The No-Compromise Retirement Plan

OVERCOMING THE COMPROMISES IN YOUR IRA
TO LIVE A MORE SECURE RETIREMENT

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SAMPLE CHAPTER

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Conflict: You vs. Uncle Sam

You've probably heard of Dave Ramsey before. He's an author, radio host, TV star, and popular purveyor of financial advice. If you've ever listened to his show, you know his most famous mantra: get out of debt!

Ramsey encourages Americans to pay off their credit card debt, car loans, medical bills – even their mortgages.

In general, it's good advice. Americans could use a lot less debt.

But I'm always alarmed Ramsey overlooks one of the biggest debts nearly every American carries.

Your Hidden Debt

I call this your hidden debt, since so few of us realize we carry it.

You may have paid off your mortgage. Student loans may be decades in your past. You may own your car and pay off your credit card bill each month. But if you've saved for retirement in a 401(k) or IRA, you are NOT debt free.

So, what's your hidden debt?

The taxes you owe in your qualified account.

My client Dave never considered his hidden debt.

Dave has $760,000 in a 401(k). When I first met him, he was laser-focused on income: he and wife needed $100,000 a year in income for the retirement lifestyle they desired. He wanted to know the best way to manage and protect his $760,000 so that, along with Social Security and his wife's pension, they could meet their income goal.

But Dave forgot about his hidden debt. He believed his IRA was worth $760,000.

It wasn't.

Dave's tax liability is around 25 percent. So, when he withdraws $50,000 from his IRA, he only gets to keep $37,500. The other $12,500? That's the taxes he owes. That's his debt payment to the IRS.

Put another way, Dave is indebted to the IRS (and its state and local partners) for around 25 percent of Dave's retirement funds. While he was saving, Dave got a tax deduction on his 401(k) contribution every year. It was like a loan he didn't have to repay anytime soon. But now, as Dave gets ready to retire, he'll start to repay that loan.

Why don't most of us think about our hidden debt? Because it doesn't impact us now. When you buy a house on mortgage, you live in the house every day and make your mortgage payments each month. But with your IRA, you're not using the money until years in the future, and the debt isn't immediately clear.

It's about to become clear.

Like Dave, when you begin accessing funds from your IRA or 401(k), you begin paying back your debt to the IRS.

And it gets worse. Because in truth, you're paying back that debt with interest. After all, you deferred taxes only on your IRA contributions. Now, you'll be paying taxes on your IRA contributions AND all the growth that's occurred in your account. The IRS is taking its cut of your principle and your earnings.

Your Silent Partner

It's time to start thinking of the IRS as the silent partner in your IRA.

Just how big of a silent partner? That depends on how big your tax liability is.

In Dave's case, around $190,000 of his IRA isn't his.

So, when Dave is planning for his retirement income, he doesn't really have $760,000 to use. He has a base of $570,000 that he'll be able to spend as income.

The Great American Savings Myth

This is the basis for what I call the Great American Savings Myth: American savers believe the money in their qualified accounts is theirs to spend.

But it's not. Not all of it, anyway. When you look at your IRA or 401(k) statement, your account isn't worth the number on that piece of paper.

Have you fallen victim to the Great American Savings Myth? Don't feel ashamed! I did, too. And so has the vast majority of our peers. Most of us are taught to think this way. We focus on the number that shows up on our statement, but not how much of that number we'll get to keep. It's how we've been trained to look at our retirement savings.

The Great American Savings Myth may be one of the costliest assumptions many of us will make in our entire savings experience. And in this chapter, we'll look at the importance of approaching your retirement accounts with open eyes and a complete understanding of how the choices you make today will impact your income in retirement.

I suspect the tax status of your retirement accounts has been an afterthought until now. This chapter will change that.

This. Is. Important.

If there is only one thing you take from this book, this is it: you MUST incorporate tax planning into your retirement planning. It is no longer enough to ensure your retirement funds are diversified when it comes to asset allocation. They must also be diversified when it comes to tax status.

Tax-Efficient Income Planning

In the financial industry, a focus on tax diversification for retirement assets is often called "tax-efficient income planning." And if you're not working with a financial advisor who's an expert in this area, you should be. Tax-efficient planning looks at the tax makeup of your portfolio and tries to get you the most *after-tax* income for each dollar of your savings.

We'll explore what this means in the pages ahead.

But for now, I want to offer a warning: savers who fail to plan with taxes in mind risk paying hundreds of thousands of dollars too much in taxes when they're retired. In the next sections, I'll show you why.

Before we go on, I want to make something clear: I'm not a CPA. I'm not a tax professional of any kind. I'm an actuary, and a saver. Additionally, I don't know your individual situation. That's one of the limitations of a book. You should consult a tax professional about any specific questions you have.

But what I am qualified to do is change the way you think about taxes when it comes to your IRA or 401(k). And that's what this chapter is all about.

The Tax Status of How You Save

There are three main tax structures you can save under for retirement.

Taxable Saving

Taxable saving means you don't get a tax deduction for the funds you put in the account, AND you pay taxes on your earnings each year. For example, think about your savings account at the bank. Each year, you pay taxes on your income and then put some of that income into your savings account. When you file your taxes, the interest earned on your account is subject to taxation. So, every year, Uncle Sam is taking a small cut. The majority of retirement savings are not held in taxable accounts, though most people have some long-term savings in this kind of structure. For example, many brokerage accounts are taxable. Usually, real estate is taxable; so are typical CDs and money market accounts you can get at the bank. Unless you acquire these types of assets through a qualified retirement plan, they are taxable.

- **Pluses**: These may be the only option for some of your funds, or some of the account types you want.
- **Minuses**: Paying taxes on earnings each year reduces the amount growing by the tax bill, so you have less money compounding.

Tax-Deferred Saving

This is the most common way to save for retirement. Tax-deferred accounts work like this: you do not pay any taxes on your contributions today. In the future, when you access the funds, you pay taxes on your contributions and all the earnings associated with the account. This is how traditional 401(k)s and IRAs work. Most of us have a good portion of our retirement savings in tax-deferred vehicles.

- **Pluses**: You can deduct contributions in the year you make them, lowering your overall taxable income for that year. For some people, their tax rate could be lower in retirement than it is today, making it wise to defer paying those taxes.
- **Minuses**: All the money you grow from the day you start saving until retirement will be taxed. If your $20,000 grows to $100,000, you will owe taxes on the entire $100,000 when you withdraw it. Additionally, you accept the risk of unknown tax rates in the future, particularly if rates rise.

Tax-Free Saving

Tax-free accounts work like this: you pay taxes on your income before you put it in the account. But, in the future, when you access your funds, no additional taxes are due: you don't pay taxes on your contributions (already paid) OR your earnings (because they have grown tax-free). This savings strategy is growing rapidly in popularity. It's how Roth IRAs and Roth 401(k)s work.

- **Pluses**: All accumulation in the account is tax-free. If your $20,000 grows to $100,000, you'll never pay taxes on the $80,000 gain. Many professionals do not expect to be in a lower tax bracket in retirement, so it makes sense for them to pay taxes upfront. You are also protected from future changes in tax rates and tax law.

- **Minuses**: You cannot deduct contributions to lower your taxes during your contribution years. There may be limitations on how much you can contribute to these types of plans each year.

Which One is Best?

I believe most savers today need to be growing and accessing at least a portion of their retirement funds tax free. It's certainly the best approach for me and my wife, and this book will help you determine if it's the best approach for you, too.

Many people forget the tax deferral in an IRA or 401(k) is not a gift. Sure, you get a deduction the year you contribute to a qualified account. But it's not like taking a mortgage deduction or child deduction on your taxes. Those deductions lower your tax bill today, with no repercussions in the future. But the deductions you get for contributing to a 401(k) or IRA today come with strings attached: they require you to pay back those taxes (with the interest earned) in the future. That's why the accounts are called tax-*deferred* accounts. You're not doing away with your tax liability; you're just deferring it to the future.

In essence, the government is giving you a very expensive loan to avoid paying taxes today. A loan you have to pay back with interest.

There are two reasons I believe many savers — including myself — are better off saving at least a portion of their retirement funds tax-free. One is theoretical, and one is actuarial.

Will Your Tax Rate be Lower in Retirement?

The first reason is theoretical. The benefit of tax-deferred saving is largely based on deferring your taxes at a higher rate, and then paying your taxes at a lower rate.

I think of this as my parents' tax strategy.

As I mentioned, my dad was a small business owner, managing a regional chain of children's clothing stores. He made a solidly middle-class living and worked hard to do it every day. When he retired, he and my mom really cut back. They'd buy generic-brand sodas instead of Coke. They didn't travel much, and while they occasionally ate out, it was mostly meeting friends for senior discounts at Denny's or coffee at McDonald's. Like many retirees in their generation, they were thrifty and did more with less. In that way, they were able to lower their tax liability in retirement, because they used less income in retirement.

But that's not the way today's baby boomers think. My wife and I are a perfect example.

When we retire, we plan to travel extensively. My wife loves castles and wants a return visit to Scotland. We both bike and enjoy bicycle trips to Europe — which we'll do as long as we can. In retirement, we also plan to spend more time dining out and trying new experiences. We recently bought a new house in a trendy part of Louisville; it's within walking distance of a variety of shops, restaurants, and the local nightlife. In fact, my daughters joke we're going to have more fun in retirement than we did in college.

Most people like me don't want to cut back in retirement. We don't want to live more thrifty lives, counting every dollar with no breathing room. We want to maintain our pre-retirement lifestyle, and to do that we'll need to maintain our pre-retirement income level.

This is part of why I believe most Americans are not going to be in a significantly lower tax bracket once they retire. To preserve our lifestyles, we'll have to preserve our incomes.

But this is only one aspect of determining if tax-deferred saving or tax-free saving is right for you. The tax bracket I'm in is half the story; the other half is how much of my income is subject to that bracket.

The Million-Dollar Question

As a general trend, do you think taxes are going up or down in the future?

I've asked that question a thousand times in the past year, and nearly every single person has answered the same way: Up.

Here's why so many of us feel that way.

The federal debt is rising and rising. In the last chapter, we talked about how this was a good incentive for the government to keep interest rates low. But it's also a good incentive for the government to grow taxes.

How bad is it?

In 2013, analysts were excited that the federal deficit that year would be the first deficit in five years to increase by less than $1 trillion.[10]

It was considered great news that our deficit was *only* going to grow by $1 trillion. One TRILLION dollars. A one with 12 zeroes: $1,000,000,000,000.

Thirty years ago, no one even spoke in terms of trillions. That wasn't even a unit of measurement most people knew. Billions used

[10] Congressional Budget Office. Feb. 5, 2013. "The Budget and Economic Outlook: Fiscal Years 2013 to 2023." http://www.cbo.gov/publication/43907.

to be a mind-blowing amount of debt. And now we measure in trillions.

Someone has to help pay for this debt, and that someone is U.S. taxpayers.

So, let's talk about ways your taxes could go up — now and in retirement.

There are four primary ways your taxes could rise.

No. 1: The government raises tax rates.

Here's the most common way people think taxes rise. Today, a couple making $200,000 pays a 24 percent marginal tax rate on their income. But Congress could change the rules, and in the future that same couple making that same $200,000 could pay a 30 percent tax rate on their income.

In fact, we know taxes are going up in the future, because they are artificially low today. In December 2017, Congress passed the most sweeping overhaul of the U.S Tax Code we've seen in nearly thirty years. It reduced the marginal tax rate for many savers, and because of it, many of us today are in lower tax brackets than we were a few years ago.

But those tax brackets don't last forever! They are a temporary adjustment. As Congress often does, it included sunset provisions in the bill. That means, in the future, the tax cuts expire and revert back to the old levels. In fact, most household tax provisions in the new law sunset in 2025. So, you can plan on tax rates rising in the near future unless Congress acts again to keep them low.

Married, Filing Jointly[11]		
Income	Previous Tax Rate	New Tax Rate
$160,000	28%	22%
$250,000	33%	24%
$500,000	39.6%	35%

No. 2: You make more money.

This is a good problem to have, but one that's not terribly likely to occur once you're retired. Today, you're making $100,000 and paying at the 24 percent tax rate. Next year, you're making $200,000 and paying at the 32 percent tax rate. You're making more money, which is great. But you owe more of it to the government as well.

No. 3: Your deductions are eliminated.

Most people can take a variety of tax deductions. For example, if you pay interest on your mortgage, it's usually tax-deductible. But there's a trend in Washington toward taking away those deductions. Put another way, you could have to pay taxes on a larger part of your income. Call it what you wish, but that's a tax increase.

Let's say you make $80,000, but with deductions and credits your total taxable income becomes $72,000. If those deductions go away, you'll essentially have $8,000 more on which you must now pay taxes. That means you could owe $2,000 extra in taxes.

[11] U.S. Internal Revenue Service via the Motley Fool. Dec. 29, 2017. "Your Complete Guide to the 2018 Tax Changes." https://www.fool.com/taxes/2017/12/29/your-complete-guide-to-the-2018-tax-changes.aspx.

No. 4: The government taxes more things.

This is another way the government could tax more of your income. Here's a good example. You don't pay Social Security taxes on every dollar you make. There's a limit, called the "maximum taxable earnings." In 2014, the Social Security taxable earnings cap was $117,000. That meant, if you made $90,000, you paid Social Security taxes on all of it, but if you made $120,000, you paid taxes only on the first $117,000. In that case, $3,000 would not be subject to Social Security tax.

Things changed in 2015, however. The maximum taxable earnings for Social Security increased to $118,500. So, if you earned $120,000 in 2015, you no longer avoided taxes on $3,000, only on $1,500. You pay more in taxes despite your income staying the same.[12]

If you don't believe there are sneaky ways your taxes could go up, consider one of my clients, Mattie. Mattie owns a catering company. She's very successful, catering not only weddings and special events but a growing number of corporate lunches and dinners in our community.

Several years ago at tax time, Mattie discovered she owed $1,266 more in taxes than she planned. She didn't have more income than the previous year, and she knew her tax bracket hadn't changed. There had been no new tax increases announced by Congress. She was more than a little confused.

Her accountant cleared it up for her: in the Affordable Care Act (otherwise known as Obamacare), there was a provision to increase the threshold for Social Security taxes. Mattie now owed Social Security taxes on a large part of her income, and, accordingly, her tax bill was higher.

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[12] Patrick J. Purcell. Social Security. December 2015. "Income Taxes on Social Security Benefits." https://www.ssa.gov/policy/docs/issuepapers/ip2015-02.html.

Since 2012, the federal government has raised taxes on capital gains and dividends, Medicare surtax, payroll taxes and taxes for higher earners. That's in the last few years alone.

Assuming That Risk

When you save tax-deferred, you are assuming the risk of future tax rates, deductions and exemptions. You accept a large unknown in your retirement account and, accordingly, in your retirement income. When it comes right down to it, how confident are you that the tax environment will stay the same over the next thirty to forty years? I'm betting not very confident.