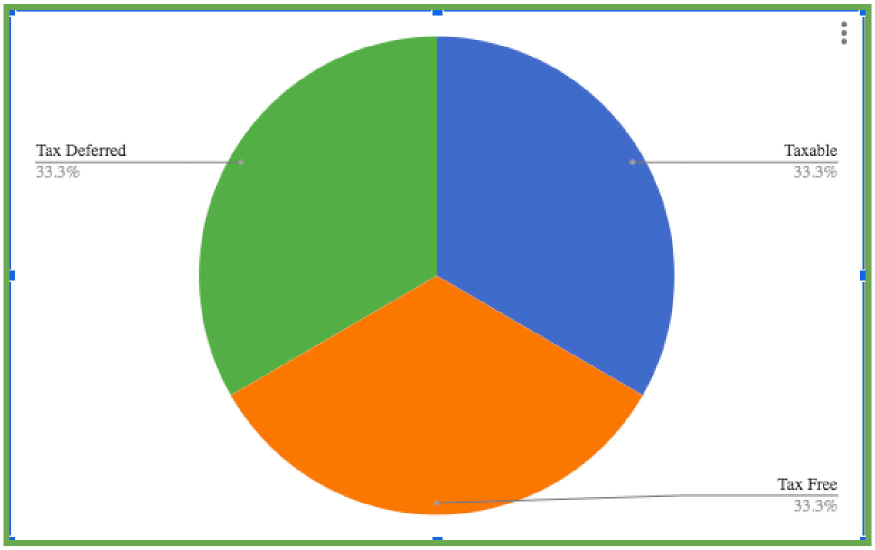
Rooted Planning Group Question of the Month

How should I maximize my retirement savings? Should I put all my 401k in pre-tax? What is the ideal tax allocation?

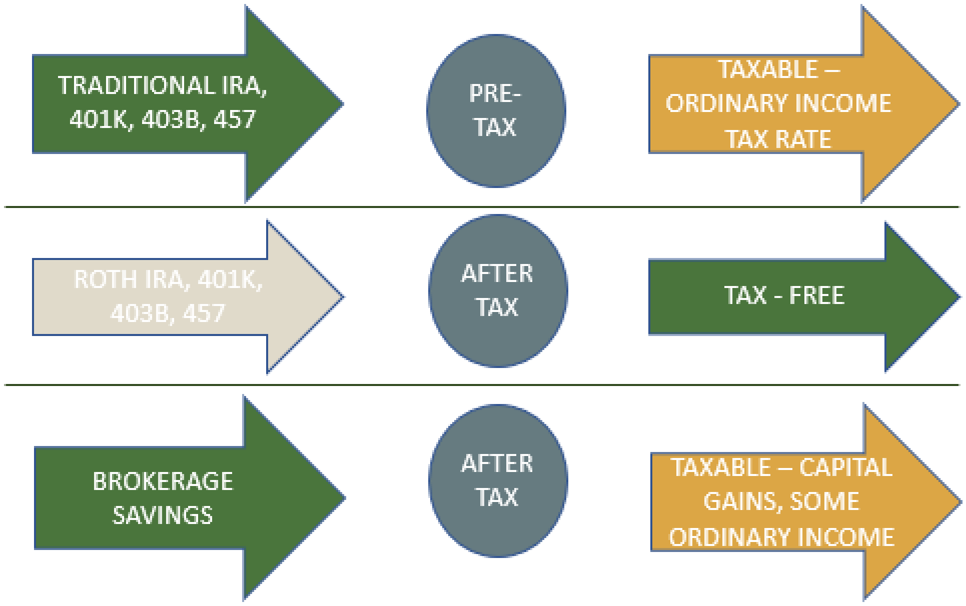
If you've worked with us in the past or read some of our blogs, you've likely seen this chart:



While this doesn't work for everyone's situation, as a general rule, we find that most plans' success rate increase when their overall portfolio is allocated this way.

- Tax Deferred = Traditional IRA, 401k, 403b and 457. You receive a tax credit for putting this money away, you pay no tax on the growth along the way, but when you take money out, it is taxed at your ordinary income tax rate (or your beneficiaries income tax rate if they inherit the account)
- Tax Free = ROTH IRA, 401k, 403b and 457. You do not receive a tax credit for putting this money away, you pay no tax on the growth along the way, but when you take money out (as long as you meet certain rules), there is no tax owed (to you or your beneficiaries if they inherit the account).
- Taxable = Brokerage/Savings Accounts. You do not receive a tax credit for putting this money away, you pay tax on the dividends, interest and capital gains along the way, but when you take money out you only pay the difference between what you have put into the investment (basis) and the gain on the investment (called capital gains).

TAX TREATMENT OF RETIREMENT PLANS CONTRIBUTIONS AND DISTRIBUTIONS



So why do we want your tax allocation to be diversified too? Here is an example:

- Married Couple Earning $150,000 at age 40 = 22% tax bracket
- If their income continues to be in the 22% tax bracket until they retire (assuming the tax brackets keep up with inflation) and they put all their savings in pre-tax, then the old adage of save now, you will be in a lower tax bracket in retirement, may not necessarily be true. Why? They would have to adjust their spending by $68,950 to drop into the lower 12% tax bracket (under today's brackets, which are set to sunset in 2025). This might be possible when you consider they won't have FICA and 401k contributions deducted from their income after retirement, combined with the standard deduction. Based on our progressive tax brackets, that would result in $9,190.
- If however, we can pull some for taxable investments (at lower capital gains rates), some income from Roth Investments, and some income from pre-tax investments, allowing cash flow to be the same, but location to be diverse, then indeed, that is a possibility! Assume they have lived off 70% of their gross income (after taxes and savings were withheld). That would be $105,000 per year - if there are multiple buckets to pull from then one scenario can look like this - an $1,800 savings! That's a vacation!

	Income Received	Income Taxed	Tax Bracket
Standard Deduction		-$25,100.00	
Pre-Tax	$70,000.00	$70,000.00	10%, 12%
Brokerage	$35,000.00	$20,000.00	0%
Tax Free	$0.00	$0.00	
Total	$105,000.00	$64,900.00	$7,390.00

- Note, we left the tax-free out of the income strategy allowing the tax free bucket to grow AND if there is an unexpected need for some additional income, we can pull from that bucket. There is also some wiggle room to pull from the brokerage account (see note below).
- Notice, we were able to receive $35,000 in income off the brokerage account, but only have taxable income of $20,000; this keeps the couple well below the $80,000 of income that affords them the 0% capital gain tax rate.