Episode #180: How to Generate Guaranteed Tax-Free Income

Video Transcription

Welcome back to "Money Script Monday." My name is Kyle. In today's episode, we'll be talking about how to create guaranteed tax-free income in retirement. Americans have done two things when preparing for retirement. One is that they've taken full advantage of the tax-deferred treatment inside their 401(K), and/or a traditional IRA, where they've accumulated a nice nest egg of money. At the same time, unknowingly, they've also accumulated a large tax liability that they will have to face.

I bring this up because taxes are your number one expense in retirement. Given the uncertainty of future tax law changes, it's important to work with a financial professional to create a plan, to show you different strategies on how to eliminate, alleviate taxes altogether in retirement, and to also show you strategies where you'll never outlive your income. What I like to say is that you're legally laundering money that's taxable and dirty into a tax-free clean vehicle. How do we do that?

The first step is to recognize tax liability. Get your pen and paper out. What percentage of your net worth falls inside this tax-deferred bucket of money? If it's a large percentage, then you got to start looking at ways to move that money into a tax-free bucket such as a Roth IRA. There's a lot of uncertainty out there, but here's what we know: there's $28 trillion of debt inside this country that we face. We have a tax and jobs cut act that is sunsetting in 2026, if not sooner. In addition, we have a $3.5 trillion deficit from 2020.

Here's the kicker. We're sitting at historically low marginal tax rates. The question for you is, do you think tax rates will be going higher, staying the same, or will be lower in the future for your retirement? If you decide that tax rates are going to be going higher, the first transaction that we're suggesting is to consider a Roth conversion. There are pros and cons to that, and we'll get into that. With that Roth conversion where we're taking money from your traditional IRA, and converting that into a Roth, we are also going to be paying an initial upfront tax that may be a hard pill to swallow, but in the long-term will save you on taxes.

Here's an asterisk: how are we going to create the income stream that we won't be able to outlive? That's where we're going to be converting at an insurance company, and funding an indexed annuity contract, of which we will explain later, of which we can then elect to turn on income at whatever age you decide. Roth conversion, that big strategy that we mentioned, there are pros and cons to each.

The first pro is that distributions are tax-free. We know that. You may have money inside your Roth IRA already, gross tax averted, and distributions are tax-free.

The second is that we don't have to take out money at age 72 like our traditional IRA. The third is that there are no 20% withholdings as if you were moving funds from a 401(k). There's no 10% additional tax if we're under 59-and-a-half and making that Roth conversion. Lastly, because of this transaction, we could lower your future tax bracket in retirement. That's a great benefit to everyone.

Cons: that conversion is 100% taxable. You will be having to pay ordinary income taxes on that conversion, which may be higher. It may be a high amount at first, but we'll explain why it will make sense. Additional distributions, sometimes people don't have money on the outside in a nonqualified asset such as a checking account, savings, or brokerage. They don't have that money on the outset to pay that tax bill, so they may have to take additional distributions. We would not recommend that, but it is there if need be. After a 5-year wait, you may be subject to an additional 10% if you start to take out funds before that 5-year window comes up.

Let's move on over here to the indexed annuity contract. That Roth conversion takes place at the insurance company for us to fund this type of vehicle. Annuities have a bad stigma but let me explain six reasons why you should consider one. Safe accumulation. We're able to participate in market-like gains, modest from anywhere from 3% to 5%, such as the S&P index, the Barclays, the PIMCO, the EURO, the Russell. While participating in it, we're also protecting our downside, so our principle is 100% secured.

Tax-deferred growth. We receive that benefit inside this contract earning that compounding interest. Flexibility, people think you have no access to your funds when you funded an indexed annuity contract. That couldn't be further from the truth. You have anywhere from 10% to 20% access any given year. If you are confined to a nursing home, you have access to the full accumulation value, and you have the option of doubling your income in retirement.

Guaranteed lifetime income, that's what we all like. That's what we all want, like pensions or social security. Income we won't outlive and that won't fluctuate due to market volatility. Lastly, legacy options. If we are uninsurable for life insurance, indexed annuities have a death benefit feature where your beneficiaries would collect a dollar amount if you were to pass away. Keep that in mind.

Here's an example. I'm not going to mention the name, but here are some of the features inside an indexed annuity contract. Let's say you gave an insurance company $100,000, day one. You're going to get an 18% premium bonus bringing up your income base value to $118,000.

On top of that, you're going to earn a 250% interest rate credit if the index performed positive that year, and every year that you defer before income. That 3% that we assume we earned, multiply that by two and a half, and we get 7.5% credited to our income-based value where we earned the 18% bonus. At the end of year one, we had $126,000, and some change that we can at any point turn on income given the withdrawal rates at that age.

Let's move on over here to a case study. Here's an example of how this strategy of Roth conversion into an indexed annuity works, compared to not doing anything and leaving that money inside the tax-deferred vehicle. We have Lee. He's 65. He's in a 24% tax bracket. He wants to retire in 5 years at age 70. He decides that he converts $100,000, or 10% of his $1,000,000 nest egg inside that tax-deferred vehicle. On that conversion, as we talked about earlier, he's going to pay ordinary income taxes at 24% upfront, one time only. His taxes are $24,000. After turning on income in year five, we're taking a future date, and looking at the cumulative income he was able to receive. It's about $241,000 that he collected at age 85.

Let's look at the other strategy of keeping our money where it's at and not incorporating this type of play. As you can see, we've paid a lot more taxes in the long run. We're paying taxes as we go, more so on the harvest and not the seed, so our liability is far more than what it is in our Roth conversion play, and our income is significantly less. I put an asterisk mark here because it ran out at age 80 if we compared that same distribution stream inside our indexed annuity.

I want to wrap up this episode and leave you with one more question. Why wouldn't you work with a financial professional to see if this strategy makes sense? There's no cost. If you think tax rates will be higher in the future, consider a Roth conversion. If you like the idea of guaranteed lifetime income, consider an indexed annuity. If you want to do a combination of both, more power to you. I just can't stress enough that this strategy is available for everyone, and your situation should be realized. I encourage you to work with a financial professional to see if this makes sense for you.

My name is Kyle. Thanks for tuning in. I'll see you next week on "Money Script Monday."