

Episode #348: How to Navigate the Most Important Variable in Retirement

Hello and welcome to another episode of Money Script Monday. My name is Luke Geller, and today we're going to talk about how to navigate the most important variable in retirement. Retirement can be a scary thing. It's the back third of your life that you've worked so hard to get to. Not only that, but navigating retirement can be extremely difficult because no two people's retirements are going to look the same. No two people are in the exact same situation, have saved the same amount of money, have the same family, or have the same situation. All those different variables that come into play.

But when we talk about the most important variable, one thing you want to make sure you understand, so that way you can navigate it, is really taxes. Taxes can be extremely crucial when it comes to retirement. Think about it: this country was founded on not wanting to pay taxes to the British government. That's how we were founded. Now, as you're entering retirement, you probably don't want to pay taxes to the U.S. government if you don't have to. That's what we're going to talk about today. We're going to look at three different buckets of taxes: the taxable bucket, the tax-deferred bucket, and the tax-free bucket.

I want you to consider these two principles when we're looking at each one of these buckets. The first principle is, if there's a tax that you don't have to pay, let's not pay it. Second, if you do have to pay a tax—if there's no way around paying that tax—let's pay as little as possible. Very simple. If there's a tax you don't have to pay, let's not pay it and if there is a tax that you have to pay, let's pay as little as possible. I want you to consider those two principles as we go through this.

We're going to start with the taxable bucket. In this taxable bucket, you have things like mutual funds, stocks, money market accounts, and

CDs. How do you know if an investment belongs in this taxable bucket? If, at the end of the year, come tax time, you get a 1099, it means that you have to pay taxes on the interest earned every single year. That's why this is considered a taxable account. That's one of the cons. One of the pros is that money in this account is liquid, meaning you can access it quickly and easily, and you can use it as an emergency fund.

How much money should you have in this taxable account or in this emergency fund? Well, a lot of national pundits may not agree on much, but one thing they actually agree on is that you should have about six months of savings as an emergency fund in this taxable bucket. Is it possible to have not enough money in this taxable account? Well, sure. If you don't have enough money in this account and an emergency comes up, that's how you get into credit card debt. You would have to borrow money or take on debt to pay for that emergency.

Can you have too much money in this taxable account? Well, you can never have too much money. However, if you have more money than what you need for your emergency fund in this account, and it's in stocks, money markets, or CDs, you're paying taxes on that every single year when you don't necessarily have to. How can we put that money into something where you're not going to have to pay those taxes?

Let's take a look at the tax-deferred bucket. This tax-deferred bucket really follows that second principle: if there are taxes that you have to pay, then let's pay as little as possible. In this tax-deferred bucket are 401(k)s, IRAs, 403(b)s, and 457 plans. These are taxes that you're going to have to pay in some capacity. These are probably the most popular accounts. The majority of Americans have their money in a 401(k) or IRA, so these are the most commonly known or commonly used accounts. At the end of the day, if you have money in these accounts, you're going to have to pay taxes on them in some capacity, either now or in the future. And if you don't pay taxes on them, then your beneficiaries, when they receive that money after you're gone, are going to have to pay taxes on it.

We know what types of accounts go in this tax-deferred bucket. Now, when we decide to take that money out, it's taxed as ordinary income. That means, at the time you pull funds from your 401(k) or IRA, it goes on top of anything else you're making, and you pay taxes based on those numbers. Think about it: that's kind of powerful. That is a huge variable in retirement because, one, you don't know what your tax situation is going to be, and two, you don't know what the government's tax situation is going to be.

What does that mean? You don't know what your tax situation is going to be. Right now, most likely your two biggest deductions are, for most Americans, their house and their dependents—their kids. When you retire, you most likely want to kick your kids out of the house and have your house paid off. You lose those two deductions right off the bat. You're most likely in a worse tax position when you're retiring than you are right now, and you probably don't want to lower your lifestyle in retirement. You want to do more things than you ever have before. You have goals and things you want to accomplish, like spending time with your grandkids.

The other thing is, you don't know what the tax brackets are going to be. Those are things we don't know. A lot of people think of stock market losses, but not enough people think of tax losses. How much money should we have in this account? There's a saying called RMD tax-free. No matter what, you're going to have to pay taxes on this money. Even if you say, "Hey, I never want to touch it," the government is going to force you to take required minimum distributions. When you do that, it's going to be taxed. Based on how much money you have in the tax-deferred bucket and the taxable bucket, there's a number that can get you to that RMD number being tax-free. Is that possible for everyone? No. But again, you're going to have to pay taxes on that money, so you want to try and have a plan and figure out how to pay as little in taxes as possible.

When we go to this last bucket, the tax-free bucket, this is the bucket that everyone wants. To be considered tax-free, think of a couple of things. That means you want it to be federal, state, and capital gains tax-free, and

you want to make sure it does not affect taxes on your Social Security. When Social Security came into place, we were told that you would never be taxed on Social Security. Now you can be taxed on up to 85% of Social Security. That law has changed twice since its inception, and the reason this changed is because the government needed it to change and wanted to tax you on it. Those are things to consider.

What are accounts that fit into this tax-free bucket? One of the big ones is a Roth IRA or Roth 401(k). Roth IRA is huge, and Roth 401(k) is huge. The downside is there are limits to how much money you can put into each of these, and if you make too much money, you can't even contribute to a Roth IRA. You want to put as much as possible into a Roth IRA or 401(k), but there are caps, and you might not even qualify to do so.

One other vehicle is cash value life insurance. Cash value life insurance fits in the tax code where you can put as much money as you want to into it to allow it to grow tax-free and have the money grow tax-deferred as well and pull it out tax-free.

In this tax-free bucket, how much money do you want in there? There's a thing called AMAP: "as much money as possible." If we put as much money as possible in this tax-free bucket, that means that when you pull it out in retirement, you're not paying any federal, state, or capital gains tax on it, and you're not adding taxes on your Social Security. If you do that and you can navigate everything and have as much money as possible in this tax-free bucket, then you're able to navigate those retirement waters as best as you can.

Just to recap: your taxable bucket is where you want emergency funds for six months. Anything else, and you're paying taxes on something you don't have to. In the tax-deferred bucket, you have your 401(k)s and IRAs. You're postponing those taxes, but you're going to have to pay taxes on them in some capacity. If we follow those principles, let's try to pay as little

as possible in this tax-deferred bucket. Then we go to this tax-free bucket. We want to fill that bucket up with as much money as possible.

I urge you to talk to a professional, talk to your advisor, and learn how you can navigate these tax waters. Navigate the most important variable, which is taxes in retirement, by trying to fill up that tax-free bucket as much as possible. My name is Luke. Thank you for joining us today. See you next time.