THE SEDORIC GROUP
of Steward Partners

Creating Tax Efficiency for the Future

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Overview

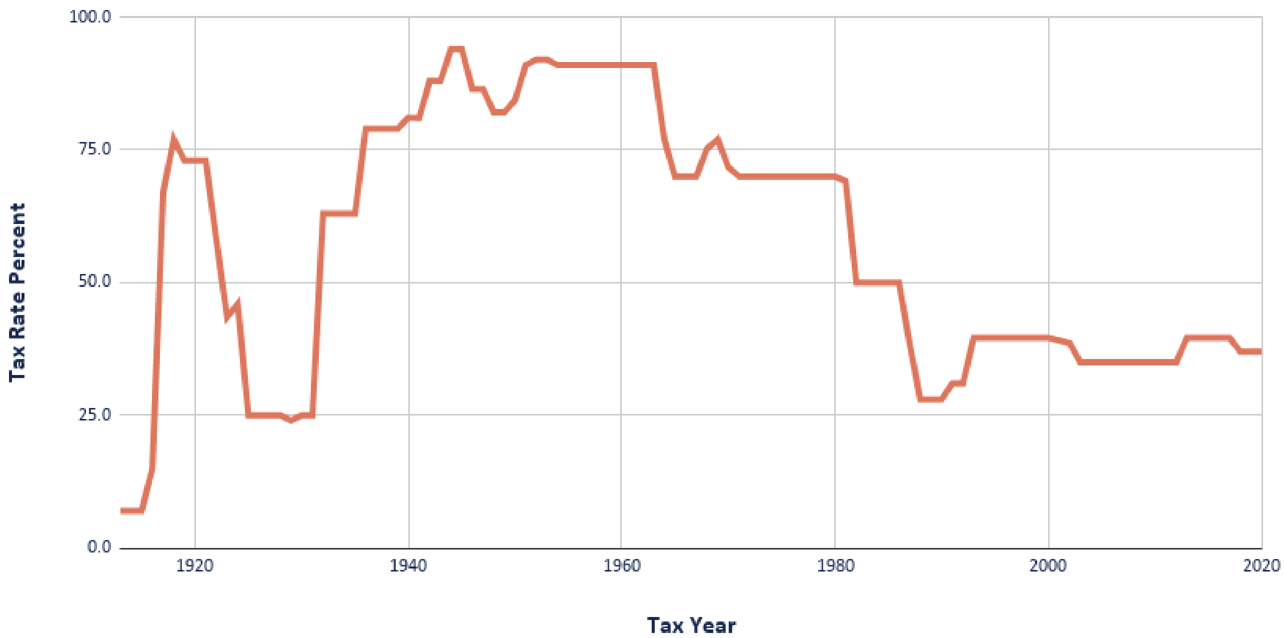
When it comes to saving for retirement, the rules the Greatest Generation and older Baby Boomers played by have changed. Defined corporate pension plans that provide a stable income into one's golden years are becoming rare. People in their prime earning years are now relying heavily on tax-deferred savings plans, like the 401(k), to build their nest egg. Yet as we see with many who approach retirement today, building one's retirement savings upon a deferred-tax foundation equates to large tax payments once that money is drawn on for retirement income. This unfortunate reality puts those approaching retirement today at greater risk of falling short in their retirement savings in the future.

The financial advisor who hammers the need to diversify investments is a bit of a cliche—most savvy savers know they should not put all their savings into one basket. Yet the concept of diversifying how and where retirement savings are invested in relation to tax liability is something that's been often overlooked in our nation's conversation about retirement savings. As people in their 30s and 40s begin to get serious about saving for retirement, it's not uncommon to be caught off guard by the need for tax efficiency—balancing pre-tax, tax free, and post-tax retirement savings—as part of that plan.

This guide discusses the shortcomings of deferred tax retirement savings and will walk you through the ways in which you can create tax efficiency as part of a well-balanced retirement savings strategy.

Understanding the Tax Landscape

Federal Income Tax Rates Through the Years



The federal tax code has drastically changed since 1913, including the top tax bracket rate, seen here.

Source: www.taxpolicycenter.org/briefing-book/how-do-federal-income-tax-rates-work

In the modern era, the taxes we pay to state and federal governments are largely the result of our earnings. Income taxes, payroll taxes, and capital gains taxes are all based on the money we make, either actively or passively. Other tax liabilities are the result of what we buy—and ultimately own—with our earnings, such as sales taxes, excise taxes, and property taxes. **Factoring all the different ways we pay, taxes are the single greatest lifetime expense.**

While taxes are our largest financial liability, it is one that has been steadily declining, especially for those in the upper-income brackets. Policies aimed at spurring economic growth and increasing the popularity of those in office have resulted in a number of tax rate cuts in recent years.

With the national debt at $20 trillion and growing, surpassing the size of the US economy in 2020, we see no way for taxes to remain this low. The pressures to fund the government and settle these debts will eventually hit a tipping point.

Because plans like the 401(k) and the IRA are taxed at ordinary income tax rates when funds are taken out for retirement income, a shift in tax rates will not only impact the near-term earnings of those in their peak earning years, it will also directly impact the amount of money they get upon retirement.

The Problem with 401(k)s

Today, 401(k) plans are supposed to be the centerpiece of millions of Americans' retirement plans. While they play an important role, these plans were not originally created to replace the pension, but to serve as a complement to something that does not exist.

It first entered the Internal Revenue Service code with the Revenue Act of 1978. A provision—Section 401(k)—let employees avoid taxes on deferred compensation. Benefits consultant Ted Benna came across Section 401(k) in 1980 while researching ways to design more tax-friendly retirement programs for a client. Under this provision, he devised a way to allow employees to save pre-tax money into a retirement plan while receiving an employer match. The idea was rejected by his client, so Benna's own company, The Johnson Companies, took the idea for itself, offering a 401(k) plan to its workers.

The IRS soon issued new rules to allow employers to fund 401(k) plans through payroll deductions and this retirement plan was off and running. Within two years, nearly half of all big companies were offering 401(k)s or were considering it, according to the Employee Benefits Research Institute.

Over the past 40 years, the 401(k) has nearly replaced the defined-benefit pension plan. According to the US Department of Labor's Employee Benefits Security Administration, the number of pension plans declined by 73% from 1986 to 2016. Many companies that still offer defined benefit plans are rethinking whether to offer them at all; Mercer reports that 63% of companies with defined-benefit pensions are considering termination of the plan within the next five years.

With so many of today's workers funneling their retirement savings into a 401(k) plan, it creates a tax-deferral dilemma for younger generations. They are told it is better to reap the benefits of lower tax obligations today, yet they likely don't realize they are betting on an unknown tax paradigm in the future.

For example, a person who wants to live on $50,000 a year would need to draw $67,000 to $68,000 from tax-deferred accounts if they properly account for taxes. Even more sobering, a couple with a baseline of $170,000 in lifestyle expenses would need to draw up to $250,000 due to the significant contribution they would need to pay to Uncle Sam.

There is often confusion about the benefits and mathematics of tax deferral, as well as pre-tax savings. People see they are saving on paying taxes today, but sometimes a tax-deferred account or investment only defers one from paying potentially more down the road. This may not always be to an investor's advantage.

How to Realign Your Retirement Savings

Seeing these numbers can come as a shock to younger clients who believed they were following the rules of retirement savings. Maximizing employer 401(k) matches and lightening the tax liability load during the years of raising children and building a home makes sense. Yet to develop tax flexibility down the road, people in their peak earning years should be saving in a way that maximizes output when they are older.

How is this done? It is not something that can be accomplished overnight. Building a successful retirement plan that has the ability to adapt to an evolving tax code must start early.

The first step is understanding your current financial situation and how it will develop over the next few decades. Here are some questions you should ask:

What is my income trajectory?

We all expect to make more money over time, with raises awarded for advancement or simply baked into your contract. How this income grows depends on the kind of work you do and can greatly impact how much you save each year in pre-tax and post-tax savings plans.

A couple that owns a successful small business expects to see steady growth in good economic times and can use revenue forecasting to estimate what they will earn in years to come. Yet someone who is on the corporate executive track and earns merit-based bonuses may find there are years with large income jumps thanks to a large bonus, followed by consecutive years of standardized raises of 2–3%.

Steady income growth is a great opportunity to slowly build up post-tax retirement savings now, in a Roth 401(k) for example, while tax rates are low. Roth/Post-tax savings also have an added advantage if your income growth will eventually put you in a higher tax bracket. However, in circumstances where there are large increases in income year-over-year, part of that windfall may be more wisely invested in a pre-tax plan that will cushion the tax liability for that year.

When building a balanced retirement savings strategy, you and your financial advisor should develop a strategy that is focused long-term and is assessed annually.

How much should I save?

That is the big question everyone always asks: am I saving enough? Developing the answer requires an understanding of your retirement goals, your tolerance for risk, and

How to Realign Your Retirement Savings (cont.)

your income trajectory. Will you be retiring to a country cottage in your 70s or do you plan to step away from work the day you turn 65 and sail around the globe? Your retirement goals and how much to save should be the first question you and your financial advisor discuss, but the next question is far more important to maximizing your retirement saving efforts.

How should I be saving?

As mentioned above, a well-constructed plan will analyze on an annual basis where funds should be allocated, whether that's in a traditional 401(k) or 403(b), post-tax investments, a Roth 401(k) or 403(b), or another account. Working with a wealth manager and accountant who thinks strategically about tax liabilities over one's lifetime will help you develop a long-term strategy, as well as determine each year how to allocate your savings.

KEY TERMS

Tax-Deferred Accounts

(also referred to as pre-tax accounts)

Pre-tax savings within a traditional 401(k), 403(b), or traditional IRA; all growth and earnings are eventually subject to ordinary income tax when withdrawn after the age of 59 ½.

Roth Accounts

Post-tax savings held within a Roth IRA or Roth 401k; all growth and earnings are tax free assuming they are qualified distributions after the age of 59 ½ and have been held for more than 5 years.

IRAs and employer-sponsored plans are long-term investment accounts meant for retirement. Withdrawals made prior to age 59 1/2 are subject to taxes and possible penalties.

Post-Tax Accounts

Traditional investment accounts funded with after-tax savings, subject to long/short term capital gains (or losses).

Creating Tax Efficiency

Tax-Deferred Savings
401(k) Plans, Traditional IRAs

They should include various types of income producing assets: assortment of bonds, dividend-paying stocks, and other more conservative strategies.

Roth Savings
Roth IRAs, Roth 401(k)

They should include moderate risk strategies: global dividend-paying stocks, high-yield bonds, and other growth and income strategies.

Post-Tax Investment Savings
After-Tax Investment Accounts

This should include your most aggressive and volatile strategies: growth stocks, small and mid-cap strategies, and foreign and emerging market stocks.

All investing involves risks, including the possible loss of principal amount invested. No investment strategy can guarantee your objectives will be met. The investments listed may not be suitable for all individuals.

Creating tax efficiency is the process of bringing these three questions together into a strategic retirement savings and investment plan. As financial advisors, we talk to our clients about what they should be saving this year, where they are going to save it, and where savings should be allocated in years to come. The goal is to align an investment strategy that maximizes the growth potential of what is being put in and helps protect against tax liabilities in the future.

To accomplish this, investors should strive to accumulate equal sums of money within three buckets by the time they reach retirement:

- Deferred and pre-tax savings
- Roth savings
- Post-tax investments

Deferred and pre-tax savings

Most people begin their retirement savings with an employer matched 401(k). In 2021, you are allowed to put in up to $19,500 if under the age of 50. Others may have started a traditional IRA, to which under 2021 tax code you can contribute up to $6,000 annually. At a minimum, you should be contributing to your company's 401(k) the amount required to realize the full employer match, if this option is available to you.

While maxing out your allowed contribution to a 401(k)—or saving the maximum amount you can afford at this time—requires little more effort than filling out a form with your HR department, it may not be the smartest place to park your savings in your peak earning years.

If held in an IRA or 401(k), any growth from company stocks or investment funds will eventually be taxed as ordinary income. This rate could be double what you would pay if the stock or fund had been held in a taxable account, sold, and taxed as a long-term capital gain. Currently, the maximum capital gains rate is 20%, far below the upper income tax rates.

Creating Tax Efficiency (cont.)

Federal tax code regulating pre-tax contributions are designed to benefit older investors, with higher caps on contributions for those 50 and older looking to play catch-up on their retirement savings. Planning to take advantage of these benefits when you are older, while allocating your money elsewhere in your 30s and 40s is one way to lower tax liability risk upon retirement.

When allocating an IRA or 401(k), it's best to focus on moderate to conservative strategies with lower risk pending your age. These investments should include dividend-paying funds and various types of bonds.

Roth savings

To provide balance to your retirement savings plan from a tax liability perspective, you should consider contributing to Roth accounts, such as a Roth IRA or Roth 401(k). Unlike a traditional 401(k) or IRA, you cannot reduce your annual tax bill by contributing to these plans because contributions are made with post-tax dollars, however, any gains you make on what you put in will not be taxed when you take them out.

For example, a $1,000 contribution to a Roth 401(k) invested in a hypothetical investment that provides an annual 6% return will be valued at $5,743 in 30 years. When you want to use that money for retirement income, you will not have to pay taxes on the $4,743 you made. The downside to this type of account is that you can't sell investments to recuperate any losses.

Roth funds are best for investing in moderate to aggressive strategies with an emphasis on growth and income. With enough time, these dividend paying strategies benefit from the magic of compounding, something Albert Einstein proclaimed is the "eighth wonder of the world."

Post-tax investments

If you want to buy stock in a company like Apple, Tesla, or another high-growth company, which account should you use? While these stocks have the potential to generate large returns, there's also the possibility an emerging technology could flop, resulting in losses not only for that company, but for you as a shareholder.

Investing in high-risk, high-reward stocks in your 401(k) or Roth IRA funds could net you higher gains over time, but when they decline in value, you cannot use losses to offset your capital gains. And you may pay ordinary income tax rates near to 40%.

Putting some of your post-tax savings toward post-tax investments allows you to take advantage of the upsides of the stock market, while also using capital losses—any money you lose due to declines in the stocks you own—to offset capital gains and lower your overall taxable income on your tax return for that year.

The stocks you invest in here should maximize growth potential but will also entail a bit more risk. Emerging markets, small and mid-cap strategies, new technologies, and high-growth companies should be the focus.

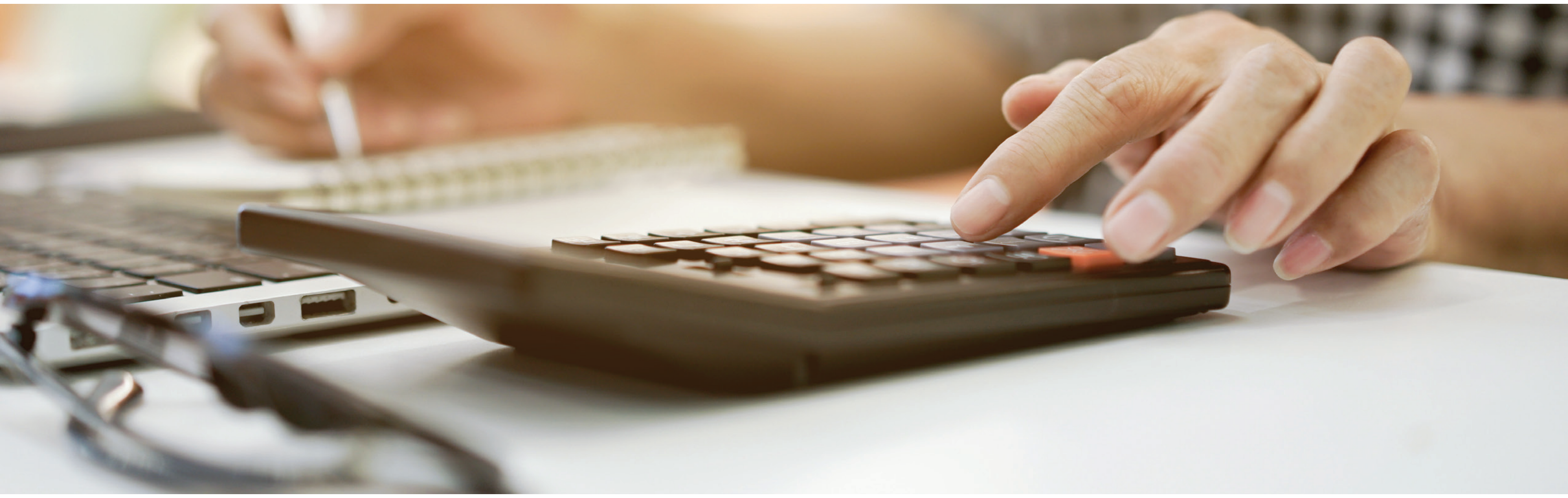
Balancing the buckets

As people are building their nest egg, it's easy to lose sight of the ultimate goal—accumulating the resources necessary to generate enough income net of taxation to fund your lifestyle. It's also easy to look at different account balances as equal even though the net amount you get to keep after taxes varies greatly depending on whether it is a pre-tax or post-tax, or Roth account.

For example, a couple that has saved $3 million in a tax-deferred 401(k) will have a vastly different amount available to them upon retirement than a couple with $1 million saved in a tax-deferred 401(k), $1 million in a Roth 401(k), and $1 million invested in stocks within a post-tax account. These two couples may look like they have equal amounts on paper, but as we noted before, the standard 401(k) will be taxed as income once it's distributed, greatly reducing its true value.

As you can see, creating a diverse portfolio of funds is an important step toward tax efficiency. Finding the right balance for savings along the way is just as important as knowing what kind of funds and investments should be made within each account as the nest egg grows. Young people striving for a financially comfortable retirement can achieve their goals with the help of tax advisors, accountants, and wealth managers who think about taxes strategically, both year-to-year and over one's lifetime.

New Rules for Retirement Savings



Many of today's older retirees benefited from a different retirement savings landscape. With a mix of investments, a company pension fund, Social Security, and a 401(k), they were able to save in such a way as to ensure reliable retirement income for years to come.

Then came the Baby Boomer generation, which has not been as successful at saving for their golden years—an estimated 45% have no retirement savings whatsoever. This is in part because of rising health care costs and the decline of safety nets like corporate pension plans, but it is also largely due to a lack of understanding about how much money is needed during retirement through the end of life.

There are signs that younger generations are learning from the mistakes of Baby Boomers. A Bank of America "Better Money Habits Millennial Report" from 2020 shows that Millennials, on average, began saving for retirement at the age of 24, far earlier than older generations. Driven by high debt loads and an overall concern about economic instability, Millennials seem to be more attuned to the high financial costs of retirement and the need to plan early. This generational shift in mindset must also come with an awareness of the need for tax efficiency and the risk of investing too heavily in tax-deferred funds. Just as this generation understands that achieving financial success will be more difficult than it was for the generation that came before them, Millennials should also expect that tax rates will be higher, the cost of health care will be more, and the amount for which they will be responsible for funding their own retirement will be greater.

Add historically low interest rates to the list of challenges because of how they equate to lower returns within many asset classes, thereby reducing one's financial margin for error, and the importance and need for tax efficiency becomes even more critical.

While this may seem like a daunting realization, the savings Millennials and Gen X are putting away today can be maximized through proper asset location and good planning. Young people are on average further ahead than Baby Boomer parents. Using a financial advisor to invest in those funds and find ways to limit the risk of future tax liabilities will help keep them ahead.

Want to know more about planning for tax efficiency?

We're happy to answer your questions. Schedule a consultation today.

Get in Touch

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