MORE WEALTH LESS TAXES

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Benefits of Tax-Free Savings

Every situation is obviously unique and there are benefits to pre-tax savings. However, because these are less understood, I wanted to outline some key benefits for you regarding tax-free savings.

1. Capital gains and dividends taxes can be lowered to 0% during distribution years if you have tax-free savings to live off of. This is the essence of the Bucket Strategy that we discussed. Avoiding a 15-20% tax rate on all taxable investment gains and dividends can have huge implications in retirement.

2. It could allow you to pay your taxes at a lower rate. Tax rates are at historic lows (for comparison the top marginal rate in the 70s was 70% compared to today's 37% top tax bracket). With a ballooning government deficit and partially unfunded liabilities like Medicare and Social Security, one may assume that tax rates will be higher in the future.

3. You could avoid Required Minimum Distributions. RMDs come into play at the age of 72 and you are required to distribute pre-tax qualified assets based on your expected life remaining. We have seen time and time again in plan modeling and actual distributions that this causes many to be in higher tax brackets than they were in their accumulation years.

4. Social Security could get taxed if your income is over a certain level which is decided by the amount you're distributing from your pre-tax savings or your taxable investments accounts. Married filing jointly individuals for this year pay taxes on 50% of their Social Security benefits if they have income between $32,000 and $44,000. Once their income exceeds $44,000, they pay taxes on 85% of their Social Security. Tax-free savings allow you the flexiblity to stay under those tax rates and receive 100% of your Social Security.

5. You're paying taxes at a known rate vs. an unknown future rate. This is like point 2, but different. There is a flexibility and peace of mind that comes with certainty. If you save tax-free, you are locking in your tax rate vs. deferring to an unknown future rate decided by Congress.

6. If you have the capability to max out all your qualified options and still save excess over that, then you can save more qualified dollars by saving tax-free. The reason for that is simple - you're entitled to every dollar you save tax-free while only entitled to the amount you distribute less taxes on pre-tax savings. (For example, the maximum you can contribute to a 401k in 2022 is $20,500. If you contribute $20,500 pre-tax and it grows to $50,000, you are only entitled to the $50,000 less taxes. However, if you save $25,000 tax-free and it grows to $50,000, you are entitled to $50,000.)

7. You can pass on your wealth more tax efficiently. Tax-free savings are passed on to heirs tax-free. However, pre-tax savings are taxable as income and even worse, they are subject to distribution rules meaning those required minimum distributions mentioned in point 3 come back into play. Oftentimes, pre-tax savings are inherited by individuals in the age range of 35-55 which is also usually an individual's highest earning years. This forces tax rates even higher, meaning the wealth that someone wants to pass on becomes less and less.

Saving into tax-free accounts may expose more of your present income to taxation now and drive your present tax bill higher. We can work with you to find additional savings opportunities in your budget to partially offset the additional taxation cost.