free!

Set up a Roth 401(k) or Roth 403(b) In 2020

You will need to have the option to use a Roth 401(k) within your retirement plan at work. A Roth 403(b) or Roth 401(k) is similar to a Roth IRA, your growth and withdrawals are tax-free. The difference is that you have the ability to contribute up to $19,500 per year, plus a $6,500 catch up if you are 50 years of age or older. You will pay taxes on the contributions, but there are no income restrictions for these plans.

Tax-Free Income from Municipal Bonds and Funds

Interest rates on bonds are near historic lows, which may make this type of investment less beneficial than it has been in the past. That being said, the tax-free income may make municipal bonds more competitive with their corporate bond counterparts. Before investing here, you will need to make sure these bonds fit your investment needs.

The short overview of tax-free income from municipal bonds is that income distribution from these bonds (or bond funds) are not subject to federal income taxes, but they may still be subject to state income taxes. For this reason, the interest rates these bonds pay is generally lower than that of taxable bonds. These bonds also have various investment and reinvestment risks, especially now that we can expect to enter a rising rate environment at some point in the future. Because of the coronavirus pandemic (and lack of response to it from the Trump Administration), we will likely see a longer delay in raising the interest rate than was previously expected at the start of 2020.

There is also the potential for default with municipal bonds. A notable example of this occurred when the City of Detroit defaulted on its bond obligations. While income from these bonds may be tax-free, your capital gains may still be taxable when buying or selling bonds.

Use a Health Savings Account (HSA) for Tax-Free Income

An HSA can be the valuable triple whammy of tax-free income. First, you can get a tax deduction for contributing to an HSA. Second, the growth of investments within an HSA is tax-free. Third, when taken correctly, withdrawals are also tax-free. You will need to have the appropriate type of health insurance in order to be eligible to contribute to this type of account, and investment options may be limited in some plans. This account is meant to be used to pay for current medical expenses, but you don't have to pay for current medical expenses now.

You could hold the HSA until retirement, with the fund growing and compounding along the way. You could then reimburse yourself for all the medical expenses you paid over the years (make sure to keep your receipts). Expenses can include Medicare premiums. The drawback is that you can only contribute $3,550, per year, or $4,550, per year, if you are 55 or older.

Cash Value Life Insurance

I call this strategy for maximizing tax-free income from life insurance, the "Rich People Roth." Most people don't think of life insurance as part of their retirement plan, and some believe life insurance isn't needed for those who are already retired.

However, cash value life insurance can be a wonderful tool to bridge the gap to financial freedom if you are married, have kids, have maxed out contributions to your other retirement account(s), or are in a high tax bracket. I won't list all of the benefits of life insurance except that some policies have benefits you can enjoy before you die. More importantly, perhaps, is the potential for tax-free income in retirement.

You should **think of life insurance as another asset class for your retirement and tax planning**. Essentially, you can set up this account like a Roth IRA without income or contribution limits. You won't get a tax deduction for your premiums, but the money will grow tax-free. If handled properly, it will come out tax-free. Also, these accounts won't incur IRS penalties for withdrawals before you reach 59 ½. This can be a huge bonus for people looking to retire early.

PPP Loans In 2020

While a bit controversial, PPP loans have helped many businesses keep their doors open during the coronavirus recession. While not truly additional income, business owners who are able to get their loans forgiven will have more money in their pockets at the end of the day, tax-free.

If you are a business owner who has not received a PPP loan, talk with your financial planner and tax-preparer to see if you may be eligible. If you have taken out a PPP loan, stay proactive with the recordkeeping requirement to get your loan forgiven without incurring taxes or interest along the way.

I don’t have a crystal ball, but it wouldn’t surprise me if taxes went up in the future, given the current deficit spending under President Trump. While the Democratic candidate, Joe Biden, has stated “no new taxes” for those earning less than $400,00, if elected, he will be faced with an economy suffering under COVID-19, and he will inherit a record federal deficit. Unfortunately, it is not as easy for the U.S. government to declare bankruptcy as it was for the Trump-owned Atlantic City casino.

Be proactive and develop a plan to reach your financial goals, including a financially secure retirement. Having more options on how you get taxed on your retirement income will help make that a much easier task.