



TAX-FREE

RETIREMENT

HOW TO LIVE A TAX-FREE RETIREMENT



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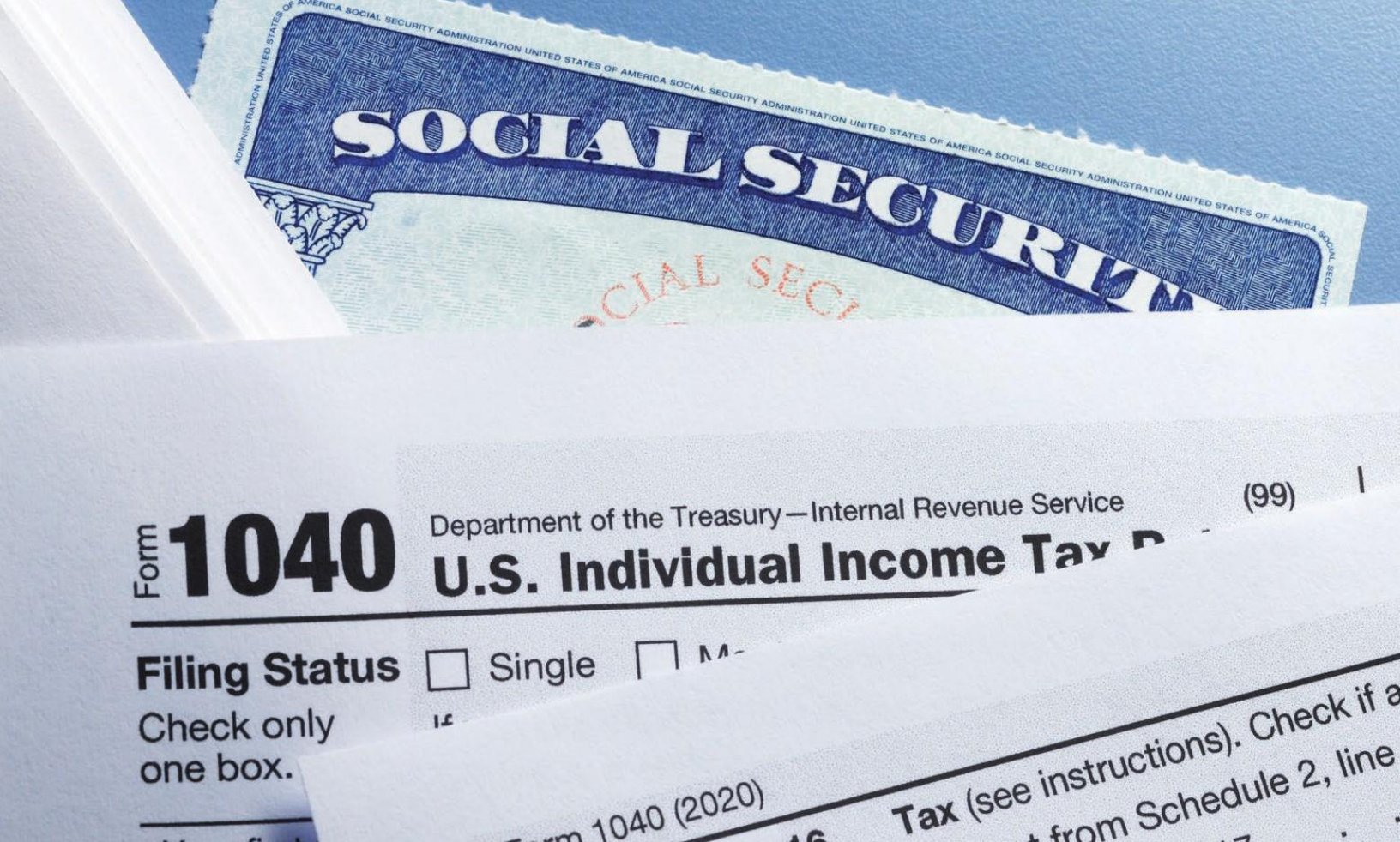
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10 MYTHS ABOUT TAXES IN RETIREMENT INTRODUCTION

You might think you know how much you have saved for retirement and whether you'll get money from Social Security or a pension. However, do you know how that money will be taxed? The sources of your retirement income and how much retirement income you draw each year will determine your taxes in retirement. And your taxes determine how much money you actually have to live on.

It's imperative that you understand how your retirement income will be taxed. If you're still working, knowing this information will help you figure out how much you need to save before you can retire. If you're already retired, it will tell you whether you need to do some additional planning to avoid running out of money. Understanding how taxes will affect your retirement can help you pursue ways to minimize your tax bill and maximize your retirement income.

To assist you with your planning, here are a few common myths that you should know.



MYTH

1 TAXES WON'T HAVE A MAJOR IMPACT ON MY RETIREMENT

Income taxes can actually be the single largest expense people face in retirement, but few people are taking the proactive steps that are needed now to reduce their tax liability.¹

“What’s one of the things that can derail an otherwise great retirement plan? Taxes,” says federal retirement expert Chris Kowalik.

“Taxes can potentially wreak havoc on your retirement since you have to pay for them somehow — and if you’re not accounting for them, you may be forced to use your hard-earned savings. I refer to taxes as the ‘carbon monoxide’ that can kill an otherwise really good financial plan. It can sneak up on you quickly and without a lot of warning.”²

Following a November 2019 Tax-Efficient Retirement Income (TERI) study by Nationwide Retirement Institute, Eric Henderson, president of Nationwide’s annuity business,

said: “The data clearly illustrates that retirees aren’t always strategically preparing for — or even thinking about — taxes in retirement, and as a result, may be paying thousands of dollars more than needed.”

Nationwide noted that, by building tax flexibility into a retirement income plan, older adults can use a variety of investment and retirement accounts to potentially avoid higher tax brackets and effectively manage their income.³

Sources:

1. “Tax Strategies for Keeping Your Retirement Income Safe” - by NJBIA (New Jersey Business & Industry Association), Oct. 14, 2020: <https://njbia.org/tax-strategies-for-keeping-your-retirement-income-safe/>

2. “4 Myths About Taxes in Retirement” - by Chris Kowalik, Jan. 23, 2020: <https://www.myfederalretirement.com/myths-taxes-retirement/>

3. “Third of Retirement Investors Not Considering Effect of Taxes” - by Michael S. Fischer, June 30, 2020: <https://www.thinkadvisor.com/2020/06/30/third-of-retirement-investors-not-considering-effect-of-taxes-nationwide/>

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YOU'LL BE IN A LOWER TAX BRACKET

It makes sense that people believe this retirement myth. They don't see themselves paying more in taxes because they're no longer earning money; rather, they're now living off what they've accumulated over a lifetime. With their income being lower than it was during their working years, the amount they'll owe to the IRS will be less, right?

Not necessarily. For a short time after they finish working, many successful retirees typically are in a lower tax bracket. But that window can shut quickly.

Once required minimum distributions (RMDs) kick in (age 72 for IRA, 401(k), 403(b), etc.), in combination with other forms of income (investments, Social Security benefits, rental income, etc.), successful retirees will quickly move into an equivalent tax bracket as they were in during their working years. They may also be pushed into Medicare surcharges and other ancillary tax.

By their mid- to late-70s, it's not uncommon to see these successful retirees end up in the exact same tax bracket that they are in right before they retire or in even higher brackets than they were during their working years — a far cry from what they envisioned.



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YOU SHOULD MOVE TO A TAX-FRIENDLY STATE

When it comes to state taxes, there are some retiree-friendly states. In fact, there are nine states that don't tax anyone's income (including pensions). Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington state and Wyoming have no income tax for any of their residents.

Sounds great, right? But before you start packing up your things and getting ready to move, you need to know that's only half of the story. Although these states don't have any state income tax, the reality is that in states that have no income tax, they typically have higher sales tax and property tax. The states must get their revenue somehow, and this is the way that they're going to do it.

While on the surface it sounds great not to have to pay state income tax, there are some consequences with respect to the other kinds of tax that you might experience. Read up carefully before you pack the moving truck!



MYTH #1 MY SOCIAL SECURITY BENEFITS WON'T BE TAXED

This was true until 1984. The Social Security overhaul passed by Congress and signed by President Ronald Reagan the year before included a provision that made a portion of Social Security benefits taxable, depending on your income level.

You will pay federal income tax on up to 50 percent of your benefits if your income for the year is \$25,000 to \$34,000 for an individual filer and \$32,000 to \$44,000 for a couple filing jointly. Above those thresholds, up to 85 percent of benefits are taxable. Below those thresholds, you don't owe the IRS anything on your benefits. (Roughly speaking, Social Security counts as income the money you get from work, pensions and investments; nontaxable interest; and half of your Social Security benefits.)

You might also owe state taxes on your Social Security income if you live in Colorado, Connecticut, Kansas, Minnesota, Missouri, Montana, Nebraska, New Mexico, North Dakota, Rhode Island, Vermont, Utah or West Virginia. Their rules on taxing benefits vary widely; contact your state tax agency to learn more.



MYTH

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I'M A FEDERAL EMPLOYEE SO I ONLY HAVE TO PAY TAXES ON THE MONEY I PUT IN THE THRIFT SAVINGS PLAN

Most federal employees know that there are taxes due on the back end of their traditional Thrift Savings Plan (TSP). Of course, this happens because no tax was paid on the money that was put into the TSP (called “tax deferred”). However, what many federal employees don’t understand is that they don’t just owe tax on the principal – they also owe tax on all of the growth.

For example, let’s say you contribute \$100,000 into the traditional TSP (over a long period of time), and that \$100,000 grows to \$200,000. Then the principal that you originally contributed (\$100,000) was not taxed at the time and the growth (\$100,000) has not been taxed yet – but don’t worry; the IRS won’t forget!

Therefore, if you were to withdraw this \$200,000 (either all at once or over a long period of time), you owe the tax on the entire \$200,000 — not just the money you put in, but all the growth, too!

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MY RETIREMENT INCOME WILL BE TAXED AT ONE RATE

In retirement, many people will have multiple streams of income coming from various sources, most of which are being taxed at different rates. Without proactive income, investment and tax planning, retirees can wind up in a higher tax bracket than what they figured.

You may therefore want to change your investment holdings in retirement — not only to save on taxes but also to preserve the principal. Below are a few ways to go about it.

Municipal Bonds

Interest on municipal bonds is free from federal income tax, although the interest may affect the tax on Social Security benefits.

Dividend Stocks

If you receive qualified dividends — essentially regular dividends from publicly-traded U.S. corporations, as well as certain foreign corporations — they are taxed at more favorable rates than ordinary income. The tax rate may be 0%, 15%, or 20%, depending on your taxable income.

Losses That Offset Capital Gains

You can use losses on the sale of securities and other property to offset capital gains so that you pay no tax on the gains. What's more, if you have excess capital losses, you can use up to \$3,000 to offset ordinary income (for example, bank interest), and any additional losses can be carried forward.



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THE DIFFERENCE IN TAX RATES BETWEEN THE OLD & THE NEW LAW IN 2026 IS JUST A FEW PERCENTAGE POINTS

What we know right now: the current tax law is in effect until the end of 2025, at which point it will sunset. This means on January 1, 2026, taxes will go up to the rates in effect prior to Tax Cuts and Jobs Act (TCJA). Many people mistakenly believe that the difference in rates between the old and the new law is just a few percentage points: between 9.7% and upwards of 25% across most brackets.

However, looking to the future, the tax landscape is likely to change. Prior to COVID-19, the United States had a staggering amount of national debt. After this pandemic and the massive stimulus bill that was passed, that debt level surpassed \$24 trillion as of April 7, 2020. At some point, our country must pay for that debt, one way being raising taxes.

What many Americans don't realize is just how high taxes can go. In 1944 and 1945, the top marginal rate was a staggering 94%. It was 91% from 1954 to 1963, and it didn't drop below 70% until 1981. As much as we want to, we can't dismiss the possibility that taxes will reach those heights in the future. That would make the value of proactive tax planning even greater.

Source: "Debunking The Myth Of Lower Taxes In Retirement" – by Garrett Gunderson, Jul. 23, 2020: <https://www.forbes.com/sites/garrettgunderson/2020/07/23/debunking-the-myth-of-lower-taxes-in-retirement/?sh=640605695cd8>



MYTH 8

I'VE HEARD THAT I SHOULD NOT CONSIDER A REVERSE MORTGAGE

“All reverse mortgage strategies are bad” is something retirees commonly hear. It may be true for some retirees, but not all. Some retirees should consider whether this option might provide benefits as part of a diversified retirement strategy. In moderation, and properly managed, a reverse mortgage can provide long-term liquidity as well as tax-free cash \$ow.

Cash paid out from a reverse mortgage, whether as a lump sum or ongoing “income” payments, is tax-free simply because it’s ultimately nothing more than a loan against an existing asset. In other words, no income or wealth is created; the borrower is simply taking out a personal loan and using his or her primary residence as the collateral, which isn’t any more taxable than getting a loan to buy a car or pay for college, or taking out a home equity line of credit or borrowing against a life insurance policy.

The fact that the borrower may use periodic cash \$ows received from the loan as an “income” substitute to pay bills, fortunately, doesn’t cause the loan to become taxable. It’s still a loan. As a result, the cash payments remain a non-taxable receipt of loan proceeds against an existing asset, just like other types of (secured or unsecured) loans.

Notably, the fact that a reverse mortgage loan isn’t income, for tax purposes, also means it doesn’t impact other tax-related issues for retirees. For instance, it doesn’t impact the taxability of Social Security payments or income-related premium surcharges for Medicare Parts B and D.

Some retirees will definitely want to steer clear of reverse mortgages because of their drawbacks. Others will find them beneficial as part of an overall retirement plan. Be sure to consult a good financial advisor before deciding which road to take.



MYTH

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I DON'T NEED TO PLAN FOR HEALTH CARE IN RETIREMENT BECAUSE MEDICARE WILL COVER IT ALL

This isn't true, so you're wise to plan for health care, which can be done tax efficiently.

While Medicare will pay for doctors visits and hospital costs, it may not cover all of your prescription drug expenses, deductibles and co-payments, most dental care, routine vision care, routine hearing exams or hearing aids, and it doesn't help with long-term care.

According to the Fidelity Retiree Health Care Cost Estimate, an average retired couple age 65 in 2020 may need approximately \$295,000 saved (after tax) to cover health care expenses in retirement. These figures do not include the cost of long-term care.

Health savings accounts (HSAs) are an ideal way for people to save and invest for retiree medical expenses. HSAs offer you triple tax advantages:

1. First, contributions are tax-deductible.
2. Second, those contributions can be invested and grow tax-free.
3. Third, withdrawals aren't taxed as long as you use them for qualified medical expenses, such as doctors visits, prescription drugs and dental care. They even include acupuncture and substance-abuse treatment.

"There's no other vehicle under the tax code that has the kind of preferential treatment that health savings accounts have," says Shelby George, senior vice president of advisor services at Manning & Napier, a Fairport, New York, investment manager.

Source: "How to plan for rising health care costs" – Fidelity Viewpoints, 08/03/2020: <https://www.fidelity.com/viewpoints/personal-finance/plan-for-rising-health-care-costs>



Retirement Plan

MYTH

I HAVE A TRADITIONAL IRA SO I DON'T NEED TO CONSIDER A ROTH IRA

To see why you might want to consider a Roth IRA in your retirement planning, let's take a look at a couple of key differences between the two IRAs.

If you've stashed money in a 401(k) or traditional IRA, you'll owe income taxes on those withdrawals in retirement. The only way to avoid paying taxes on retirement account withdrawals is to invest in a Roth IRA. With a 401(k) or traditional IRA, your contributions are tax-deductible upfront. But with a Roth IRA, you'll pay taxes when you make the initial contributions -- so your withdrawals will be tax-free.

Some workers have invested in both IRAs. If you're one of them, it enables you to come up with a withdrawal strategy to minimize your tax bill in retirement.

For example, if there are years of retirement when you know you'll be spending a lot more money -- like if you have several expensive vacations planned or want to renovate your home -- it's a good idea to withdraw more of your income from your Roth IRA because that money will be tax-free. Then, during the years when you're spending less, you can withdraw more from your traditional IRA or 401(k).

If you want to minimize your taxes in retirement, you may choose to invest primarily in a Roth IRA now so the bulk of your savings will be in this type of account. True, you'll owe taxes upfront, but if you're currently in a lower tax bracket than you expect to be when you retire, saving in a Roth IRA could help you ultimately pay less in taxes than if you save exclusively in a 401(k) or traditional IRA.

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