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Want to retire 'tax-free?' Pay your taxes now

Take action to minimize or possibly eliminate the expense in the future

BY DANIEL COHEN

Good financial planning will have you debt-free in retirement. Who wants to be paying a mortgage or other debt during the years when there's no more earned income coming in?

For most people, eliminating the mortgage by the time they retire is an important goal, since eliminating this fixed expense relieves most people of a heavy burden. But an even bigger expense in retirement for many is taxation, especially taxes on one's retirement savings.

For most, little is done to eliminate or at least lower their ongoing tax expense, until it is too late. To make matters worse, the amount of taxes one will owe in the future is very unpredictable. But there are things you can do now to minimize or possibly eliminate the expense in the future.

For financial planners, taxes are a major factor to consider when giving advice. There are choices to be made whether someone should deposit funds to a retirement account and get a tax deduction now or else forego that deduction to allow the funds to grow without being subject to taxes in the future, no matter how much the account grows.

Avoid assumptions

Long-term investment decisions are ideally made when factors like tax rates are known and stable. A simple calculation can be used to project whether it makes more sense to take a tax deduction today or to pay the tax when the funds are withdrawn years into the future.

Let's take the hypothetical case of a doctor and business executive spouse achieving a modest level of success. It's likely they are currently in the 35% federal tax bracket. With their level of financial success, they are probably saving toward their retirement. It sounds attractive to be able to save money and be able to deduct that 35% on the funds saved, and the conventional wisdom assumes once this couple stops working, they will be in a lower tax bracket.

In practice, though, couples like this often find that, in retirement, tax rates may be the same or close to what they were during the working years due to the growth of one's investments and other factors, like inheritances. So, how can we run the numbers for tax rates in retirement when we don't even know what tax rates will be next year or after our next election? The projections are not very reliable.

Just as I encourage clients to be debt-free in retirement, I encourage them to live tax-free in retirement, or at least limit the uncertainty of taxes in those years by making changes now that will help them reach that goal.

A majority of companies that offer retirement accounts allow for participants to put funds into a traditional retirement account or into a Roth account. The traditional account gets the current tax deduction but is taxed fully in retirement while the Roth account does not get the tax deduction, but the account is tax-free in retirement.

Each worker under age 50 can contribute $19,000 this year to a retirement account, and those 50 and over can contribute $25,000. Many people choose to save up to the limits on their retirement accounts and then save no more. But choosing the Roth option forces many to save more as they are giving up the tax savings to reach their plan maximum and so are unintentionally saving more, and will have more tax-free savings in the future.

Self-employed individuals without employees, such as consultants, contractors and Realtors, can set up individual retirement plans that allow savings up to the same participant limits and also allow for Roth accounts.

And to really accelerate their savings potential, they can contribute to individual Roth IRAs in addition to their company's Roth accounts in those plans. Couples under 50 utilizing these strategies can potentially save a combined $50,000 into Roth accounts, and at 50 or older $62,000. Think about the potential future value in saving those amounts annually with the growth tax-free in 10, 20, or 30 years in the future.

These self-employed individuals can save additional amounts of up to $37,000 on top of the participant contributions if carefully planned, and those amounts can be converted to Roth accounts.

More tax-saving opportunities

In addition to the significant amounts that can be accumulated in Roth accounts, additional tax-free savings can be accumulated by utilizing the investment options in Health Savings Accounts, or HSAs. Families can save $7,000 per year in these accounts, and projecting the growth 10, 20 or 30 years in the future can be a meaningful contribution to building wealth.

Always remember the difference between tax deferral and tax-free accumulation. If the rules are followed, Roth accounts and HSAs allow your money to grow tax-free. Traditional retirement accounts, IRAs and insurance products like annuities, grow your money tax-deferred, meaning eventually the accounts will be taxed, either during your life or your beneficiary's life.

The Tax Cuts and Jobs Act was the largest overhaul of the tax code in many decades. Tax rates were reduced for both individuals and businesses. But, for individuals, there are fewer items that can be deducted from income, and other items like property taxes are limited so that some may be paying more in taxes than before the changes.

For the most part, the change in the tax code has been positive, but for many it added complexity. But with the advice of a qualified financial planner, you can greatly reduce the uncertainty of your tax burden and keep your savings less subject to the ever-changing policies driven by our political system. NHBR

Daniel Cohen, CEO and chief investment officer at Cohen Investment Advisors, can be reached at 603-232-8351 or investwithcohen.com.

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