PAYING The PIPER

7 TAX TRAPS HIDDEN IN YOUR 401K & IRA

...AND STRATEGIES FOR PLANNING YOUR ESCAPE

CRAIG WEAR, CFP®

PAYING THE PIPER

...And Strategies for Planning Your Escape

BY CRAIG WEAR, CFP®

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ACKNOWLEDGMENTS

THE IDEA AND OUTLINE for this book was birthed four years before I began working on getting the information into tangible form. The latest changes in the tax codes in 2017 served as the final impetus to provide all who were willing, with the knowledge necessary to take advantage of historical low tax rates. Saying I was going to write a book is much easier than actually doing it. I have several people that came alongside me to make this happen for this first-time author.

Dudley Lehmer is a long-standing friend whom I admire and respect tremendously. He's normally the smartest guy in the room but possesses the humility that never presents himself as such. Dudley is also a generous and kind-hearted man; always willing to help and sacrifice his time to share wisdom from the publishing experiences of one of the most successful books offered by one of the largest book publishers in the world. His guidance and friendship are of great value to me.

David Spencer was among the first to read the manuscript for this book. Our friendship is born out of a love for the mountains, hiking, and RVs. While our relationship is relatively young, he's become a great friend. I value his unswerving honesty and humility, and trust his objective input. His feedback as 'guinnea pig-reader' gave me the confidence to push through and finish the book knowing that others would find the information and recommendations valuable.

Larry Bolton is a new friend that quickly became like a big brother to me. Our morning conversations along the river while walking Charlie and Bristol (our dogs) forged the beginning of a great friendship. He's been very successful in his family life and professional endeavors. My respect for him and his knowledge of the financial industry prompted me to ask him to review the manuscript and provide some 'tough love'. He took a lot of time to provide specific and meaningful input to help you – the reader – have a better outcome from reading the book.

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I'd also like to acknowledge a handful of friends that reviewed 'nearly completed' drafts of the manuscript and provided valuable feedback. Their input allowed me to hone the message and make it simple to read and understand, and hopefully to act upon.

And lastly, to the two true loves of my life. To my wife, Pam, for her undying love, encouragement and support. She's been my rock and my cheerleader for soon to be forty years. Without her belief in me, many things in our life would never have come to fruition. And to Christ, my ultimate source of inspiration and hope for an amazing future. I am but a dirty and broken vessel from which I hope his love is poured generously into the lives of others while we share time on this Earth. He deserves the ultimate credit.

1. SETTING THE TRAP

AN URGENT AGENDA

The "BIG IDEA" of this book

WHERE DO WE LEARN about money and planning for our financial futures? Most of us learn from the "school of hard knocks." If you apply for enough credit cards, you will quickly learn the hard lessons they teach. After you buy a few vehicles, you'll learn the art of finding the right one and negotiating a fair deal. Buy a home or two, and you'll understand the mortgage process. But how do you learn to plan for retirement if you only do it one time?

My career as a financial advisor began in the depths of the huge economic recession of the 1980s. In addition to the basic licenses required to be in the business, I immediately went to work on the two-year curriculum to earn the right to use the marks of Certified Financial Planner®. My finance degree coupled with the professional accreditation were my ticket to begin my practical real-life education. Although I've sold my thirty-plus year-old financial planning practice, I began as an independent advisor and remain one today.

My experiences were not influenced by a large sales organization. Instead, the tutors I've had on this subject have been the thousands of people who have allowed me to walk with them along their path into retirement. Through this process, I've learned what works and what really doesn't. What I propose to do in the following pages is

to share the knowledge I've gained from these wonderful people who travel down a very thin lane. The specific lane I'm writing about has everything to do with the enormous and avoidable cost of excessive income taxation that comes from "too much of a good thing."

Saving for retirement inside of a 401k or IRA is a great practice to engage in early and consistently. However, just like many things in life, doing so in excess can cause hundreds of thousands, even millions of dollars of income taxes over the saver's lifetime. It sounds far-fetched, but it's absolutely true. To minimize the risk of living longer than your savings you can most easily accomplish this by starting early. And if you have a 401k savings option available at work, they are a wonderful vehicle – if used wisely. Taking full advantage of the company matching percentage is an example of a wise practice.

However, within many 401k plans the saver has the opportunity to contribute after tax dollars. Because of the current state of our relatively low income tax rates, any amount that is contributed to after tax accounts will most likely save significant taxes later on. In later chapters we'll reveal specific parameters and strategies to incorporate into your long-term savings strategy.

So "the one thing"—or the "big idea" that Curly would ask about (movie humor for anyone who happens to catch it)—is this: there is a freight train of tax burden headed your way, but it's avoidable if you'll only just get off the doggone tracks you're standing on.

The strategies and tools that will help you mitigate this are safe, simple, and totally legitimate in the eyes of the IRS. Most often, the solution is simply to change the way you're currently doing something.

Come with me now as I share my thirty-plus years of experience. If you learn to recognize the issues and take action, you'll be able to dodge much of the sting. I recognize that financial subjects can get pretty boring very easily, so I've tried to weave in illustrations and analogies from the lives of people I've interviewed and counseled over the years. Read on to discover more about the lessons I have learned so you can have a better future yourself.

Time is of the Essense

In 2017, the Tax Cuts and Jobs Act created the lowest income tax structure in modern times. It has increased the amount most families are able to deduct from their income, which reduces the amount taxed. It also reduced the rates at which their income is taxed. There are a host of other targeted credits and programs that are also mentioned in the act. IRS Publication 5307 (https://www.irs.gov/tax-reform) provides a great deal of information about the changes that affect individuals as a result of The Act.

Did you know that many of the benefits are set to expire at the end of 2025? Unless you believe that tax rates will become even lower than their current fifty-year lows after this expiration date, anything you can do to put yourself in a better position after 2025 should be on the table for discussion. In a future section I'll illustrate just how low our current tax rates are compared to historical rates. If you've been saving for quite a while you probably received a tax deduction at these higher rates. Now that rates are low – for a while – it seems like a fantastic time to benefit. You might even consider that you 'won' on both ends – a greater deduction when you put the money in, and a lower tax when you take the money out. But you have to use correct strategies and timing to make this work to your advantage. I'll cover those in the latter section.

My wife loves to shop sales. I enjoy saving money on an item or service today, especially when I know I'm going to need it later. I can commit to a lower price per gallon of propane for our cabin today in order to lock in the low rate and not pay higher rates over the next year or so. For the next few years, your income taxes for the future are "on sale." If you believe (as I do) that income tax rates have little chance of decreasing in your lifetime, then why wouldn't you do everything in your power to reduce those future income taxes if you are able?

Because of this expiration date, there is a countdown clock already ticking down to the day these historically low rates may go away. One of the underlying premises of this book is that many American 401k savers will be hundreds of thousands of dollars ahead of the tax man if they adopt specific strategies to pay some tax now, at historically low rates, in order to save taxes later. And they can add to their benefits by implementing specific strategies that generate higher sources of tax-free income at the same time.

Since the strategies are normally executed most efficiently over a period of several years, it is imperative that you choose your position on this now and act quickly. My hope is that you don't compound your "tax trap" by procrastinating on this opportunity.

Christmas Trees

GROWING UP in an entrepreneurial home, you might say I was destined to start my own business one day. My first job after college was to start a rental car business under the umbrella of my father's company and to expand a national used car rental franchise across the state of Texas. We had great success for a couple of years leading up to the huge recession that hit the Great State in the early 1980s. The recession was so severe that we ceased operations, leading to my next position with an established national brand. After a short few months as an employee of this national car rental company, the local general manager and I had a conversation where we mutually agreed that I was probably not the right person for the job. I had come to the stark revelation that they were not going to change their corporate marketing direction to appease the whims of this recent college graduate. Having 'incubated' in an entrepreneurial environment, the corporate wheels moved much too slowly for this impatient young man.

Needing a way to provide for my young bride, she and I agreed to risk all of our unsubstantial life savings to purchase Christmas trees in bulk, hoping to resell them for the season. We bought 300 trees from two friends in the business, partnered with a local hardware store that was in a great location, and set up shop around Thanksgiving. Within ten days we'd sold every single tree—including our consummate "Charlie Brown twig" tree. The net proceeds gave me the naive confidence to launch into the field of personal financial planning. I already had a finance degree, so I thought it was an obvious choice.

Implementing that decision turned out to be much more difficult than I ever imagined. I was in my early twenties but looked like I was eighteen years old. I was six feet tall and 150 pounds; there was barely a whisker above my lip. I survived a few rounds of the interview process at several of the major financial firms, but each attempt ended with some version of "You're not ready yet."

My reasons for wanting my own business in the financial industry were probably a bit too romantic. My mom and dad were entrepreneurs who did well enough to have a nice lifestyle, but nothing over the top. But when it came to making financial decisions, there really wasn't any one person they could turn to for wise, unbiased advice. I felt a need to help people sort out the pieces of their own financial-life puzzle. At the time, I had no idea what a financial planner really did, but I knew I wanted to help people live less stressful and more meaningful lives. Like it or not, money has something to do with all of that in Western society. But the institutional, big-firm reality of the bottom line just didn't suit my altruistic view of helping and serving people.

As it turns out, those companies were spot-on about my timing in entering the business. My first full year of business, my gross income was around $8,000—yes, for the entire year. The second and third years were not much different. I'm sure that you have your own story of struggle; sometimes life is just hard. My amazing wife was working full-time while I was trying to figure out how to get in front of people to let them see how eager I was to help. One evening, she went to the refrigerator to contemplate "What's for dinner?" and found it almost empty: all we had was some butter, a little milk, and a couple boxes of mac-n-cheese in the pantry. I'll admit that was a difficult day for this guy's ego. But those experiences strengthened my resolve, motivated me to learn faster, and certainly solidified my faith in a bigger purpose.

I was learning my craft and deciding what I truly believed about the business of offering financial advice to others. One of the first things I did was to enroll in a certification and education program to become a CERTIFIED FINANCIAL PLANNER™, and by the age of twenty-nine, I had earned the right to use the marks. What else did I need? Real life experience. At twenty-nine, most of us don't know much about how money really works, or what it takes to actually keep some of our hard-earned cash.

My experiences with clients in those early years was a foreshadowing of the many rewards of my chosen career, now entering its fourth decade. Among the more rewarding benefits I've received from my financial planning business, a significant gift continues to be the wisdom I have gleaned from the life experiences of others who were much further down the road of life. Whether rich or poor, they have all provided clues to the principles and strategies that contribute to a successful financial life. The corollary, of course, is that they also reveal those moves that are most ineffective or damaging. The words between the covers of this book are an attempt to ferret out the fluff and give you the benefit of all those who have gone before you.

Takeaways:

- Income tax rates are lower than they've been for over fifty years.
- Most Americans have been led to believe that the best place to save is in their 401k.
- Too much money in tax-deferred accounts can cause a lifetime of excessive taxes.
- There are simple strategies to reduce this expense.
- These low income tax rates are set to expire at the end of 2025.

INFLUENTIAL EXPERIENCES

Deacon's CD

ONE OF THE MANY shortcomings of our education system is that real personal finance is not taught. You can graduate from a respected business school with a degree in finance and many hours of economics but never learn how to balance a personal checkbook. You don't learn the perils of credit cards or debt in general, and you certainly don't learn much about the world of saving for retirement. Most savers just pile away the money and seemingly put off the question of *what to do with it* until they absolutely can't. Our institutions, educational and financial, have spent billions of dollars in non-personalized formulaic advice and corporate sales pitches. At the end of the day, it's all about shareholder value and monthly sales leaderboards. It is difficult for the man or woman dispensing advice to remain neutral in that environment.

One Sunday, while walking through the church hallway, one of the older men (bear in mind that "older" means something totally different to me today), a "Mr. Deacon," approached me and said he'd heard that I'd made the transition into the "financial business." He asked if I had any ideas for something to do with a jumbo CD he had maturing. Two

thoughts occurred to me immediately: "Yes, of course," and "Wow, $100,000 to invest!"

If you're "of a certain age," you'll recall what was going on for much of the 1980s in our country. This was the mid-1980s in the Houston area, and the economy was in really bad shape. We were in the heart of the oil and gas industry, and people were afraid of losing their jobs, houses, and businesses. Interest rates were soaring, and fear was in most headlines.

You can imagine that as a starving newbie, I was excited to get to meet with Mr. Deacon at the appointed time later that week. Back in the day, it was a pretty common thing to take your office to a client's home. I am sure I showed up promptly, and I remember his home was a simple and comfortable nest. Family pictures and symbols of their faith generously accented the end tables and walls, speaking to the kind of salt-of-the-earth people they were. I don't recall anything about the home that was trying to show off—or "put on the dog," as we say here in the South.

As I was invited in to take a seat at the kitchen table, Mr. Deacon asked his gracious wife to offer me some iced tea. He then disappeared through the living room and into the hallway, where I watched him reach up and pull down the attic ladder that was folded up and hidden into the hallway ceiling. I recall seeing the light in the attic turn on, and up he went, returning quickly to the kitchen with a large file box in tow.

He dug into the box and pulled out one of the manila file folders toward the front of the box. With the file open and turned around for me to see, he showed me his tax return from 1957. From what I remember, he made an income of $2,530 that year. My memory could certainly be off, but I clearly remember that in 1980-something dollars it didn't seem like much money. This dear friend then proceeded to waltz me through the box, hitting high points and low points of his life. Kids were born, second jobs were secured, more kids were born, and his wife went to work to help make ends meet. Layoffs occurred,

economies ebbed and flowed, but somehow he was able to save a jumbo CD.

It was obvious that he was trying to make a point, but I had no clue why he was so painstakingly revealing a tax return showing that their gross income was in the neighborhood of $70,000. With the precision of a well-seasoned surgeon, he turned to me and shared why he had just taken me on this trip down memory lane.

"Craig, you're a solid young man. I appreciate your family and believe that you're an honest person or you wouldn't be here tonight," he said. "But you're awfully young and, well, frankly, you don't have any idea of what it took for the Mrs. and I to save this money. We have several of these jumbo CDs, and they represent a whole lot of struggle, work, and sacrifice over the last thirty-plus years. So when I tell you I want something that is safe to put our money in, I want you to know that this isn't just money to us. It's the result of a lot of life." Then, satisfied that he'd made his point, he looked me in the eye and said, "So, what do you have?"

He had taken the long way home, but he had certainly made his point. This incident from decades ago, which I can recall with such clarity, made quite an impact on my life. This encounter may not always be on my mind, but it frequently returns to remind me of the incredible responsibility of those in my industry.

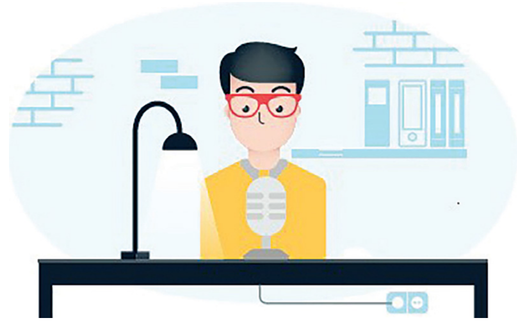
My recommendation to him that evening was a tax-free municipal bond investment. Income tax rates were very high, making the tax-free nature of the interest income he received very attractive for many years. The bonds were insured against default and he 'clipped coupons' for years – totally free of income taxes.

Sadly, not everyone accepts and stewards this responsibility. But when you know the right questions to ask of a potential adviser, it is not too difficult to figure out if you're getting warmer in your journey to find the right one. My own experience in closed-door meetings, continued education, and due diligence conferences has shown me that most of these "right kind" of advisors are genuinely interested in helping others. We have our own quirks, but I'm greatly encouraged

by the character and ethics of the men and women of our industry. I'm also mortified by the lack of respect for your life and life's savings by those in the wrong part of the industry.

The evening with Deacon taught me that saving money is much harder than making money. It also taught me that for most families, every dollar saved represents some significant sacrifice, and that sacrifice and diligence are to be respected. Over the years, I've been reminded that something so significant deserves an equal measure of assessment as to whether we are doing all that we can to maximize the ultimate benefits and rewards.

Saturday Morning Live



MANY OF THE EXPERIENCES I'll share with you came as a direct result of the people I spoke with on live talk radio every Saturday morning. Gosh, it was exhilarating! For just over five years, I was in one of the largest radio markets in the United States, on the air, listening to the concerns and questions of people from every walk of life. I'd do a short bit, take a break, and come back and take questions.

The show was called *Clear Direction for Retirement*, but we covered almost everything you're *not* supposed to talk about: money, religion, and politics. But it was incredibly rewarding to be able to reach so many people and help them straighten out their thinking about the real questions surrounding money and retirement. There's just so much misinformation and sales garbage out there in the financial world.

One caller asked the very common question of 'how much money does it take to retire?' If you stop and think about it, the answer really depends on many factors; how much are you going to spend, what do you want to assume about rising prices over your lifetime, what other sources of income will you have, what rate of return will you assume for your investments, and of course, what rate of income tax will you pay. There is really no simple answer to that question. I always tried to get people to think about the implications of their assumptions. While I wasn't able to give the caller a specific bottom line answer,

I did convince them of the need to do more involved planning on something as important as their retirement.

I've hosted and spoken at numerous business conferences over the years, speaking to thousands at a time (for goodness' sake, I'm even comfortable with praying out loud!), but the radio microphone and headphones were intimidating.

Fortunately, I had just the right guy across from me doing production. I recognized him as a longtime radio personality and asked him for a few tips. His advice was awesome. It went something like this:

Him: So you're in the financial business, right?

Me: Yessir. Financial advisor.

Him: Well, my experience is that most financial advisors have a pretty hefty ego and love to be the smartest guy in whatever room they're in.

Me: Okay...?

Him: My point is that talk radio is about building relationships with your listeners. You just need to be *you*. If you kid around, kid around. If you're serious, then don't try to kid around. The people will either like you or not. There's not much you can do about it. They'll see right through the phony and change the channel. If they like you, they'll listen and call. If they don't, well, you won't be on the radio long.

That was the best advice anyone could have given me. I'm sure glad I wasn't the smartest guy in *that* room… I relaxed and just "did me." The show lasted for 260 weeks, and we had a blast helping people cull through all of the smoke screens and sales pitches to see the real issues in their financial lives.

I remember one of my early calls, where a lady (we'll call her, Anne) who called in asking about whether she should take a loan from her 401k to pay off her $50, 000 of credit card debt. Learning to ask

the right questions goes a very long way to helping someone with a problem. After asking a few questions I learned that she had sixteen credit cards. Conventional wisdom would say to cut up all but one or two for emergencies and stop using them as a first step. Her 'twist' was that she had every single credit card number memorized, with expiration date and CVS codes!

Her issue wasn't in her credit cards, was it? She had a bigger problem than paying them off. Anne ultimately came into the office where we devised a snowball payoff plan that would let her 'earn' her way out of debt more quickly. We kept the 401k in-tact and referred her to a family therapist for some help in other ways. With hard work and diligence she and her husband worked through all of the issues. Situations like these are gratifying when you get to see other people improve their lives and their future because of a seed of advice that they took action on – and succeeded!

And then there were the calls from know-it-alls who only called to let the world know how much they knew about a particular subject. Most often they would take a contrary position just to mix it up a bit. So, we had some fun with it and let them have their five minutes of fame, and in the process used the contrary position to solidify our own. Always respecting the people who called in, hoping that all the other listeners would find a thread of assistance to help them with their own questions.

There are so many mistakes that well-intended, hard-working savers make, all the while believing they are doing exactly what they should. This next section is a great illustration of what is all too commonplace, and perhaps you can relate to some of the elements.

Meet the Joneses

TOM AND BETTY were the typical middle-class working family: they went to work every day, attended church regularly, raised a family, stayed out of too much debt, and diligently saved what they could. Tom's long career with a petrochemical company produced the added benefit of watching company stock appreciate greatly over the years. In addition, he saved no less than 10% of every paycheck inside the company-sponsored savings plan—a pretty typical 401k retirement plan. At retirement, he also earned a pension that would provide a nice addition to their Social Security retirement benefits for both of their lives.

They are the much-written-about "millionaires next door" who were never too caught up in owning *stuff*. Despite their financial status, they still maintained a modest lifestyle.

Tom called me after hearing me on our live radio broadcast one Saturday morning. I had been talking about saving, investing, and taxes. It was the discussion about the last of these that really piqued his interest. He came to see me soon after and described the pain he was feeling every year around tax time.

After he'd retired from the company, they rolled over their 401k balance into an IRA which had grown in excess of $2 million. Having the $2 million was not the painful part, as you may have guessed. He had just paid income taxes, and he was exasperated at the excessive amount they were forced to distribute from their IRAs every year since he had reached the 70 ½-year milestone.

Their living expenses had been covered pretty much every year by the sum of their Social Security benefits and Tom's pension. Now in their mid-70s, they only needed about $10,000 per year from their IRA to make up the difference, but their required distribution was $100,000! Think about what happens when you add another $100,000 of taxable income to your tax return! His lament was that they only needed $10,000.

"Why do we have to keep taking so much out?" he asked.

The short answer is because that's the deal they made with Uncle Sam when Tom chose to take advantage of all that "tax savings" in his 401k—but eventually there comes a time to pay the piper. In fact, as they learned, they had the opportunity to pay the piper each and every year for the rest of their lives, whether they needed the money or not. While the numbers change with every situation, this epitomizes just one of the consistent themes that cost Americans billions and billions of a variety of "intended benefits." Everyone who has used tax-deferred savings is at risk of similarly negative outcomes.

Tom and Betty enjoyed their working years during the early years of 401k plans, and they had many years of compounded tax-deferred growth. Thankfully, they did have a company plan available to them to save for retirement. During most of their career there really were not many alternatives. But if they would have been advised about Roth 401k's and IRA's, or counselled to save money outside of the company plan at times, their tax bill would have been dramatically changed. They could have invested in pretty much the same things; just outside of the limitations and 'tax traps' of the 401k account.

Every $1 million dollars of IRA/401ks has over $800,000 of lifetime taxes hidden inside the account!

Unintended Lifetime Consequences

Let's take a look at the taxes that could be paid over a lifetime when you do what you have been told is the very best way to save for retirement. Per IRS rules:

Total taxes paid on RMDs at withdrawal	$400,428
Taxes paid on growth of reallocated assets	$153,771
Taxes paid by heirs on remaining IRA value at death	$268,988
TOTAL ESTIMATED LIFETIME TAXES	**$823,187***

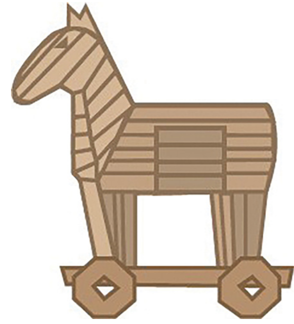
* This hypothetical example assumes the following:

- 60-year-old with 25% tax liability
- IRA worth $1,000,000 and growing at 5% annually
- Money from RMDs not used for income (all) reallocated to other financial vehicle earning taxable growth at 5% annually
- Account holder and spouse live to age 90

This example shows the enormous problem that exists and is not usually brought to light until it's too late.

Takeaways:

- Saving money is much harder than earning money.
- We can learn from others' experiences and use them to better our own.
- 401ks and IRAs are great but have negative unintended consequences to deal with.



A TWISTED BACKGROUND

How we got here

GREEK MYTHOLOGY details the Trojans' ingenious battle plan to take over the city of Troy. As the story goes, the Greeks pretended to abandon their siege, leaving behind a huge wooden horse. But as you might remember, the horse was a trick. The guards at the gates of Troy assumed the risk had passed and rolled the horse into the walled city. Believing they'd won the battle, they began to celebrate. This decision ultimately lead to their demise, as the horse was constructed with a hollow core. Once the party started, out jumped the Greek "special forces" to pillage Troy, claiming victory in the final battle.

The warriors of Troy presumed they'd won the battle, only to discover that hidden inside the spoils of victory was the trap that was their ultimate undoing. This is also true of your 401k, my friend. Those much-touted tax savings, the spoils of victory, are a ruse in many cases. Hidden within is the very trap that enslaves you to a lifetime of excessive taxation, with the parting shot of continued taxation for your heirs upon your death.

"Save money tax-deferred" is the common battle cry heard throughout your working career. It comes complete with alluring charts and graphs pointing to the amazing benefit of not paying your taxes now and watching the money *grow, grow, grow!*

The story is so compelling that you begin to think that you'd have to be an idiot not to take advantage of this opportunity. While trying to point you in the right direction, however, many a watercooler adviser (the one at your office who knows everything about personal finance and investing), human resources department, or well-intentioned relative has actually set you on a course of excessive taxation for the rest of your life. Don't get me wrong—they aren't mean-spirited; they just haven't had the benefit of living with the results of that path into retirement. Their opinions are not based on a full life's experience.

As I've said, one of my greatest benefits in life has been learning numerous lessons from others who have walked down the retirement road and allowed me along for the journey. Other than future unknown healthcare costs, the single greatest challenge my retiring and retired clients face is the huge bite of excessive taxable income that becomes a part of their annual game plan for the rest of their lives.

The tax "trap" millions of American savers are plagued with was not born from some evil plot to subject us to excessive taxation for the rest of our lives. Instead, it's the saver's overzealousness to put away money that causes this problem to sneak up on him or her. Similarly, it's not the single credit card charge that creates the mountain of debt, nor is it the occasional greasy burger and fries that kills you. It is the excess of any one thing that causes the problem.

At this point, you might be asking yourself, "Well, how did we get to this place, and how can I avoid these unnecessary issues?" First, let's address the common reasons why people invest heavily in their 401ks, only to suffer for it when they retire.

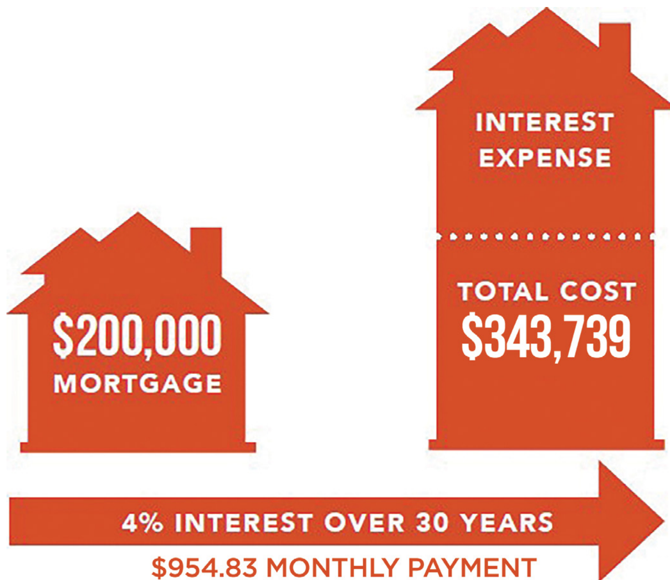
Historical Tax Rates

When most of the readers age fifty and above entered the workplace, the United States had historically high, income tax rates. Investing $100 into your retirement account meant you saved $50 (or more) of income taxes. The economic and financial environment at that time

was all about saving income taxes, so it seemed a no-brainer to defer your taxes until later.

The abundance of tax saving deals and schemes hit excessive levels in the early 1980s, when tax-oriented limited partnerships were developed and sold for the sole purpose of saving taxes! There was no real economic value to the investment other than the investor saving income taxes. Think about that: no real value was left after you invested your money—just the tax savings. Those were ultimately dealt with as they should have been by regulators and lawmakers.

This era created a mindset that I believe has permeated our thinking, to some degree, even today: "Grab the tax savings, no matter what." I hear from clients all the time who insist on keeping low interest rate mortgages because it's the "biggest tax break." People don't want to save the hundreds of thousands of dollars of interest they'll pay because it will save them 20% on their collective income tax returns. Let me show you what I mean:



The total amount paid for the duration of the mortgage will be $343,739. The total cost of the home due to the added interest rate almost doubles the mortgage amount.

But the American mindset is that most would rather pay the interest—because it's tax-deductible. Let's review the math on that:

$143,739 × 25% = $35,934

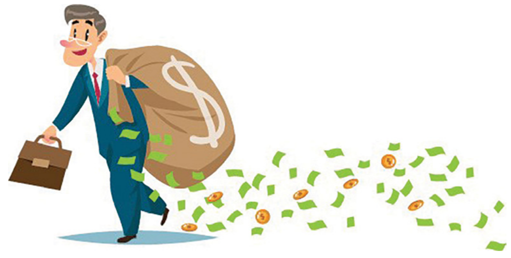
INTEREST EXPENSE × AVERAGE TAX RATE = SAVINGS

Wow, you saved $35,934. Good job! But before we get too excited here, let's look a little closer. How much did it *cost* you to save that amount? Well, you had to have the mortgage to get the deductions, right?

And presuming you paid your mortgage payment, it cost you $143,739 for the right to deduct the $35,934. Your cost—not savings—was $107,805.

Now, I'm not advocating that you stop making 401k contributions so you can pay off your mortgage. Instead, you should get an adviser to evaluate your finances based on all of the pertinent facts. The responsible adviser would help you prioritize the important areas of your life based on your specific situations. If you're not prepared for

retirement, then he/she should advise you to continue saving. If they can prove that you're further along on the retirement goal than you think then perhaps a plan to accelerate the repayment of your mortgage could be devised. These are examples of thought processes that help to remove the paradigms we all have about saving taxes. You and I are just having a conversation about taxes and important principles to consider, and I'm attempting to show you how ingrained "tax saving" is into our thought processes. By the way, real advice needs to come on the heels of full information about your situation.



The "HOLY" Retirement Account

SO WHERE DO YOU SAVE for your retirement? If you work in corporate America, you do that through your 401k. If you're a teacher, you do so with your 403b or similar "retirement" plan. If you are self-employed, you probably do that in a Simplified Employee Retirement Plan (SEP/IRA) or a pension plan. A few employees still have defined benefit pension plans that are provided by the employer, but those are going away fast.

Given how it's advertised, it would be easy to assume that you can only save money for retirement within your 401k or similar plan. It's as though the "holy" resting spot for all things retirement *must be* inside of the tax "advantaged" savings vehicle available to you. You may be the exception, but an overwhelming majority of the people I've met with in my financial planning practice had hardly any money saved outside of these plans. From what I've seen, most retirees or soon-to-be retires couldn't pay for a new car or an expensive vacation without reaching into their retirement plan.

What's the problem with this? Well, that's what I aim to address throughout this book. When you're in that situation, every decision you make for the rest of your life is dependent on how much tax you'll pay. In addition, saving excessively this way also subjects you to whatever legislative decisions are thrust upon citizens. If you had a variety of

sources of income with less income tax due on them (or absolutely none), I think we'd agree that would be a very good situation.

So why can't you develop other pockets of savings outside your 401k? In the coming chapters, I'm going to show you several alternatives that are as simple as implementing small changes in how you manage the money that comes in and out of your household. Changing a few habits and paradigms can make a huge impact on your future. At the very least, I'll show you how to dramatically reduce your total tax liability over your lifetime—and probably for your kids too.

This doesn't always involve you purchasing a financial product. These are simply strategies to employ that require you to redirect existing savings habits.

The Allure of Company Matching

How much of your own contributions to your company plan is matched by your company every month?

I'd venture to say that nearly 70% of the people I meet with have no idea what exactly the company is matching. They just know that there is some sort of matching provision and want to make sure they get what they're entitled to. Now, I'm not going to throw rocks at that—I'll take free money any day of the week. The issue is that oftentimes, the fact that there is matching causes the participant to put more in than they normally would.

If you are reading this book, you're probably not part of the group that needed to be convinced to save. You've probably saved well, and that's the reason this subject piqued your interest.

Another great couple come to mind who had saved well but were unaware of the tax traps that were waiting on them. Darrin and Eve came into the office one week. Eve had retired early, and Darrin had worked for a variety of firms over the years. For many of the last ten years, Darrin had been contributing the maximum amount allowed to his 401k. They had paid down their debt, put kids through college, and

were enjoying a comfortable lifestyle that didn't command a lot of his salary. So, the "responsible" thing to do with the excess was to put every possible cent into the company retirement plan—or so they thought. It was eye-opening to them when we showed them the excessive tax they were going to pay over their remaining lifetimes.

We showed them how to divert much of the extra into strategies that built their readily available funds and stop some of the increase in future tax bills that they were unaware of. They simply stopped making as big of 401k contributions in favor of socking away reserves to be used at a later point in retirement.

Catch-Up Provisions

I'm quite sure there is no way I could ever count the number of times I've sat across from someone we were trying to help who proudly announced that they were "saving the maximum, including the 'catch-up' amount."

For savers who are over the age of 50, the IRS allows for additional contributions to their retirement plans above the normal limits. Currently, the "catch-up" amount is $6,000. While I appreciate their desire and commitment to save, they've actually revealed that not only are they probably in for a tax storm later, but it's gonna be a doozie, as we say down South.

The solution is really simple: *stop doing it!* When we do the math and projections, eight out of ten times, this unsuspecting "super-saver" has developed an obese 401k account that is only going to cause a lot of tax pain in the future. I'll begin describing these pains as we get into the *Tax Traps* sections of the book. For now, hang on to this idea so that you'll have a solid foundation of knowledge as you get into the later sections.

Follow the Money

YOU CAN LEARN A LOT by finding out who is making money on any given transaction, and how they get paid. The server at your favorite restaurant probably earns much of their income through tips. Now, I can deduce two things from this: he/she is motivated for us to buy more, and he/she is motivated to offer excellent service. When an insurance agent, securities broker, or financial advisor makes part of their living by selling commissioned financial products, you can be sure that they are motivated to sell their products.

Some of the latest studies indicate that there is approximately $17 trillion in company-sponsored retirement plans. An overwhelming majority of all of that money is in mutual funds. Mutual fund companies and managers earn more revenue as they attract more investment.

With hundreds of billions of dollars in fees to capture, why would financial companies suggest that you withhold your contributions from the company retirement plan? There is no motivation to tell you to do something else with your money all the way through the distribution and sales of 401k and retirement plans. The message of saving for retirement and deferring income taxes seems sound, so why would we ever doubt the marketing messages?

Once again, this is not an evil plot—it's just the way the system works. It's also much easier for a saver to take the most readily-available,

seemingly sound advice than to think about the right answer. And to be fair, the regulations make it very difficult for a financial professional to provide advice outside of the context of your specific relationship with them. So the mainstream advice becomes "max out the retirement plan and defer income taxes."

Combine these five ideas masquerading as savings and you'll end up with a lot of money saved, but a whole lot of income taxes to be paid in the future. If there were no alternative, then we'd just call it a day and be thankful that you've saved the money. But there are other ways that are very simple to understand and easy to implement. This is why it is important to at least ask questions and determine if there are benefits for you out there that you might be missing.

Takeaways:

- **We all have paradigms (reinforced over decades, in many instances) about saving money and income taxes.**
- **The sting of the paradigms doesn't hit you until it's already painful.**
- **To escape the traps, you must learn enough to adopt new beliefs.**

2. THE SEVEN TRAPS

THE SEVEN TAX TRAPS

RETIREMENT can happen when you have enough recurring income coming into your checkbook that you no longer need the paycheck from your occupation. There is no magic age for when you can retire; it's most often tied to the amount you've saved and your cost of living.

When I've asked people when they are going to retire, the answer normally is wrapped around the timing of their Social Security retirement benefits start date—or for a few, the date that their company pension begins. If I were to ask you that question, you might have a similar answer. I've also noticed most people fail to take into account a lot about the retirement lifestyle. They often significantly underestimate their total expenses, and they rarely fully grasp the effect of income taxes on their future.

If you start planning now—at almost any age—you can set in motion strategies that allow you to pay far less income tax in the future and over your entire lifetime. I'll also show you how many of these strategies will also benefit your children and *their* children, even on the off chance that you find yourself in the minority of savers who cannot utilize the strategies. Yes, unfortunately, there are situations in which the calculated benefit from implementing changes won't be that great, and I'll regretfully recommend no changes.

When you discuss some of these ideas with your tax preparer, CPA, or financial adviser, prepare yourself for the possibility of skepticism. Not all tax professionals and financial advisers have even given thought to the ideas I'm going to share with you.

What If You Paid Less Income Tax?

If 20% of your income goes to pay income taxes, then your lifestyle is decreased by the same percentage. If we look at it another way, you have to increase your income by 25%, not the 20% that taxes took, to get back to the original lifestyle you had before taxes took their bite.

To really bring this simple concept home, let's make it personal. If you have not yet retired and know you need $40,000 from your investments to supplement your Social Security and/or pensions, you can figure out how much money you need to save in order to do so. The calculation isn't the important part for now, so stick with me. The amount that you need has to incorporate the tax bite to give you the net of $40,000 in your pocket. In my example above, you'd have to have saved enough to generate $50,000 of taxable income to be left with

the $40,000 that you want and need to live the life you've dreamed of living.

If taxes were not part of the equation for that $40,000, you'd retire when your investment and savings were 25% less. You'd retire sooner, with an equivalent lifestyle! Work longer if you like, but I'd like to show you how to retire sooner, smarter, and with less exposure to future tax decisions by Congress.

Takeaways:

- **Income taxes take away from your retirement lifestyle and therefore extend the date that a person has the ability to retire from work.**

TAX TRAP #1

LITTLE OR NO CONTROL OF TAXATION TIMING

Sources of Retirement Income

IF YOU KNOW that you will need income in the future, why not find ways to minimize the impact of taxes on said income?

In addition, when you consider that inflation (the ever-present reality that prices always go up over time) will require more and more of your savings in the long run, you have to conclude that your income also has to grow over time to keep pace.

When you retire, you will reap the rewards of whatever you've sown while working, and of any plans you implement early on in your retirement.

For many people, there are limited options for how this will play out for them. This lack of options is a really big deal when it comes to planning your retirement. The single biggest problem retired clients deal with is the amount of income taxes that are coming due in the future.

Not only are current taxes due on income that you receive from your IRA or 401k, but at some point, the entire balance of your IRAs will have taxes due. You'll either pay taxes on the Required Minimum Distributions after age 72 or your heirs will pay income taxes on what you've left to them. Let's take a look at the most common sources of income for your retirement and what the tax impact will be:

Pensions

While not as common as they once were, many Americans still retire with the option to receive a monthly annuity payment from a retirement plan at work. Most of the time, you are offered a variety of payment options to choose from. The most common options offered all have to do with whether or not you'd like your spouse to receive all or some portion of the monthly amount after your death. The greater the amount that's chosen for the surviving spouse to receive, the greater the discount during the retiring employee's lifetime.

Most of the time, it's much better to take the alternative that offers your spouse 100% of your retirement annuity. While it does lessen the amount you receive monthly, the total benefits over both lifetimes can be very significant. It's always best to work with a fee-based adviser who can show you the long-term impact based on your unique circumstances. Monthly annuity payments from your pension are 100% taxable.

Earnings From Part-Time Work

I've noticed over the years that more and more retirees are choosing to take on some part-time work. Some do so out of a real need for added income or health benefits. Others work simply to stay active and engaged with other people, doing something productive.

The income from this part-time job is completely taxable, just as it was during your career. Be very cautious about working and earning income while also receiving Social Security retirement benefits prior to your full retirement age. The penalty applied to your Social Security benefits for earning too much is significant. Check the IRS.gov website for additional detailed information. They also have an easy-to-use online calculator to give you an idea of how this works for your personal situation.

Social Security Retirement Benefits

Currently, up to 85% of your Social Security retirement benefits can be taxed at your normal income tax rates. The calculation of how you get there is a little complicated unless you're used to working with this sort of thing, but you can find the details in IRS Publication 915. A base amount of income is established by the IRS codes each year, and every dollar of taxable income is used to determine how much of your Social Security retirement benefit is taxed. In addition, tax-exempt forms of income like municipal bonds are added back into this calculation.

Distributions from IRAs and 401ks

I've observed that, for the most part, when retirees needs additional income at retirement, the primary way they get it is through their 401k/IRA balances. An overwhelming number of retirees do a good job of getting the funds "rolled over" into their own individually-owned IRA account from their 401k at work. From there, they have much more control over the funds and a great deal of added investment alternatives from which to manage in retirement.

When any money is taken from the IRA, it is called a "distribution." Don't let the word scare you; it simply means that you took money from your account. When these funds are distributed, there are different outcomes, but each outcome boils down to at least paying income taxes on the total amount distributed.

If you distribute from an IRA and you are not yet 59 ½ years old, there is an additional 10% penalty for dipping into the cookie jar too soon. You made a deal with Uncle Sam saying that you'd leave it there until age 59 ½ or you'd pay the penalty. There is another part of that "deal" we will get to soon—and it is a huge problem for many retired and retiring employees.

A very significant point to know is that the rules can be a little different for money that you withdraw from your 401k after retiring. This significant change applies if you are retired *and* not yet 59 ½. The IRS rules dictate that if conditions are met, you can take money prior to 59 ½ and *not* be subject to the early withdrawal penalties I've discussed. So you might avoid the penalty, but everyone will always pay the income taxes on every penny of distribution.

Annuity Income

Millions of Americans have purchased annuities to help them with planning for their retirement. The super-basic description is that you can defer income taxes on all of the earnings or investment gains—until you start taking money out of the product. Whether it's in an IRA or not, the income from your annuity will be reported on your income tax return.

Even annuities that are owned outside of an IRA have a portion of the income that is taxed. The current IRS rules dictate that the accumulated earnings are deemed to be received first and taxed. After they have been taxed, then the income has some tax benefit.

Interest Income

Deposit accounts at banks hold trillions of dollars of the American people's savings. While presumed to be safe, the interest paid on these accounts is all taxable.

Bonds also pay interest. Most every type of bond pays interest that is also taxable. Bonds issued through municipalities across the nation do, however, have significant tax benefits to the recipient. At

this writing, bonds may have two potential challenges: first, with interest rates at historic lows, there is a significant risk that the value of bond investments may decrease when interest rates increase. Secondly, because interest rates are so low, tax-free bonds pay very low rates of interest.

Stock Dividends

Many stocks pay out some of their earnings to shareholders in the form of dividends. It is possible for part of these dividends to get preferential tax treatment. However, for tax purposes, it's important to know dividends are considered either "qualified" or "nonqualified." Qualified dividends are:

- Tax-free for those with income falling within the 10% and 15% brackets to the extent qualified dividend income remains within those brackets
- Taxed at a 15% rate for those with income falling within the 25% to 39.6% tax brackets
- Taxed at a 20% rate for higher-income taxpayers whose income surpasses the 39.6% tax bracket
- Nonqualified dividends are taxed at the same rates as ordinary income

Analysis of many clients' circumstances reveals that even if income tax rates do not increase, there are several strategies that you can use now, right now, to accomplish three important objectives:

1. Lower the amount of taxes you pay over your lifetime
2. Increase your net worth
3. Create resources that produce tax free income

After we've dug into the seven traps, you'll have a good grasp on the problems. Once you understand the problems, the strategies will make a lot of sense. So hang in there, and keep going through the book.

Takeaways:

- **Unless you specifically plan for tax-free income streams, you are opting in to a lifetime of taxation.**

DAVE AND CAROLE were excellent savers. Both had mid-level professional occupations. They raised two sons and had several wonderful grandkids. They saved diligently for years, and one day discovered that they had more than $1 million in retirement funds.

Like many of my clients, they were astounded at how much they had accumulated. Their lifestyle was nothing extravagant. They bought new cars and used them for many years. They lived in a "normal" upper-middle-class home in their part of the country.

When we began to look deeper into their future tax situation, they were shocked to learn how much excess income they were going to have after age 72. All of this income was due to Required Minimum Distributions and was going to create significant annual income taxes.

Required Minimum Distributions

The second hidden tax trap focuses on the forced taxable distributions headed your way through Required Minimum Distributions (RMDs), which you will pay for the rest of your life, and the life of your heirs. When you made a deal with the IRS, they agreed to give you a tax deduction for every time you contributed to your company retirement plan or deductible IRA. In exchange, you agreed to pay taxes on every dollar you withdrew. Furthermore, at age 72 you also agree to forced distributions.

The amount of your RMD is based on your age (or your age and your spouse or beneficiaries' spouse's age) your retirement balance

every December 31. You agree to this process whether you need the income or not. In my experience, very few retirees who have planned well need all of this income into retirement. For many, the IRA is there to handle the "what ifs" of their future: new cars, second homes, family trips, etc.

In reality, RMDs create unnecessary taxable income year after year. The income from the required distributions is unused and only serves to add to your tax burden year after year and slowly dilute your total assets.

The following table assumes a 6% annual growth rate for a couple who are both age 62 today and have $1,000,000 in retirement savings. My objective here is not to weigh down the discussion with the minutia of how this is calculated as there are plenty of free resources online that can assist with that.

Age	IRA Balance	RMD
72	$1,790,847	$69,954
75	$1,883,998	$82,270
80	$1,978,012	$105,776
85	$1,955,661	$132,139
90	$1,771,752	$155,416

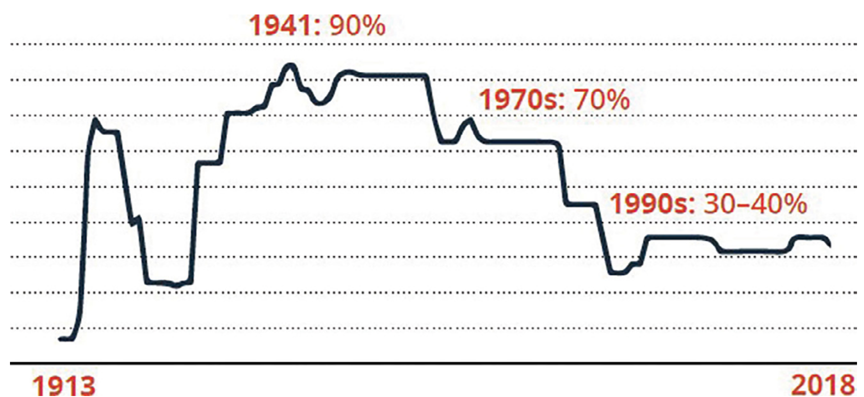
The purpose of showing you this table is to illustrate the impact of the RMD, and to point out that at a modest rate of return to your investments, the RMDs will grow significantly over time. They will continue to produce more and more taxable income every year which you will have no control over unless you take action ahead of time.

Takeaways:

- RMDs begin around age 72 and last a lifetime.
- Unless you do something to reduce the amount of your IRAs, your RMDs are most likely going to increase over time.

WHERE will income tax rates go in the future? No one knows what will happen to the income tax structure in our nation, but we can look around us and behind us for some clues. Many people don't realize we are currently enjoying seventy-year lows in the income tax rates that we pay. In 1941, the highest tax rates were 90%, the 1970s saw the rate top out at 70%, and since about 1990, the top income tax rates have been between 30% and 40%.

Marginal Income Tax Rates, 1913–2018



2020 U.S. Marginal Income Tax Rates

Taxable Income	Tax Rate
Less than $19,750	10%
$19,751–$80,250	12%
$80,251–$171,050	22%
$171,051–$326,600	24%
$326,601–$414,700	32%
$414,701–$622,050	35%
Over $622,051	37%

With all the problems concerning the swelling government debt and increased pressure on social programs, it seems like the only way for U.S. tax rates to go is *up*. If you believe that to be a strong possibility, then I need to ask, "What are you doing about it *now* to protect yourself?"

The following table illustrates the dramatic effect of higher income tax rates in the future, all due to the impact of Required Minimum Distributions. But even if income taxes never change, the problem will only become more pronounced over time.

Age	RMD	15%	25%	35%	50%
72	$36,923	$5,538	$9,231	$12,923	$18,461
75	$45,831	$6,875	$11,458	$16,041	$22,916
80	$55,622	$8,343	$13,905	$19,468	$27,811

*Assumes $1,000,000 retirement balances at age 72.

The Real Price You Pay

Before we go too much further, I want to make sure I communicate why this matters. You see, it's popular to complain about taxes, but they're much more significant than some may realize. When you are in your earning years, the income tax burden has significance—but not nearly the impact it has when you retire from full-time work. What you've saved up to this point will have to last you for the remainder of your life and your spouse's life.

Whether tax rates go up in the future or not, the lifetime impact of taxation on your 401k and IRAs is significant. However, if we consider for just a moment the possibility that income tax rates *will* increase, the impact could be even more dramatic. An increase in the tax rates from 25% to 35% equates to a 40% increase in your lifetime taxes on the account!

The bite that you would feel from your RMDs if income tax rates increased would be significant. One pain point would be the smaller amount of available cash to meet your future needs or wants. Another, however, is the realization that your total net worth will not grow as you may have planned.

My position on this is just an opinion, but it has been formed over many careful years of watching and studying this issue. In my view, if it is a real threat with a solvable outcome, we should attempt to do all that we can to minimize the risk of loss of buying power and net worth over time.

Takeaways:

- We are enjoying historically low income tax rates, so the risk of an increase is large.
- RMDs are for a lifetime, so if rates increase, you will pay significantly more income taxes than at the current rates.

IF YOU ARE MARRIED, your spouse can inherit your 401k/IRA without any taxes due at the time of your death. However, when someone other than a spouse inherits any portion, that portion has tax consequences. The non-spouse beneficiary (child, grandchild, or anyone other than your spouse) does have a few options upon receiving their inheritance:

1. Cash out the IRA immediately
2. Cash out the IRA within 10 years

Each of the above is taxed, and the longer the beneficiary waits, the more risk there is of increased income tax rates and the more they subject their inheritance to financial market fluctuations. I cannot provide statistical data on what normally occurs, but in my experience, most of the beneficiaries cash out the IRA well within five years. They pay off debt, fund college tuition, or buy something new.

Do you want to leave a fortune to your kids?

If you're like almost everyone I've ever met with, you really don't feel the burning need to leave your children well-off. Most people I've counseled hope that there will be something left for their children when they are gone, but they have more of an interest in doing what they want during their lives. This certainly includes family, loved ones,

and causes they feel strongly about, but you work and save for forty years so that you can provide for yourself—whether you're in great or poor health.

If you have any money left, would you rather see it go to your kids, or to the IRS?

Now that's a peculiar question, isn't it? The tragic truth behind my question is that because you've enjoyed the "benefits" of tax deferral, whenever the money comes out of the 401k or IRA, during your lifetime or at your death, *someone* has to pay taxes on it. The IRS rules used to allow special treatment that allowed heirs to 'stretch' the distribution out over a longer period of time. But this was recently eliminated in an effort to raise billions of dollars of tax money. Further evidence of the increased pressure to increase taxation.

How It Impacts Your Family

One of my clients was the only heir to her mother's sizeable IRA, which was fully invested in an annuity. During the last few years of her mother's life, the funds came in very handy: the daughter used them to provide 24-hour care for her sick, elderly mother. But when her mother eventually passed, this client was forced to continue distributions. My client had saved well for her own retirement and really didn't need the funds from Mom. In fact, she was going to have a problem when she attained the age for her own required minimum distributions. Nonetheless, the distributions from Mom's accounts were in the tens of thousands of dollars annually. This added to her own taxable income and, over time, diluted the total inheritance from her mother. It was a blessing to have the funds and to have saved well on her own, but the wasted money spent on taxes proved to be a very inefficient use of hard-earned money.

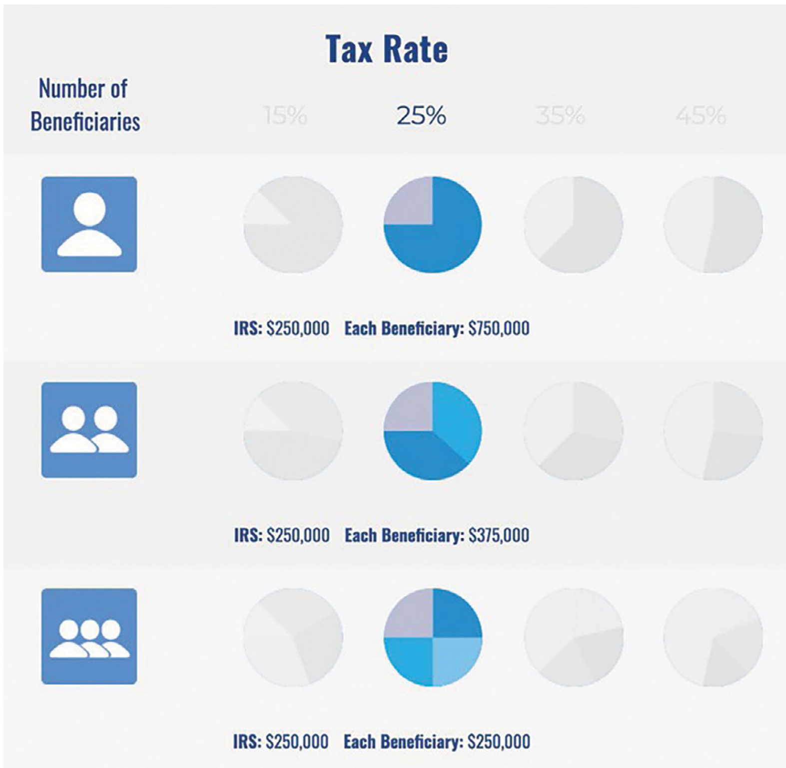
Since every penny in your retirement account is taxable, the IRS is going to get their share at the appointed time—that's the deal that you made. The formula for understanding how this will work out is pretty simple: every dollar distributed is taxed at the normal income tax rate for each recipient.

It's impossible to know what the tax rate will be in the future, but it's entirely possible that distribution to an heir could actually be large enough in any one year to push them into a much higher tax bracket. This would actually make the costs higher than I've projected.

Depending on how many ways your retirement account is divvied up, it's entirely possible that collectively, more money would be paid in taxes than any of the individual heirs would receive. Check out the illustration on the next page.

As you can see, in a family of three surviving beneficiaries, the IRS might receive approximately the same amount as each of the beneficiaries. There are much better ways to plan for the efficient distribution of your hard-earned savings. Coordinating with a financial advisor, tax advisor, and estate planning expert is crucial when you want to truly maximize the amount that goes to the people and causes you care about most.

PROJECTED TOTAL TAX TO YOUR CHILDREN



Takeaways:

- Leaving your IRAs to your heirs does nothing to avoid paying income taxes on the remaining balance.
- Depending on income tax rates at the time, it is possible that the IRS will become an equal beneficiary to your kids unless you make changes.

I'VE COMBINED both of these tax traps into one section because they each make a similar point, but in different ways. If you have less control over your taxable sources of income and receive higher and higher Required Minimum Distributions over time, this will only cause added grief later in your retirement. These traps are generally looked at by retirees as "ankle biters"—nuisances that can't really be solved. But one of the byproducts of resolving the more significant tax traps is that you can spare yourself a lot of pain by doing so.

Higher Income Tax on Social Security Retirement Benefits

If you and your spouse file a joint return with a combined income below $32,000, your benefits are out of reach. For income between $32,000 and $44,000, up to 50% of your benefits may be taxable, and up to 85% if your combined income is more than $44,000. Combined income, according to Social Security, means adjusted gross income and nontaxable interest plus half of your Social Security benefits.

Another thing to keep in mind is that 28 states, plus the District of Columbia, do not tax Social Security income. The remaining states may or may not tax SS benefits based on a variety of rates and state policies. Check with your state of residence to see what the impact is there. The IRS has Publication 915 available to help you figure out how much of your Social Security retirement benefits are going to be taxed. Let's look at a very simple example using these assumptions:

IRA Distributions	$35,000
Household Social Security Benefits	$42,000

First, calculate the taxable portion of your SS benefits:

Gross Income (wages, salaries, dividends, IRAs, pensions, annuities)	$35,000
½ Social Security Benefits	$21,000
Combined Income	**$56,000**

Compare this amount to the base amount for your filing status. In this case, we've assumed a married couple filing jointly. Since the base is in excess of $44,000, 85% of Social Security benefits are taxed.

Now take this back to Form 1040:

Gross Income:

IRA distribution	$35,000
Taxable Social Security (85%)	$35,700
Adjusted Gross Income	$70,700
Less Standard Deduction	($24,000)
Taxable Income	$56,700
Total Tax	**$6,416**

If the IRA distribution was non-taxable, the only income to be considered in the calculation would be half of the SS benefit. And since that would be less than the base amount, there would be zero taxes due.

Potentially Higher Medicare Part B Monthly Premiums

The second section of this particular tax trap may not seem like a big deal because most retirees don't see themselves with income high enough to require higher premiums. But it's a real issue to consider when you take into account that you could find yourself in a situation where you have to pull funds from the taxable IRA/401k for large expenses for a year or several years.

If you want the second home, or you want to pay off the second home, all of your forms of income plus the added amount could easily do it. A real threat to all is the possibility of a health situation which could require added expenses of $60,000-$90,000 per year. If the only resources you have to tap are taxable, then you'll get the notice for higher Medicare Part B premiums.

Developing alternatives that create tax-free income insulate you from this and the other traps makes more and more sense as we dig deeper into the variety of challenges that are created by over-contributing to the 401k accounts for a lifetime. The strategies that I present encourage you to moderate how much you invest in before-tax accounts and how to convert taxable dollars to tax free dollars. Here is the short take on some of the relevant components of Medicare:

Medicare Part A is the insurance that covers hospital stays. It has an annual deductible, currently $1,264, but is premium-free for most seniors.

Medicare Part B is the medical insurance component of the Medicare program. It pays for certain medical expenses like doctor's office visits, medical equipment, and even outpatient procedures. The annual deductible is currently $185. After meeting the deductible, beneficiaries normally pay 20% of the cost of Medicare-approved covered services.

So I've covered the standard deal, but if you fit into the category of a high-income earner, you might have to pay significantly more each month. Like the Social Security taxability formula, Medicare has an awkward way of computing things. They use your Modified Gross Income (MAGI) from your tax return from two years ago to determine your premiums. The table below shows you how it breaks down:

Individual Tax Filers	Joint Return Filers	Married Couples Filing Separately	2019 Medicare Part B Premium
$85,001–$107,000	$170,001–$214,000	N/A	$189.60
$107,001–$133,500	$214,001–$267,000	N/A	$270.90
$133,501–$160,000	$267,001–$320,000	N/A	$352.20
$160,001–$499,999	$320,001–$749,999	$85,001–$414,999	$433.40
$500,000 and above	$750,000 and above	$415,000 and above	$460.50

Takeaways:

- Taxable distributions from your IRAs (including RMDs) can end up causing more tax on your Social Security benefits and increase your Medicare Part B premiums..

IT IS WIDELY BELIEVED and written about that one of the greatest strains to our finances will be the high and continually rising cost of medical care, followed closely behind by housing and transportation costs. Unlike the prior generation, future retirees probably won't have similar access to employer or union-sponsored health benefits. Health care costs will take a large part of your resources in retirement, so I suggest that you plan accordingly.

There are a number of factors driving this retirement health care cost challenge of the future. In general, people are living longer, health care inflation continues to outpace the rate of general inflation, and the average retirement age is lower than in prior times.

So how much should you plan to pay in health care costs after you retire? There are several sources that regularly publish their projections. Of course, the amount you'll need will depend on when and where you retire, how healthy you are, and how long you live. According to the *Fidelity Retiree Health Care Cost Estimate*, an average retired couple age 65 in 2018 may need approximately $280,000 saved (after tax) to cover any future health care expenses. Because women live longer, a 65-year-old woman can expect to spend $22,000 more in total health care costs over the course of her retirement than a man of the same age.

It's the "after taxes" part that concerns me: if all of your retirement savings is in before-tax accounts, it doesn't take a rocket scientist to realize that your true cost will be much higher than $280,000. Think about how it's likely to play out on your tax return year after year as

you take higher distributions. These higher distributions may very well cause some or all of your money to be taxed at the next higher tax bracket. If you plan now by developing strategies to transition funds to non-taxable-later status, you may save tens of thousands of income taxes.

The chart below shows the current expenses for certain health care costs, like long term care, as well as future projects of cost down the line. As you can see, the rate has increased drastically in 25 years.

Cost Per Year	Current	25 Years
Home Health Aide	$41,184	$54,812
Assisted Living Facility		
Private One Bedroom	$40,035	$153,394
Nursing Home		
Semi-Private Room	$47,538	$88,563
Private Room	$61,320	$108,002

Takeaways:

- **Medical costs are projected to be a significant drain on retirees' savings. When you also have to pay taxes on distributions to pay for medical care, it could drain the account even faster.**

MANY CLIENTS I've met with over the years have done a wonderful job of saving for retirement. They did exactly as they were advised and socked away funds into their tax-deferred accounts. They've worked a lifetime and are ready to enjoy some of the fruits of their labors. But almost all of their savings are in one of these accounts with taxes due with every distribution. At retirement, few people have much saved in accounts that have already had taxes paid.

Clients often come into an advisor's office to fine-tune their retirement plans and see how feasible it will be to purchase the "dream" (the home, motor coach, boat, or vacation). I can't begin to count the number of times we were able to assure them that they could indeed afford the goal, only to watch them back away from attaining it after they'd done the math on the taxes that would be due.

Taxes Due on Taxes Paid

When these large purchases or experiences come along, they almost always force taxation at the higher tax rates. To add insult to injury, because all of their savings have gone into tax-deferred accounts, they have to pay taxes on the distributions with an additional distribution—which is also taxable—causing another distribution to pay the taxes on the taxes… causing a vicious cycle. Let me show you what I mean:

Cost of desired item	$10,000
Taxes due	$2,500
Taxes due on taxes distributed	$625
Total "cost"	**$13,125**

But there are other ways you can set aside your money to help you achieve your retirement goals without sacrificing the opportunity to save. I recall the very first time a client approached me with an idea for a big purchase. Luckily, the results were positive, and it made a huge impact on me. This is why I have such strong beliefs about the ideas in this book—I've had the opportunity to experience them through the lives of others.

The Barnes' had been clients for a short while when they requested an update on their financial situation. During the meeting, they brought up how much they enjoyed traveling to one particular area near a national park. They had rented homes in the area a few times and decided to look around for a modest second home of their own in the area. They had dreams of decades of joy and love shared with family and friends.

The conversation began with their general belief that they could never afford something like that. To their delight, the projections proved overwhelmingly that they could actually do what they wished without having a negative impact on the rest of their retirement. They were not what you'd call wealthy, but they'd had the good fortune to have accumulated funds outside of their retirement plans. A big portion of their investment portfolio had been diversified into an after-tax stock portfolio and bank accounts. The Barnes family enjoyed that purchase for many years before "upgrading" to an even nicer place for family and friends. I love it when a plan comes together!

Yes, I've had many clients who have been able to act on their big desires and dreams. It feels really good watching them act in

confidence knowing they are able to do these things for their families. Unfortunately, the majority of people are simply not prepared to do those things. They may have enough money, but they have it in the wrong type of accounts, making it very difficult psychologically to pull the trigger on the purchase. Keep in mind that they're not hesitating because they can't afford the purchase. When faced with the reality of the after-effect on their tax return, however, people sometimes wait a number of years—or abandon the plan altogether.

Darren and Lucinda both had long careers with a Fortune 100 company when they came to see me. Their situation was unusual because they had worked for the same company since graduating from college. They were in their mid-50s at the time and were interested in transitioning to a different stage in life where they no longer worked full time. Neither were ready to do the traditional "retirement," but they were ready to slow things down, travel, spend more time with their young grandbabies and work part-time when they wanted.

The problem for them was this very issue: all of their savings (almost $2 million) were in their respective 401k accounts. This was a problem for them because they couldn't get easy access to their funds for another 4-5 years, when they'd be 59 ½ years old. It didn't make sense to pay the 10% penalty for taking early distributions, so they were stuck. They had a lot of money, but no access to it without taxes and penalties.

It's very sad and disappointing to witness situations like this where folks are denied the juicy fruits of their labor just because they didn't plan their tax futures. I'll address some specific money-saving strategies that I've had others implement successfully in the last five to seven years of their careers later in the book. These are strategies that run the gammit of either getting ahead of the future problem by changing your contributions or changing the timing of when you choose to pay taxes. All of them have the result of saving a lot of income taxes over the rest of your life.

Here are examples of some big-ticket items people typically go after when they've retired. I've shown below what can happen to the actual

cost of these items when you are forced to pay taxes on the money you withdraw from a 401k.

Purchases	Base Cost	Taxes 25%	Tax on Taxes	Total Cost
Auto Purchase	$50,000	$12,500	$ 3,125	$65,625
Trip with Family	$25,000	$ 6,250	$ 1,562	$32,812
Vacation Home	$250,000	$62,250	$ 15,625	$327,875
Motor home	$380,000	$ 95,000	$ 23,750	$498,750

Takeaways:

- When most of your savings is in tax-deferred accounts like IRAs and 401ks, all of your expenses are higher because you also have to pay taxes in order to access the money.

Decision Time

Now that I've revealed new information regarding the seven tax traps I've identified, you have a decision to make: Are you going to *do* anything about them? Throughout this section, I've tried to point out the tremendous tax costs that Americans incur every year simply because they saved all their money in pre-tax accounts.

The next section focuses on strategies that you can implement immediately to stop compounding your costs and begin lowering your ultimate tax burden. I mentioned early on in this book that time is running short for you, so you should take this information and plan your next moves with confidence *now*. Most of the tax breaks that make this perhaps the least expensive time in history to solve these issues will be gone at the end of 2025. Every month, every year that passes adds to the risk of paying a much higher tax on implementing the strategies that I'll share in the next section.

Get a fresh cup of coffee, give your brain a short break, then turn the page and let's talk about solutions to these problems.

3. STRATEGIES TO ESCAPE THE TRAPS

STRATEGIES TO ESCAPE THE TRAPS

A Window of Opportunity

TAX REFORM seems to be a way of life for Americans. The most recent tax changes went into effect at the beginning of 2018 and provide lower marginal income tax rates for most. In addition, the standard deduction (the amount you can deduct if you don't have itemized deductions that are greater) doubled, providing a larger amount that is "exempt" from being taxed every year.

Most of these new benefits, however, expire at the end of 2025. There's really no way to know if the current rules will stay in effect past that date, but chances are that whatever political party is in power at the time will have their way with the existing rules. In the previous section, I demonstrated that we are already at a fifty-year low in income tax rates.

If I were someone who wanted to save a ton of income taxes by taking advantage of the current tax rates, I would do *everything* in my power to beat the sunset date of the current rates. Odds are pretty high that rates after 2025 will be higher than they are today, signaling a more expensive gesture when solving any tax trap issues. You have to decide whether you want to pay taxes at cheaper rates or higher rates, but one way or another, you will still have to pay.

One of the reasons I feel so strongly about this subject is because the massive amount of tax-deferred growth that has, will, or is occurring within your 401ks and IRAs causes significant future tax liability for you. In a normal 401k account, the contributions over time represent the lesser component of the total of your account. This is just basic math. Over time, the “magic” of tax-deferred compounded growth reveals itself as “black magic,” subjecting you to excessive tax for the rest of your life.

There are three primary areas that will greatly influence your choice of strategies. Each will have an impact on your account and should be weighed heavily when determining the right strategy or combination of strategies to use.

AGE

CASH FLOW

FINANCIAL ASSETS

Three Critical Elements

Age: Rather, how long before you retire and how much more life you have to live. The optimal combination of strategies will differ depending on age. If you’re younger and have more time to accumulate after-tax savings, certain strategies can be used to get you on track and achieve more balance over time. If you’re over the age of 50, you really need to get to work on this, and you probably have more resources to solve the tax bite over the next seven or ten years. If you’re in your 60s, the simpler strategies aren’t going to have a huge impact unless you implement them on a large scale. If you’re pushing close to age 72 and Required Minimum Distributions, well, you’ll have some urgent decisions to make.

Your Current "Extra" Income: The fact that you're reading this indicates that you *have* saved. Saving is a result of having "extra" income (in the financial world, we like to call it "discretionary income"). It's the amount of your income that isn't spent on lifestyle.

If you have a lot of this extra every month, you'll be able to implement strategies faster get to a place of greater financial balance sooner. You'll also have some decisions about which of the strategies to use, and in what amounts, to achieve greater control over future taxes and income.

Projected Income Needs: Let's not lose sight of the fact that our ultimate objective is to create a wonderful lifestyle of your choosing, free of the burden of excessive taxation and full of enough income to do the things you desire. Most people, though, never take the time to truly understand what their needs will be.

What will "a year in the life" of you look like? If you want to call it a budget, call it that, but it's really just a plan for retirement spending. If that spending plan is outside of your financial capability, knowing that beforehand is so much better than finding out two years into retirement. My memories are abundant with names and faces of clients who grossly underestimated their need for income into retirement. If you don't pay great attention to this before you retire, you'll likely feel the sting of poor planning at a time when you really don't want to.

Financial Assets, Before- and After-Tax: Why the distinction between before- and after-tax? Because this is the main point of the book. Without significant after-tax savings, you have fewer options. Sometimes people are confused by the label "after-tax." It's simply the accounts you have that are not in tax-deferred status. They are reasonably accessible without penalty. And they are best applied if they don't involve selling something that causes a great deal of tax to liquidate.

The after-tax amount of your savings is the storehouse from which you can implement the more significant strategies. It's the place to draw from every year to balance out the tax return, avoiding the next tax bracket in some cases. "Cash is king," as you'll see in the strategies presented.

THE ELEPHANT IN THE ROOM

Your Existing Advisors

WHY HAVEN'T THEY already called this to your attention? How should you open this subject with them? This section is a bit uncomfortable for me to write because I've been an advisor for over thirty years and I know how they think. For the most part, they are men and women who genuinely care about their clients and want to do right by them, so I'm going to assume that if you have an advisor, they're one of the good ones.

But because I've been an advisor for so long, I can confidently tell you that if they haven't already called this to your attention, they aren't thinking about the big picture in this segment of the financial world. Most advisors want to do the best they can by you by getting you the biggest deductions possible *today*, because that's what most clients want.

The advisor will have to change some of their own paradigms, just as I did. The problem is that paradigms change slowly, and then it may be too late for you to save. Many advisors also have hefty egos, so confronting them with information to review before you really know your stuff isn't going to do you much good—for several reasons.

They'll listen and then they'll tell you why their way is *the* way without ever giving serious consideration to the proof. Your advisor will assume that I'm a shark in the water trying to steal their client. Well, I'll tell you right now that I have no interest in that kind of long-term, comprehensive relationship with new clients. At this stage of my life and career, my focus is on delivering great advice on this topic to as many willing ears and minds as possible.

Think about how much better the conversation with your advisor will go if, after you've done your research, you present them the facts. As someone who has been around advisors and CPAs for decades, I promise you that if you want a fighting chance at saving a ton of taxes, you're going to have to take ultimate responsibility for your own outcome by investing a couple of hours in learning *a lot* about this subject.

THE "JUST SAY NO" STRATEGY

Stop Compounding the Problem

If I had too much credit card debt and I decided I wanted to be free of that debt, what would be the first step to solving my problem? Or if I were overweight and had truly decided I was ready to make a lasting life change, what would be the very first step to solving my weight problem? In each of these cases, the very first step would simply be to stop: to stop using my credit cards—or to immediately begin eating less.

So *stop* putting all of your retirement savings in before-tax accounts!

I am not advocating that you stop saving, just as I wouldn't advise someone with a weight problem to stop eating altogether. But if the excessive amounts are causing the problem you must redirect the funds—*now*.

TIP: If your company plan provides for company matching of any amount of your own contributions, then you should at least do that amount. So if they match the first 5%, keep contributing 5% in the plan. This is like getting an immediate 100% "rate of return" on those first contribution amounts.

But what should you do with any future contributions? I have two simple strategies for you to think about:

THE "STASH THE CASH" STRATEGY

Systematically Build After-Tax Balances

This is a strategy I've used with clients who were within five or ten years of retirement, and it has provided a greater life impact than any other strategy I will talk about here. After a complete financial evaluation, I've advised clients to discontinue contributions in excess of their company's 100% match. The excess was then directed into a local savings or money market account.

Current contribution percentage	15%
Company 100% matching amount	6%
Difference to savings	**9%**

The problem I've seen time after time is that most of my clients had saved well, but did not have even $20,000 they could access without paying taxes on an IRA distribution. If they needed a new air conditioner for their home or a new car during the first year of retirement, the only way they could get it was through a distribution of their retirement account.

Not everyone appreciated this approach on the front end. Let's face it—the advice is not conventional. I was actually telling them not to invest, and to put money into a lower-returning money market or savings account instead. Remember, this was recommended only after a thorough investigation and analysis of many facets of their personal and financial affairs. But I am pleased to report that this one little change has made all the difference in the world for each and every one of my clients who have had the discipline to implement the change. They retired with $80–100,000+ in liquid, easily-accessed funds.

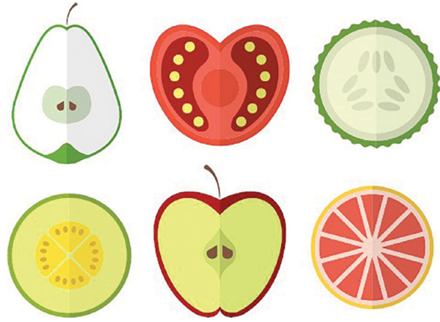
This liquid money gives you the capacity to solve bigger tax issues over the years from retirement until your 70s, when the Required Minimum Distributions begin. It also gives you options when it comes to which pot of money you live out of first when you retire. When your cash is easily accessible, you rule your world instead of it dictating to you what you must do next.

"But isn't that going to really hurt my overall rate of return on my retirement funds?" I was frequently asked. Well, yes, it's going to change it some, but I always point out that not every dollar needs to serve the purpose of growing. Some dollars serve the purpose of security; some dollars are waiting to save their master tens of thousands of dollars of income tax. In real life, once a significant amount had been accumulated (relative to my clients' own personal budgets and needs), we did redirect into after-tax brokerage or investment accounts to help with the rates of return needed for their retirement objectives.

If you have the cash, you can qualify for and benefit from a multitude of strategies that build your net worth and lower your income taxes for your lifetime. This cash can also be used to create much higher guaranteed income streams than you can achieve by owning only financial assets that are subject to the whims of stock and bond market fluctuations. As far as I'm concerned, a fat wallet of cash (metaphorically speaking) feels really good when you lay your head on your pillow at night.

TIP: Redirect amounts above your company's 100% matching amount into after-tax savings accounts until you've achieved significant balances in those accounts.

THE "FREE FRUIT" STRATEGY



Redirect Contributions in Your 401k to Roth (if Available)

IF YOU ALREADY have access to a meaningful amount of money outside of your IRAs and 401k, there are other strategies that can have an impact on your tax situation in the future.

In 1997, Delaware Senator William Roth was the chief legislative sponsor of the Taxpayer Relief Act. The Roth IRA is one of his claims to fame. It's a pretty popular savings vehicle, but for what we're trying to accomplish, it has some significant contribution limitations—it just won't get the job done. But if the Roth option isn't available in your company 401k plan, funding the maximum amounts in a Roth IRA is a great second-best alternative.

Let's review the benefits of a Roth but focusing specifically on the Roth 401k. Every Roth account allows funds to grow without any taxation—forever. As long as you play by the rules (leave the funds in the account for at least five years and don't withdraw before you're 59 ½), you'll never pay tax on the gains. Your heirs won't pay taxes when inheriting your Roth, either. To get the benefits of tax-free growth, you forgo the tax deduction when you make the contribution. In my view,

it's a small price to pay for a lifetime of tax-free money. See, this plays right into our hands.

I like to explain a Roth like this: let's assume you love oranges. You know that you want oranges for the rest of your life—you *need* oranges! Oranges don't just feed you; they're a currency you can trade for things you want (food, utilities, travel, cars, education for the grandkids, a motor home…) So there are two options offered by the guy in charge of all the orange trees: the first option is that you don't have to pay for the seeds to the orange trees you want, but you *do* have to pay every time you want an orange. The other option is that you pay for the seeds, but never pay for oranges when you want or need them. For argument's sake, let's say that the price is the same, today or when you pick the oranges.

The analogy probably breaks down at some point, but I hope you understand the simple but profound difference: in your tax-deferred 401k and IR,A you get the tax break on the seed, but you pay every time you want a distribution. In a Roth, whether a Roth IRA or a Roth 401k, you pay for the seed, but *never* for the oranges.

Looking at it in those terms, it's almost a no-brainer, right? That's certainly not because I have any superpower or even because I'm any smarter than the next person. Unfortunately, the allure of the all-important tax break is like some sort of addictive drug that Americans think they *must* have—which is exactly the problem! It's like the must-have credit card purchase or food craving in our earlier example. You don't need the tax break, but I'll submit that you dearly need a secure financial future. Taxes put that outcome under significant stress.

About 60% of employer-sponsored 401k savings plans now include a Roth alternative. If you have a Designated Roth 401k option available to you, there are a few benefits compared to the conventional Roth IRA. But you should note that the Designated Roth 401k does not allow a qualified distribution for a first-time home purchase. If you leave the funds in the Roth 401k after retirement, you will have to take Required Minimum Distributions, which are *not* taxable. The normal Roth IRA allows you to leave the funds there for your lifetime (see table on page 87).

TIP: Only contribute the percentage amount that the company matches 100%. Redirect all current and future contributions into your company Roth 401k option if available. Amounts above the matching percentage will most likely help you more if they go to the next strategy I'll discuss.

	Designated Roth 401k	**Roth IRA**
Contributions	Designated Roth employee elective contributions are made with **after-tax dollars.**	Roth IRA contributions are made **with after-tax dollars**.
Income Limits	No income limitation to participate	Income limits: 2019: modified AGI married $203,000 single $137,000 2018: modified AGI married $199,000 single $135,000
Maximum Elective Contribution	Aggregate* employee elective contributions limited to: **2019:** $19,000 **2018:** $18,500 (plus additional $6,000 for employees age 50 or over)	Contribution limited to: **2019:** $6,000 plus additional $1,000 for employees age 50 or over **2018:** $5,500 plus additional $1,000 for employees age 50 or over

Taxation of Withdrawals	Withdrawals of contributions and earnings are not taxed, provided it's a qualified distribution—the account is held for at least 5 years and made on account of disability / on or after death / at or after age 59½.	Same as Designated Roth 401k Account, and can have a qualified distribution for a first-time home purchase.
Required Distributions	Distributions must begin no later than age 72, unless still working and not a 5% owner.	No requirement to start taking distributions while owner is alive.

THE "SET YOURSELF FREE" STRATEGY

Unlimited Roth Conversions

WHILE EACH OF THE STRATEGIES has its own place and time in a saver's journey, none make as powerful an impact as this strategy. As with the others, I'd suggest you consult with an advisor or tax expert who understands and agrees with what you're trying to accomplish. I'll warn you, however, that many tax people haven't given consideration to these principles or run the numbers for their lifetime impact. They do a great job of helping you save taxes on *this year's* return, but most tax experts are not up to speed on the principles presented here—not because they aren't smart or great at taxes, but because it just hasn't been their professional focus and direction.

The same is true with most financial advisors. Their lives are about getting people to save and invest—unless they serve as a fiduciary *and* have given serious thought to the various outcomes, in which case they will draw conclusions similar to the ones presented in this book. So be sure to find counselors who understand the outcomes you're attempting to create.

I've advised you to discontinue making excessive contributions to your existing 401k if you are still working, and that's a great start. Unless you're still in the early part of your career, however, just doing

that is not going to make the impact you really need. In order to make a considerable impact, you should consider taking strategic distributions from your retirement accounts in order to gain greater tax efficiency later.

IMPORTANT NOTE
This strategy can have a powerful impact by rescuing you from being trapped by excessive taxation for the rest of your life. But it is accomplished by choosing to pay some tax today so you can eliminate greater and longer-lasting taxes in the future. Careful consideration should be given to the long-term impact of the longevity of your retirement assets.

The Exception that Opens the Door

In general, when you withdraw funds from an IRA prior to age 59½, your withdrawal is subject to income tax and the 10% early withdrawal penalty on the entire distribution. But the 10% penalty is waived if your withdrawal falls under one of the exception categories, including a first-time home purchase, certain medical expenses, and so forth.

One of the exceptions to the penalty is a withdrawal for a Roth Conversion. You still must pay tax on the conversion, but normally the 10% penalty will not apply to amounts converted from a traditional IRA to a Roth IRA. Many 401k plans allow for an "in-service distribution" prior to age 59 ½, which effectively allows you to transfer funds to an IRA that is outside of your company plan. This kind of transfer is simple, but you must pay close attention to the paperwork and make sure you get it right.

The most familiar way to get funds into a Roth account, whether IRA or 401k, is by contributing them from your earnings. But there's

a far more effective way to get ahead of the tax traps by using the Roth rules to your benefit. While there are limitations to the dollar amounts an earner can contribute to these accounts, there is no limit on the amount that can be converted from tax-deferred accounts (See . If it were in your best interest, you could actually convert your entire tax-deferred balances in any year you desire.

Normally, it's not economically feasible or wise to do that because all of the amounts you are converting have to be included in taxable income for that year. In addition, few people have enough financial balance in their lives to be able to pay the taxes on that large a taxable event. But you may recall Tom from an earlier section, who converted $2 million from his IRA to a Roth. He didn't want to leave his three children holding a bag of money with a lifetime of added taxes after he and his wife died.

After presenting Tom, then in his late 70s, with the facts, it was apparent that his goals and his other finances were prime for this "all-in" conversion. I ran the numbers and created spreadsheets and templates for him to take to his CPA. The CPA cranked the numbers, reviewed the tax codes, and agreed. To avoid paying a lot more in taxes, and to prevent his legacy to his kiddos from diminishing, he converted over $2 million from his IRA to a Roth that year. The check for the taxes was *amazing*! The total savings to him and to his children was almost double the amount of the check to the IRS. Think about everything he did well that allowed him to escape all of that tax: he saved well, developed large after-tax balances, and had an open mind to strategies that would help him. He sought qualified counselors and had the faith and trust to carry out the plan.

A word of caution about conversions. There are a couple of situations where the 10% penalty could impact you as you initiate your Roth Conversion if you are under age 59 ½.

The first situation that causes a 10% penalty:

Here is one of the reasons I came to strongly believe everyone should have access to a meaningful amount of funds that can be withdrawn without associated income tax or penalties.

Let's assume you want to convert $40,000 from your IRA to a Roth IRA. To do so, you used $10,000 of the proceeds to pay the tax on the conversion. The IRS looks at this as if you only converted $30,000, so the $10,000 was withdrawn for other purposes and does not meet the exception list. If you are under age 59 ½, the 10% penalty will, therefore, apply to the funds that you used to pay the tax on the conversion. The $40,000 is taxed at ordinary income tax rates for the conversion to occur.

Convert	$40,000
Income tax (assumed)	-$10,000
Penalty	-$ 1,000
Net proceeds	**-$29,000**

The second situation that causes a 10% penalty:

The Five-Year Rule

A qualified distribution from a designated Roth account is excludable from gross income. This is a distribution that occurs at least five years after the year of the employee's first designated Roth contribution (counting the first year as part of the five), and is made:

- On or after attainment of age 59 ½,
- On account of the employee's disability, or
- On or after the employee's death

A nonqualified distribution is a distribution that will be partially included in gross income if there are earnings in the account.

The distribution will be treated as coming pro-rata from earnings and contributions.

The 10% tax on early withdrawals may apply to the part of the distribution that can be included in gross income.

How to Convert to a Roth

A Roth IRA conversion is simply a rollover from an IRA or 401k to a Roth account. All custodians have simple paperwork to affect the official rollover, generating the appropriate tax record. If the IRA to Roth conversion is taking place through the same custodian, it should be a pretty painless experience.

I'd suggest that you be really cautious when you're trying to convert an IRA at one custodian into a Roth IRA at another. Just be careful to do it correctly to avoid a world of pain at tax time. In any case, the process is very common at the companies that hold your accounts. Just be clear about what you want to do—and follow directions to the letter.

How Much Should You Convert?

This is the really tricky part. This is where it's extremely helpful to have a financial advisor and a tax expert working in tandem for your benefit. There are so many variables to get the right answer to this one. The "right" answer is dependent on much more than just income tax marginal tables. It has much to do with your life, present and future. In my own experience, converting large sums of tax-deferred funds to a Roth can be very beneficial to most people, but there are still many circumstances that have caused me, at one time or another, to recommend a "no-go" on this strategy.

For example, if you have very little savings outside of tax-deferred accounts, it will be nearly impossible to use this strategy. And if you're a very high-income earner with a modest lifestyle, nearing retirement within a few years, you'll probably be one of the few who dramatically lower their tax bracket after retirement. You'd probably be better off waiting to see what happens to tax rates at retirement when your income is much lower.

But since I want to provide some guidance here, I'll say that your starting point is your income tax return from last year. For most people, the target we're trying to hit is the dollar of taxable income just below the next highest marginal income tax rate that you're already paying.

Looking at the table below, let's assume your tax return for this year reports $121,000 of taxable income (not how much you made, but the calculated number from line 10 of your 1040). If you refer back to the current marginal tax bracket table provided earlier, we see that the top of the current tax bracket for that income would be $171,050. This would create the possibility of converting as much as $50,050 this year.

You can project forward what you believe will happen to your income in the future to get an idea of what kind of an impact you can have over a few years.

	This Year	Year 2	Year 3	Year 4	Year 5
Top of tax bracket *	$171,050	$171,050	$171,050	$171,050	$171,050
Projected Taxable income**	$121,000	$124,000	$128,000	$130,000	$135,000
Same Cost Conversion Amount	$ 50,050	$ 47,050	$ 43,050	$ 41,050	$ 36,050
Cumulative conversion	$ 50,050	$ 97,100	$140,150	$181,200	$217,250

*Assumes 22% tax bracket for married filing jointly.
** Line 10 on Form 1040 tax return.

If your income or the conversion pushes you into the next tax bracket, it doesn't necessarily convince me that you should *not* do a conversion. In this example, the next tax bracket is just 2% higher tax but allows up to $326,600 of taxable income. Your personal situation, age, and financial objectives could very well put you in a position where a more aggressive conversion amount would be in your best interest. Don't be afraid of the tax brackets. An emotion-free evaluation should be conducted to see if the numbers make sense for you.

Important Reminder

Converting IRA or 401k funds to a Roth is a great strategy at any age. Two benefits are avoidance of the 10% premature distribution penalty and the tax-free growth that occurs in a Roth. But after age 59 ½, you can take distributions from your IRA/401k without incurring the premature distribution penalty. So if you don't have after-tax money to work with, paying the tax on a distribution is no different than paying the tax on a conversion of funds to a Roth. You may find that you need or want to do some normal distributions and put the funds in more liquid accounts instead of moving all of them to Roth accounts.

Roth Conversion vs. Roth Contribution for Maximum Impact

People frequently tell me they are already contributing the max to their Roth IRA, implying that they see no real benefit in converting funds. You should always use money in a way that gives you the greatest benefit, so let's take a quick look at the differences between the two by way of a simple example. You have two options: make a

Roth contribution, or convert the equivalent amount from a tax-deferred account and pay the tax. If you make the Roth contribution, you deposit $6,000 of cash and your resulting benefit is an additional $6,000 in your Roth growing tax-free for your life.

But what if you chose to use the $6,000 to pay the tax on converting some of your existing IRA or 401k funds? If you are in the 22% tax bracket, this would mean you could convert $27,272 this year! In one case, you have $6,000 in your Roth; in the other, a whopping $27,272. Heck of a deal!

Roth Contribution	$6,000
Tax Bracket	22%
Conversion Equivalent	$27,272

Now, use the same line of logic when considering a large annual contribution to your company's Roth 401k. Many Americans have orphaned 401k accounts from previous employers, or have rolled that prior 401k into an IRA. All of those funds are also causing the problems we've discussed in the tax traps.

Recall that the contribution limits for a company Roth 401k are as much as $25,000 if you are over age 50 and utilize the catch-up provisions. If you assume that every dollar is taxed at the next highest tax bracket for the same out-of-pocket expense as contributing to the Roth 401k, you'd be able to convert $104,000! Instead of putting funds into the Roth account, use them to pay taxes on converting existing TAXABLE funds. The impact is that you'll have roughly four times the amount in a better tax position for the rest of your life.

Which is better? Using $25,000 to contribute to a Roth 401k or converting $104,166 to a totally tax-free status using the same $25,000? You may want to work with your advisor to help you choose the best option for you.

Roth 401k Contribution	$25,000
Tax Bracket	24%
Conversion Equivalent ($25,000 / .24)	$104,166

Remember, these decisions need to be made with the benefit of a broader view of your current finances and the impact these conversions may have on your long-term balances and income needs after paying the taxes.

TIP: Develop a comprehensive coordinated plan to minimize your lifetime taxes by strategic conversions to Roth accounts before income tax rates go up.

A SAMPLE CASE

Putting it All Together

Let's take a look at how you can put all the pieces together. We'll assume we have the same facts as my clients referenced in the first section. Without a complete set of financial details about our hypothetical couple, we can't really evaluate each strategy's utility, but we'll know enough to demonstrate how simple it can be to save over one hundred thousand dollars of lifetime taxes.

Total taxes paid on RMDs at withdrawal	$400,428
Taxes paid on growth of reallocated assets	$153,771
Taxes paid by heirs on remaining IRA value at death	$268,988
TOTAL ESTIMATED LIFETIME TAXES	**$823,187***

For our case study, we will be looking at a 60-year-old married couple with one million dollars of retirement savings, who are both 91 years old when they die. The standard 25% tax will be assumed with no changes to tax rates over their lifetimes. The most significant and simplest strategy—converting funds to a Roth—can be effective only if funds are available outside of the IRA. There's always a balance that must be struck between saving taxes and making sure there's enough

money left after taxes are paid to last the rest of your life. This is a reminder of the need for a comprehensive evaluation before taking aggressive action.

In this situation, converting $326,667 of the $1 million into a Roth IRA account will save $187,241. But it's usually not advisable to convert the entire amount all at once. From most of the cases I've analyzed, the drain on your account from paying the tax all at one time can have a dramatic impact on how long your money will last. It's possible, but without further information, I'll present the most conservative approach. The best path would be to do this slowly. This illustration assumes that the conversions are taken over the full seven years remaining before the possible changes to tax rates.

This path would create an additional $46,666 of taxable income on the subjects' tax return each year. For this to work, we want to make sure that the client would still be in a "reasonable" tax rate after the $46,666 is added. Doing this slowly allows the client to start down a path that gets to prove itself year after year and accumulate the benefits:

Do Nothing	$0	
Better Strategy	$187,241	$546,837
Best Strategy	**$187,241**	**$688,426**

You will notice that doing nothing about this problem creates absolutely no benefit, subjects you to full taxation for the rest of your life, and leaves a tax liability to your heirs after your spouse dies. You can also see that there are still a lot of taxes to be paid, even after the strategy for savings. This can be avoided by younger savers if they'll heed this warning and redirect their saving, moving from tax-deferred to tax-free accounts. Think about how simple this is—merely moving funds from a tax-deferred account through the totally legitimate

conduit provided by the U.S. Tax Code: a Roth IRA conversion. No products to buy or complicated tax schemes to deal with.

My hope in putting my experience in writing is that you'll have information that motivates you to do something about the enormous amount of taxes that are hidden just under the surface of your next IRA/401k statement. The strategies I've outlined are not complicated, but you are advised to seek credible and experienced counselors who understand income tax strategy and financial planning projections. I've scattered many real-life situations throughout the pages of this book to illustrate how simple it is to greatly improve your tax situation, and therefore your personal lifestyle for the rest of your life. Client after client experiences have shown me how little attention is paid to this very impactful part of your financial life and future.

While reading a book about how to position yourself for a better future it's really easy to forget the hopes and dreams that you desire as a result of the benefits of the information presented. What do you really want for your future? My experiences have taught me that paying some taxes now can have the result of a much higher after-tax income stream for the remainder of your life. But if you do nothing with the information presented, you will continue to own the problem.

From what we know now, you have until December 31, 2025 to solve this. Many of us have a strong belief that income tax rates will not be lower than they are now for decades. For those who can benefit from these strategies, my experience and my analysis of hundreds of clients' situations demonstrate that people's financial lives will be better for having implemented these strategies—even if tax rates do not increase. The purpose of undertaking this writing project was to sound the alert so that the good people of the land can help themselves while they may.

If you do not act before the current tax rates change, you will remain firmly in the grasp of income taxes for the rest of your life. Furthermore, you will leave a legacy of an income tax burden to your

heirs. I've shown you the path out of the "trap" now it's time to get moving!

"With great knowledge comes great responsibility"

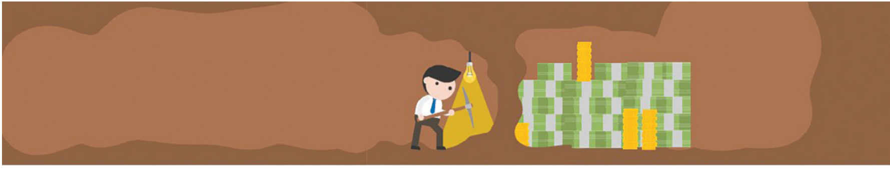
Spiderman (and Voltaire)

For additional resources, please visit

www.C **ar.com**

ABOUT THE AUTHOR

After a thirty-two year career as an independent financial adviser, Craig sold his practice and focuses his experiences, and efforts toward alerting savers to the large tax obligations that are built in to their retirement accounts. This birthed his book Paying the Piper, and a supporting online education course, Escaping the Tax Traps.



Resources To Personalize Your Escape

Online Course: Escaping The 401k Tax Traps

You've already learned that your large IRAs and other retirement accounts are subjecting you to a lifetime of taxation. And we've suggested that the latest changes in the tax codes have opened an unprecedented window of opportunity. Now, you need a game plan!

The course includes four parts presented in audio and video by Craig. Each part is just 20 - 35 minutes, so you receive almost two hours of information about the Tax Traps. You'll discover the information you need to formulate a plan to escape.

You are provided with a Personalized Worksheet to complete as you step through the four distinct parts. The goal of the course is to have you organized and prepared to decide which of the strategies you'll implement and to what degree. If you have a financial or tax advisor, the Personalized Worksheet will be appreciated by them as it will present the core information the two of you will need to formulate a personalized game plan.

One-on-One Personal Consultation

Because you're interested in additional resources, it is highly likely that you are ready to do something to dramatically reduce your lifetime taxes. You've read the book and now it's time to get serious about solving the problem!

If you're ready to take the next step but don't want to do this by yourself, I can help. All you need is a simple game plan that allows you to have the confidence and sense of security that you've done all that you can to hold on to more of what you've saved for so many years.

We take this information very seriously and have the experience to apply the right financial planning principles to arrive at solutions for your situation. We've done this for many years and can save you a lot of time solving this tax problem.

To learn more about the costs and what you'll receive, go to CraigWear.com.

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You're rocking along, taking care of business by saving diligently in your 401k - not even realizing that you're creating a costly monster!

Through required minimum distributions, excess accumulation and taxes upon death, you may owe as much as 80% of your 401k balance in income taxes.

This book uncovers the reasons that cause a lifetime of taxes and reveals specific strategies that allow you to take immediate action.

"Craig has demystified the advantages of the conversion of 401k plan funds into the Roth IRA. Most folks tax planning stops once they have participated in the "Company" 401k or defined benefits plan. Craig methodically takes you beyond the Company Savings plan to maximize the tax benefits and attributes which will benefit the 401k contributor and subsequently their heirs. Bravo Craig!" **- Todd G, Retired CPA**

Craig Wear, CFP®

After a thirty-two year career as an independent financial adviser, Craig sold his practice and focuses his business interest, experiences and efforts toward helping people invest wisely within their company retirement plans, and alerting savers of the large tax obligations that are built into their retirement accounts.

On a personal note, Craig and his wife travel and live full-time in their motor coach to experience the great places and people across America.

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