Episode #299: If Taxes Never Increase Again, Won't My Retirement Be Safe?

Hello and welcome to another episode of Money script Monday. My name is Luke Geller, and today we're going to be talking about “If taxes never go up, will my retirement be safe?” And today I want to start off with a story. The story is about two farmers, and these two farmers have been doing what they do for a long time, and it's that time of year for them to go into town and get seeds to be able to plant their crops. So they're going into town and then they go to the store.

When they get to the store, they find the seeds that they want and they go bring it up to the register and it's the owner and the owner says “Hey, we actually have a special deal on these seeds. These seeds are great. They're going to make your crops better than ever. We actually have two different ways that you can pay for. First way is you can pay for them regularly, you just pay for the the cost that they are now, go ahead and walk out, and everything is yours that that they that grows from them. Or I'll give you these seeds for free for now and then at a later date once you grow these crops, once you harvest those crops, then I'm just going to take a small percentage of whatever those crops are.

Both these farmers are thinking about it. And they're like, “Hey, well, I kind of really need the money that I'm paying for these seeds so it would be nice.” So the first farmer says, “You know what? I'm going to take you up on that offer. I'm going to take these seeds, and I'm going to go and I'll pay you later, whatever that amount is.” And so the store owner says, “OK.”

Now the second farmer is thinking, “Wow, yeah, that that is kind of a good deal well. Let me ask you one question. When I sell my crops and I sell that harvest, how much of it are you going to take?” And the store owner says “That is a great question. I'm not sure it's really going to depend at the time on what I need and how much my debts are. Really, I'll tell you at that time."

The second farmer is thinking about it says well, "I really don't like that deal because I don't have the control that I would normally have and so he says, "You know what? I'll pay for them now. It's going to suck. It's going to be hard, but I'll pay for them now, and then everything I grow from it will be mine. And so we fast forward.

The farmers planted the seeds, grew the crop, and it was the best season that they've had ever and the crops grew exponentially, astronomically. It's a great harvest and both farmers are so excited. They're both thinking how great that is. But that first farmer can't put his finger on it, but he has something that's bothering him in the back of his mind. And then he realizes. You know what? Not all of this crop is mine. I actually, I owe that store owner something.

When it when it comes time to harvest, that first farmer calls up that store owner and says, "Hey, I know we made the deal and so how much do I owe you? I had an amazing harvest, a great season. What percentage of what I made do I owe you?" And the store owner goes, "You know what? I actually had one of the hardest years of my life. I am in debt beyond belief. I owe so many people money, so I'm going to need a lot more than I thought at that time. I'm going to need 40% of what you grew and sold." The farmer goes, "Yeah, Dang it. You know, I made a deal so I have to pay you, but I would have saved so much more if I just paid for these seeds up front."

I'm telling you this story because really it's a metaphor for taxes and retirement and when you're thinking about where you're going to put your money to grow in retirement. If you're thinking, "Hey, if taxes never go up, if taxes stay the same, is my retirement going to be safe?" Well, that's really going to depend on where you have your money and how you treat that.

So what we're going to go through today is the three different types of buckets that you can put your money into in retirement. In this first bucket, we're going to go over what's called the taxable bucket and you'll notice this taxable bucket has multiple holes with water spilling out. And what's in this? The taxable bucket would be like a checking account, savings account, money market account, investment funds that you trade, accounts where you just trade some mutual funds in there and try to grow some savings that you have. All that money would be in this taxable bucket and every single year that money grows and has realized growth, you're going to be taxed on that growth, and that's why you see all of these holes coming out of that bucket, right? The more money you put in that, you're paying taxes on before you put it in, and any growth that you have in there is taxed as well. Not bad, but not the best.

Then we go over to this tax-deferred budget. This is probably the most popular bucket that's out there. Most people, probably 90% of people, have the majority of their money in this tax-deferred bucket. Now what that tax deferred account is is it would be like a 401A, 403B, and IRA. All that money, all those accounts, are treated in this tax-deferred bucket. So when you have money that you get from your paycheck and you put it in this tax-deferred bucket, you don't have to pay taxes on it yet.

It's very similar to not paying for those seeds right away, paying on the harvest in this bucket. All the money you're putting away, you don't have to pay taxes on. And just let it grow and grow and it's going to grow bigger than that taxable bucket because you're not paying taxes on it every year. You haven't paid taxes on it yet, so it's going to grow pretty big and you say, “Hey, wow, I have a lot of money in this account!” But I want you to remember one thing. Not all that money's yours, right?

Not all those crops were that farmers and what I like to think about is this diagram here when we're looking at this chart. If we’re to grow this tax deferred account to $1,000,000, you have $1,000,000. Well, you actually don't. If you're in a 28% tax bracket. You have $720,000 and you actually owe the government $280,000.

So you put in all this hard work, you grew these crops, right? You grew this money in this tax-deferred bucket, but it's not yours, right? Not all of it's yours and you know it. This tax-deferred bucket can be a great tool. It can be very useful, but I just you want to remember that not all that money in that bucket is yours.

Finally, we have this tax free bucket. Now this tax free bucket is going to be like a Roth IRA, or 401K, a 457 college plan, municipal bonds, or cash value life insurance. And in this tax free bucket, you pay taxes on the money that you put into this bucket, but anything that money grows to, is going to be tax free and when you take it out, it's going to be tax free.

Now, each one of those different vehicles is treated a little differently. You might have limits to what you can put in and you should definitely talk to a professional about how you can fund this bucket. But if we're talking about how to really protect your retirement, and we're talking about how to make sure, “Hey, if taxes go up, taxes go down, if taxes stay the same, how can I make sure my retirement safe?” By making sure that you have some money in this tax free bucket, but really you have a take a diversified approach to taxable accounts and retirement.

As I said earlier, most people have most of the money in this tax deferred bucket, but that's not taking the diversified approach. What you want to make sure you have is money in all three different buckets. By doing so, you're going to be able to make sure that your retirement safe, whether taxes never increase, keep going up, or even reduce because you have the ability to pull money from any of these buckets to help you in retirement.

Just like that second farmer who, when his crops were growing, he had zero stress because he knew that it was going to be the best season of that he's had, by putting your money in that tax free bucket, by making sure you don't have all your money in that tax deferred bucket, and taking that tax diversified approach, you're able to have that stress free retirement to where you can pull money from any of the accounts you need to and be able to use these accounts however you want to have a stress free retirement, not worry about taxes going up or down, and being comfortable where you are.

I hope that today you're able to take something from the story that I talked about, from the different taxable buckets they have, and remember that just because you have so much money in that tax deferred bucket, in your 401K, it doesn't mean all that money is yours. Thank you for attending today and we look forward to seeing you next time.