TAX WISE

STRATEGIZE. OPTIMIZE. TAXWISE.

A WHITE PAPER

MAKING THE CASE FOR TAX-FREE RETIREMENT

CREATING MULTIPLE STREAMS OF TAX-FREE RETIREMENT INCOME

THE RISING TAX-THREAT

In order of taxes to normalize to the historical averages, tax-brackets must rise roughly 20%. In order to stop our deficits, they must double.

TAX-PROCRASTINATION PLANS

Traditional qualified retirement plans like 401(k)s and IRAs have procrastinated taxes, creating a tax-bomb for millions of Americans. This tax liability many times greater than perceived pre-tax savings.

TAX-FREE SOCIAL SECURITY

Social security is rarely taxable on its own. In fact, it is usually the other assets in a retiree's picture, poorly positioned, that cause social security to become unnecessarily taxable.

“...the tax rate for the lowest tax bracket would have to be increased from 10 percent to 25 percent; that tax rate on incomes in the current 25 percent bracket would have to be increased to 63 percent; and the tax rate of the highest bracket would have to be raised from 35 percent to 88 percent.”

-David M. Walker in the 2008 CBO Report: *The Long-Term Economic Effects of Some Alternative Budget Policies*

> In America, there are two tax systems: one for the informed and one for the uninformed. Both systems are legal.
>
> *— Learned Hand*
> *Former Judge of the United States District Court for the Southern District of New York.*

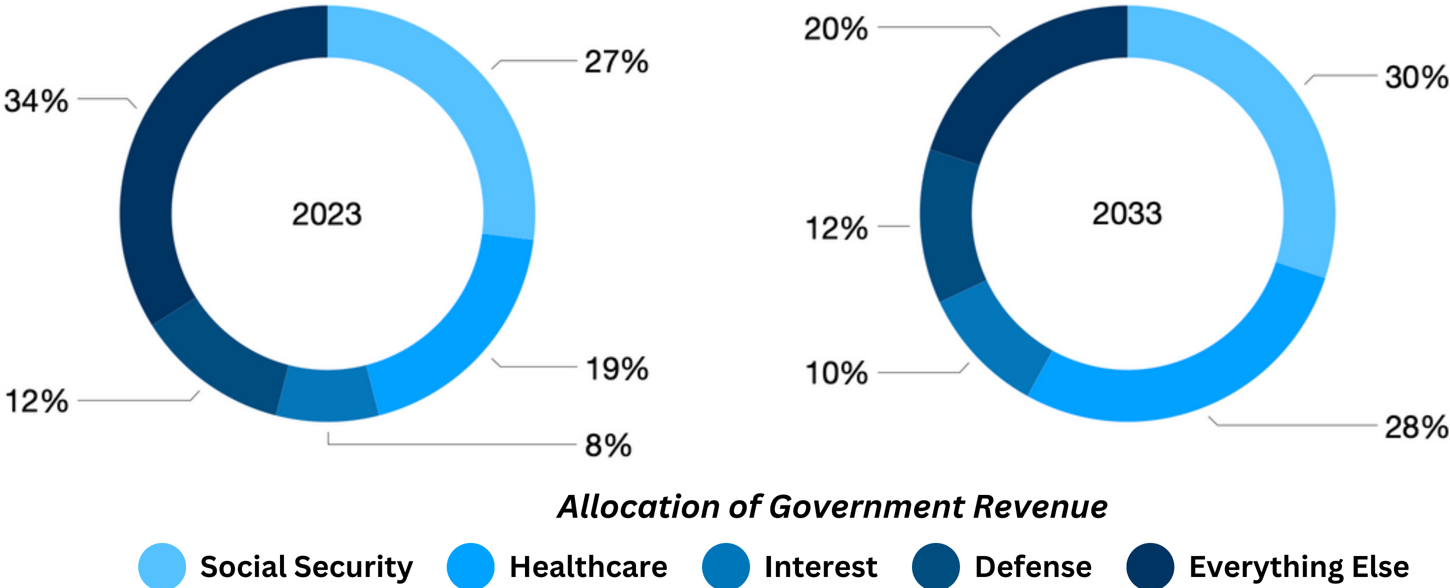
The Need

Currently, for every dollar of revenue the federal government takes in, 54% is spoken for by three things:

- Healthcare (Medicare, Medicaid, etc.)
- Social Security
- Interest on the national debt

After national defense is taken into account (another 12%), the federal government is left with 34 cents from each revenue dollar to fund everything else.

Over the next decade, these mandatory expenditures (healthcare, social security, and interest on the national debt) are expected to rise from 54% to more than 68% of the pie chart. Assuming national defense did not similarly increase, that leaves less than 20 cents of every revenue dollar to fund everything else.



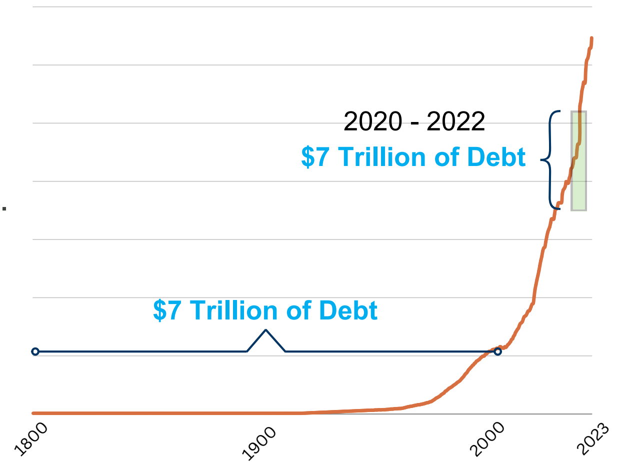
Allocation of Government Revenue

Social Security · Healthcare · Interest · Defense · Everything Else

The government has not taken in enough revenue to support its spending for many years, creating trillion-dollar deficits, adding to the national debt at a record pace. This is only expected to accelerate. The interest on the debt is scheduled to *triple* over the next decade alone.

Two Centuries of Debt in Two years

In fact, it took just over two centuries to reach $7 trillion of national debt (from George Washington to George W. Bush). However, from March 2020 to June 2022, the federal government added another $7 trillion–in just over two years. As of this writing, the national debt increases by $2 million every sixty seconds.



Debt to GDP Ratio

Our national debt currently stands at roughly 120% of our GDP. One way to think about this is that our debt is 20% larger than our entire economy. This has only happened once in our nation's history before, during the final years of World War 2. However, it fell precipitously after the war ended, falling back to long-term norms. This time, the inverted ratio is predicted to stay, running up to 195% of our GDP by 2053. For the first time in our history, our debt will grow faster than our economy.

Unsustainable

To say the above facts portray an unsustainable picture is an understatement. We hearken back to what the honorable David M. Walker, Comptroller General of the United States at the time, testified before congress regarding what tax-brackets must do in order to just stop the bleeding:

> ***...the tax rate for the lowest tax bracket would have to be increased from 10 percent to 25 percent; that tax rate on incomes in the current 25 percent bracket would have to be increased to 63 percent; and the tax rate of the highest bracket would have to be raised from 35 percent to 88 percent.***

When Mr. Walker said this, the national debt was $8 trillion. It is currently $33 trillion. We wonder what Mr. Walker would say today. In line with the data, it is simply irrational and reckless to plan on taxes being lower in the future.

The Myth of Lower Taxes in Retirement

There are many retirement myths that are relied on in planning for retirement. None, however, is perhaps so destructive in its effect as the belief of having lower taxes in retirement. This hypothesis from the 1970s may have had honest intentions, but now 45 years since the advent of the 401K, the data largely does not support the hypothesis. Many advisors, in fact, report that their clients end up paying more in retirement. Why?

Four main reasons present themselves.

1. Loss of Deductions

First, while working, we have deductions and tax-credits that generally don't exist in retirement. For example, many save money in pre-tax vehicles, such as 401Ks and IRAs that procrastinate taxes until the future in exchange for upfront "tax-savings" due to pre-tax investing. While this is not a true tax-deduction, it does lower your tax-liability today. In retirement, that disappears.

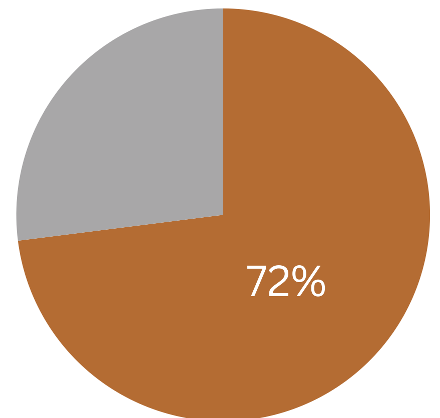
If we've followed conventional wisdom, our mortgage is all but paid off in retirement, so that deduction is also lost (if you are itemizing deductions).

Finally, children are grown and out of the house. We no longer enjoy child deductions or child tax-credits.

The three largest deductions we have while working typically disappear into thin air the closer we get to retirement, leaving us with only the standard deduction. For many retirees, even if they are in a lower tax-bracket in retirement, they find themselves paying about the same in actual tax due to the loss of deductions.

2. Increasing Taxes

Taxes are poised to rise sharply on January 1, 2026 when the Tax Cuts and Jobs Act (often called the Trump tax cuts) expires and revert to the Obama levels. For example, currently, someone with taxable income of $78,000 finds themselves in the 12% federal tax bracket. However, when the Trump cuts expire, that same income will then be in the 25% federal tax bracket, *more than a 100% increase*. While most will not experience this severe of a tax-bracket increase (but some will), an increase of 25-50% will be commonplace if nothing changes.



A recent study showed 72% of Americans are concerned that higher taxes will negatively impact their qualified retirement accounts

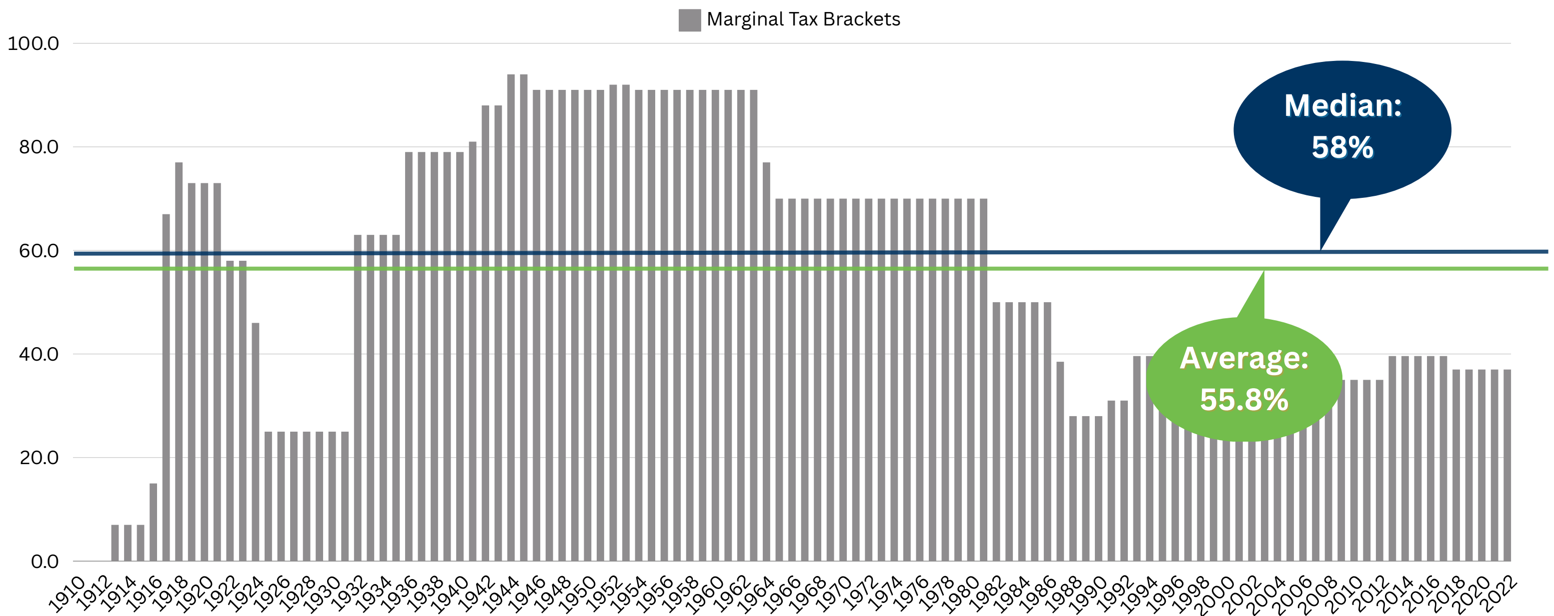
There are three main ways taxes can increase:

- Changing tax-brackets (as described above)
- Changing deductions (Congress often changes how much and what may be deducted)
- New legislation (such as what occurred when Social Security benefits became taxable)

Taxes are currently on sale, but that sale is ending. Our current tax-brackets are historically low. Many are shocked to learn that the highest tax-bracket we've ever seen in the United States is 94% (the last two years of World War 2). Through much of the 1960s and 70s, the highest tax-bracket was 70%. While the Tax Reform Act of 1986 slashed tax-brackets (the highest going from 70% to 28%), it also slashed deductions, and American paid more in net taxes after the legislation was passed.

In order for taxes to "normalize" to long-term averages, tax brackets would have to increase roughly 20% at every level. in order for deficits to cease, the change would have to be much more severe.

History of the Highest Tax-brackets



3. Provisional Income

Distributions from traditional, pre-tax plans (such 401Ks and IRAs) count as what is termed “provisional income” (PI). PI is the summation of all income sources (except two, which will be discussed below) plus 50% of your social security income. If that summation totals more than $32,000 per year for married filing jointly ($25,000 for single filers), then up to 50% of your social security income is suddenly taxable at your highest marginal tax rate. If the total is more than $44,000 ($34,000 for single filers), then up to 85% of your social security is taxable at your highest marginal tax rate. This presents a frustrating situation as social security, on its own, is rarely taxable. The culprit of these unnecessary taxes is typically pre-tax retirement plans. This is usually preventable through proper tax-efficient planning.

4. Pre-tax Penalty

Most of the financial world espouses the ability to save money pre-tax as a significant advantage. For some, this can be true, but not for most. Not only does pre-tax investing procrastinate taxes until the future when taxes are all but certain to be higher (one way or another), but we now come to a point that very few have made.

Short-term capital gains occur when you hold an investment for a year or less and sell for a gain during that time. The gains are taxed at your ordinary income brackets. Long-term capital gains occur when you hold an investment for over a year and sell for a gain. This time, your gains are taxed at lower rates, called "long-term capital gains rates." For most people, this means a 15% federal rate instead of their higher tax-brackets. In short, long-term capital gains save you in taxes compared to short-term capital gains.

Remembering that, let's come back to 401Ks and IRAs. How long do you hold money in these accounts? Longer than a year? Decades? Yes. Definitely *long term*. When you go to use the money (after holding it for so many years) do you get that lower, preferred long-term tax rate?

Not a chance. You must pay as if all your money is short-term gains (ordinary taxes), no matter how long you have held it. This is the deal you make with the IRS by taking them up on their offer of pre-tax savings, something we term the "pre-tax penalty."

Multiple Streams of Tax-free Income

Over $37 trillion reside in pre-tax retirement accounts. This constitutes a target-rich environment for Congress. Indeed, recent proposed legislation (Build Back Better) contained several elements that would have severely hindered retirement savings through extra taxes. The bill did not pass, but it (and many other recent proposals) revealed Washington's disposition of viewing retirement accounts as a "solution" for the nation's severe fiscal condition.

It is more critical than ever to put a tax-efficient retirement strategy in place to create multiple streams of tax-free income. Taking advantage of the current tax-sale and insulating retirement assets against inevitable tax increases will likely prove the most paramount piece of retirement planning you can undertake. Removing the largest fee (taxes) in your retirement accounts has many positive effects.

A tactical and strategic plan to shift tax-hostile assets in pre-tax accounts to tax-free accounts can pay massive dividends. Not only do future growth and distributions become tax-free, providing protection against future tax increases, but several other detrimental side-effects of pre-tax accounts dwindle. RMDs, social security taxation, taxes to heirs, Medicare premium surcharges, and the ACA tax on investments are highly mitigated if not eliminated altogether.

When done properly, a tax-free road map typically shows an average increase in net-spendable income in retirement of ~30%. Alternatively, the longevity of the retirement assets is increased on average by 7-10 years. In some instances, both benefits are observed in some combination. Further, market risk is generally reduced as a natural consequence of this approach due to less risk required to experience a similar of improved outcome versus a more traditional, tax-hostile approach.

Beyond the financial aspects of tax-free retirement planning lie the positive effects on lifestyle, stress, and longevity. With the IRS no longer a partner in your retirement (or minimally so), stress reduces and lifestyle improves. These factors have been shown to bring about a longer, healthier, and happier life.

This is the point of proper retirement planning. The case for tax-free retirement is compelling.

These results do not happen by accident. They happen on purpose. They happen because of dedicated, strategic action. Creating a well-developed tax-free roadmap is the starting point toward the foundation of tax-free retirement.

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