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How To Avoid The Middle Class Tax Bomb

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1. Introduction to Tax Planning

If you are reading this, I assume you're not a fan of paying taxes. We're not either. With this guide, you will learn how to pay the least amount of taxes, not just in any given year, but over the course of your lifetime. This distinction is important, because there are all sorts of ways to reduce taxes in the current year... but it often comes with a tradeoff later on, which may mean much higher taxes. Knowing the difference can save you millions of dollars in taxes.

That's right, MILLIONS. That's not an exaggeration. What could you do with $1 million or more of extra income across your lifetime? The answer- whatever you want. That's what tax planning allows you to do.

Tax planning is hands down the most valuable thing a financial planner can do for you. A lot of people go to a financial planner for investments. Yeah, we do that. But investments without a tax/financial plan is like taking a road trip without knowing where you are going. Literally everything you do in life has tax consequences.

First things first- tax planning is NOT tax preparation. Yes, we do that too. But tax prep is BACKWARDS looking, while tax planning is FORWARD looking (often way into the future). It takes into account changes in income, spending, tax brackets, and even changes in the tax code, no matter how minor.

It involves making moves today to reduce taxes in the future, because everything you do today will have tax consequences later in life, for better or worse. Sometimes, the things that save you money now can cost you MORE money later.

Tax planning tells you when (at what stage of life) and where (which types of accounts) to put your savings/investments. It tells you whether you should do tax loss/gain harvesting, withdrawal sequencing, and how it will affect your Social Security and Medicare taxation in retirement.

Unfortunately, many financial advisors don't do tax planning, for three reasons-

- It takes work. It takes time to do tax planning, as well as keeping up with tax laws and education. It's also pretty damn boring… except to me.
- Most clients don't expect it, or even know that they should. Up until the last 10-20 years, the vast majority of advisors just managed money and met with clients maybe once per year. That has been slowly changing, but it is probably only about 50/50 still.
- There's no product for it. Many advisors are at least partially compensated by commissions on product sales, such as mutual funds, insurance, or annuities. There is no product for tax planning, so no commissions, therefore no incentive to do it. We personally believe that clients are better served by fiduciary advisors that don't get paid by commissions at all

With that said, we know TONS of great advisors, and would be happy to pass along referrals!

Now let's get to the real problem.

2. The Middle Class Tax Bomb

The "middle class tax bomb" refers to a situation where middle-class taxpayers face unexpectedly high tax liabilities due to factors related to retirement savings and income.

This happens because of the complex nature of the U.S. tax code, where certain tax benefits phase out as income rises, or because of the interplay between different types of income and deductions. On top of that, tax laws are changing constantly!

Here are some of the key scenarios that can lead to the "middle class tax bomb."

- **Required Minimum Distributions (RMDs) from Retirement Accounts:**
  - When retirees reach age 72-75 (depending on when you were born), they must start taking RMDs from their traditional IRAs and 401(k)s. These distributions are taxed as ordinary income and can push retirees into much higher tax brackets.
  - Higher income from RMDs can also affect the taxation of Social Security benefits and increase Medicare premiums (known as a stealth tax).
- **Social Security Benefit Taxation:**
  - Up to 85% of Social Security benefits can be taxable if combined income exceeds certain thresholds. Combined income includes adjusted gross income (AGI), tax-exempt interest, and half of Social Security benefits.
  - Many middle-class retirees are surprised by the high tax rates on their Social Security benefits when other sources of income, such as RMDs, are factored in.
- **Capital Gains and Medicare Surtax:**
  - Selling investments can trigger capital gains taxes. For those with significant investment income, capital gains can push their total income above the threshold for the 3.8% Medicare surtax on net investment income.
  - This surtax applies to individuals with modified adjusted gross income (MAGI) over $200,000 ($250,000 for married couples filing jointly).

- **Phase-Outs of Tax Deductions and Credits:**
  - Many tax deductions and credits phase out at higher income levels. For example, the Child Tax Credit, education credits, and itemized deductions such as medical expenses or state and local taxes can be reduced or eliminated as income rises.
  - These phase-outs effectively increase the marginal tax rate for middle-class taxpayers.
- **Alternative Minimum Tax (AMT):**
  - The AMT is designed to ensure that high-income taxpayers pay a minimum amount of tax. However, it can also impact middle-class taxpayers, particularly those with high state and local taxes, large families, or significant deductions for mortgage interest and medical expenses.
  - The AMT disallows certain deductions and exemptions, leading to higher taxable income.
- **Medicare Surcharges:**
  - Many retirees may accidentally face increased premiums for Medicare due to poor tax planning. This can cost them in excess of $6,000 per year!
  - This primarily affects retirees with high pretax investment accounts.
- **Estate Taxes and Inherited IRAs**
  - While you are currently probably not subject to estate taxes (the 2024 exemption is $13.6/$27.2 million for single/married couples), if you or your kids inherit a pre-tax IRA, you are forced to take it out over a period of 10 years. If the number is a substantial amount, it could inadvertently push you up several tax brackets, along with triggering all the rest of the things on this list! Furthermore, the estate tax exemption is constantly changing depending on which political party is in office, and the exemption used to be as low as $500,000.

The "middle class tax bomb" can be avoided with careful tax planning. In some cases, we can eventually lower your tax bill to $0! As you can see below, this client never pays taxes after age 75, and only pays an average rate of 17% in retirement before that.

And it all begins with an understanding of the 3 different types of retirement accounts: pre-tax, after-tax, and taxable. There are also life insurance and annuity products that get pushed to clients, but these are usually the worst of both worlds- expensive insurance, and low returns. There are certainly circumstances where these products make sense, but they are rare and outside the scope of this guide.

3. Pre-Tax Accounts (401k, 403b, 457, Traditional IRA)

Pre-tax retirement accounts defer taxes on the contributions and earnings until the funds are withdrawn, typically in retirement.

Here's how pre-tax retirement accounts work.

Contributions:

- Contributions to pre-tax retirement accounts are made from your income before taxes are deducted. This means the amount you contribute reduces your taxable income for the year.
- For example, if you earn $100,000 annually and contribute $10,000 to a pre-tax retirement account, your taxable income for the year is reduced to $90,000, and you save about $2,400 on taxes that year.
- There are limits to contributions, depending on account type. This ranges from $7,000 to $69,000. Savers over 50 can actually contribute a little more!

Tax-Deferred Growth:

- The money in pre-tax retirement accounts grows tax-deferred. This means you do not pay taxes on investment gains, interest, or dividends as long as the money remains in the account.
- Over time, this tax-deferred growth can significantly increase the amount of money available at retirement.

Withdrawals:

- When you withdraw money from a pre-tax retirement account, usually during retirement, the withdrawals are treated as taxable income.
- The idea is that you will likely be in a lower tax bracket in retirement than during your working years, potentially resulting in lower overall tax liability.

Benefits of Pre-Tax Accounts

- Immediate Tax Savings: Reducing your current taxable income can result in a lower tax bill for the year contributions are made.
- Tax-Deferred Growth: Investments grow without the drag of annual taxes on gains, which can accelerate the growth of your retirement savings.
- Employer Contributions: Many employers offer matching contributions, effectively providing "free money" to your retirement savings.
- Charitable Giving: Once individuals become eligible for Qualified Charitable Distributions at age 70, they become eligible for much more tax efficient charitable contributions.

Considerations

- Future Tax Rates: Your future tax rate will impact the total tax you pay on withdrawals. If you expect to be in a higher tax bracket in retirement, a Roth account (funded with after-tax dollars) might be more advantageous.
- Required Minimum Distributions (RMDs): Starting at age 72-75, the IRS requires you to begin taking minimum distributions from most pre-tax retirement accounts, which will be subject to income tax.
- Early Withdrawals: if you have to take money out of these accounts before you turn 59 ½, you will not only pay taxes, you will also pay a 10% penalty! Some exceptions apply to this, such as disability and 72t elections.

4. After-Tax Accounts
(Roth 401k, IRA, etc)

A Roth account is a type of retirement account that offers tax-free growth and tax-free withdrawals in retirement. Unlike traditional IRAs, contributions to a Roth IRA are made with after-tax dollars, meaning you do not get a tax deduction for the contributions but the distributions are tax-free.

Here's how a Roth account works.

Contributions:

- Contributions to a Roth accounts are made with after-tax income. This means you pay taxes on your income before you contribute it to the Roth IRA.
- There are limits to contributions, just like pretax accounts
- Roth IRA contributions are subject to income limits. For 2024, single filers with modified adjusted gross incomes (MAGI) up to $153,000 can contribute the full amount, with contributions phasing out between $138,000 and $153,000.
- For married couples filing jointly, the phase-out range is between $218,000 and $228,000.

Tax-Free Growth:

- Once the money is in the Roth IRA, it grows tax-free. This includes all investment earnings, such as interest, dividends, and capital gains.
- You will not pay taxes on these earnings as long as certain conditions are met.

Tax-Free Withdrawals:

- You can always take out your contributions, but not your earnings, without tax or penalty.
- Under certain circumstances, you can withdraw your earnings tax-free even before retirement! These rules are complicated, however, and could take up this whole guide. I don't want to bore you that much!
- If you withdraw earnings from a Roth IRA before age 59½ and before the account has been open for five years, the earnings may be subject to taxes and a 10% early withdrawal penalty.
- Roth IRAs do not have required minimum distributions during the account holder's lifetime, which allows your money to continue growing tax-free for as long as you like.

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Benefits of a Roth account

- Tax-Free Withdrawals: The main benefit of a Roth IRA is the ability to withdraw your money tax-free in retirement, which can provide significant tax savings, especially if you expect to be in a higher tax bracket in retirement.
- No RMDs: Unlike traditional IRAs, Roth IRAs do not require RMDs, allowing you to let your savings grow if you do not need the money.
- Flexibility: The ability to withdraw contributions at any time without taxes or penalties adds a level of flexibility that can be beneficial for unexpected expenses.

Considerations

- No Immediate Tax Benefit: Since contributions are made with after-tax dollars, you do not receive a tax deduction in the year you make the contribution.
- Roth IRA contributions are subject to income limits. For 2024, single filers with modified adjusted gross incomes (MAGI) up to $153,000 can contribute the full amount, with contributions phasing out between $138,000 and $153,000.
    - For married couples filing jointly, the phase-out range is between $218,000 and $228,000.
- Five-Year Rule: It's important to be aware of the five-year rule to ensure your withdrawals qualify for tax-free treatment. There are actually 3 different five-year rules, which again are way out of our scope here.

5. Taxable Account (Brokerage)

A taxable account is basically just a savings account that you can hold investments in. Unlike the other account types, brokerage accounts are taxable, meaning you may owe taxes on any income or capital gains generated from your investments.

Here's an overview of how brokerage accounts work and their tax implications.

- **Contributions**:
  - Contributions to a taxable account are made with after-tax income. This means you pay taxes on your income before you contribute it to the account.
  - Unlike retirement accounts, taxable accounts have no contribution or income limits!
  - You can hold pretty much anything in a taxable account, including stocks, bonds, crypto, or whatever.
- **Income Recognition:**
  - Income is recognized (and taxed) in the year it occurs. Meaning, you are only taxed if you sell an investment for a profit, or if it pays a dividend or interest.
  - Losses are also recognized, so if you are effective at tax loss harvesting, you can actually get tax deductions!
- **Withdrawals**:
  - You can withdraw at any time, for any reason. There are no limitations or penalties.
- **Capital Gains Tax:**
  - Short-Term Capital Gains: investments that you hold for less than a year are taxed at your ordinary income tax rate.
  - Long-Term Capital Gains: investments that you hold for a year or more are taxed at reduced rates, which are typically 0%, 15%, or 20%, depending on your income level.

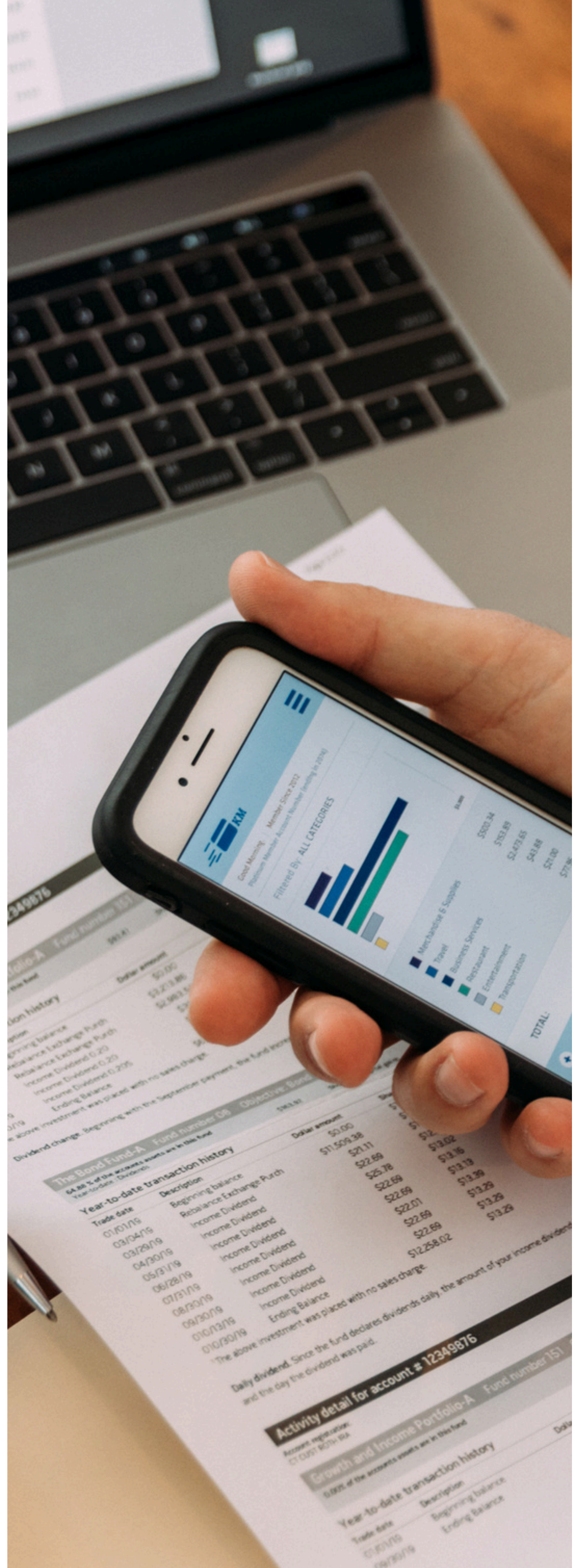
- **Dividends**:
  - Qualified Dividends: These are dividends from U.S. companies and certain foreign companies that meet specific requirements. Qualified dividends are taxed at the lower long-term capital gains tax rates.
  - Ordinary Dividends: These are dividends that do not meet the criteria for qualified dividends and are taxed at your ordinary income tax rate.
- **Interest Income:**
  - Interest earned on investments, such as bonds or cash held in the brokerage account, is typically taxed as ordinary income.
- **Capital Losses:**
  - If you sell an investment at a loss, you can use the loss to offset capital gains. If you have more losses than gains, they can roll over to future tax years.

Benefits

- **Flexibility**:
  - Since there are no limits to contributions or withdrawals, this account offers the most flexibility of them all.
- **Lower Tax Rates:**
  - Since only gains are taxed, and at lower rates, a taxable account can actually be more tax efficient in the long run.
  - If your income is low enough in retirement, you could potentially pay 0% on capital gains.
- **Line Of Credit:**
  - It is not uncommon to use these accounts as collateral to borrow against.
  - This allows the account to continue to grow, and the interest paid will almost always be lower than the taxes to liquidate.
  - This is the secret of the super rich!

Considerations

- **Tax-Loss Harvesting:**
  - This involves selling securities at a loss to offset gains from other investments, thereby reducing your overall tax liability. You can also offset ordinary income by up to 3k per year, and this carries over into future years.
- **Holding Period:**
  - By holding investments for more than one year, you can benefit from the lower long-term capital gains tax rates.
- **Asset Location:**
  - Place tax-efficient investments (like stocks that generate qualified dividends and long-term capital gains) in taxable accounts and less tax-efficient investments (like bonds generating interest income) in tax-advantaged accounts (like IRAs).
- **Net Investment Income Tax:**
  - If your income is over a certain threshold ($200k single, $250k married), you will also be charged a 3.8% surtax on gains, which is why you want to make sure your account is as tax efficient as possible.



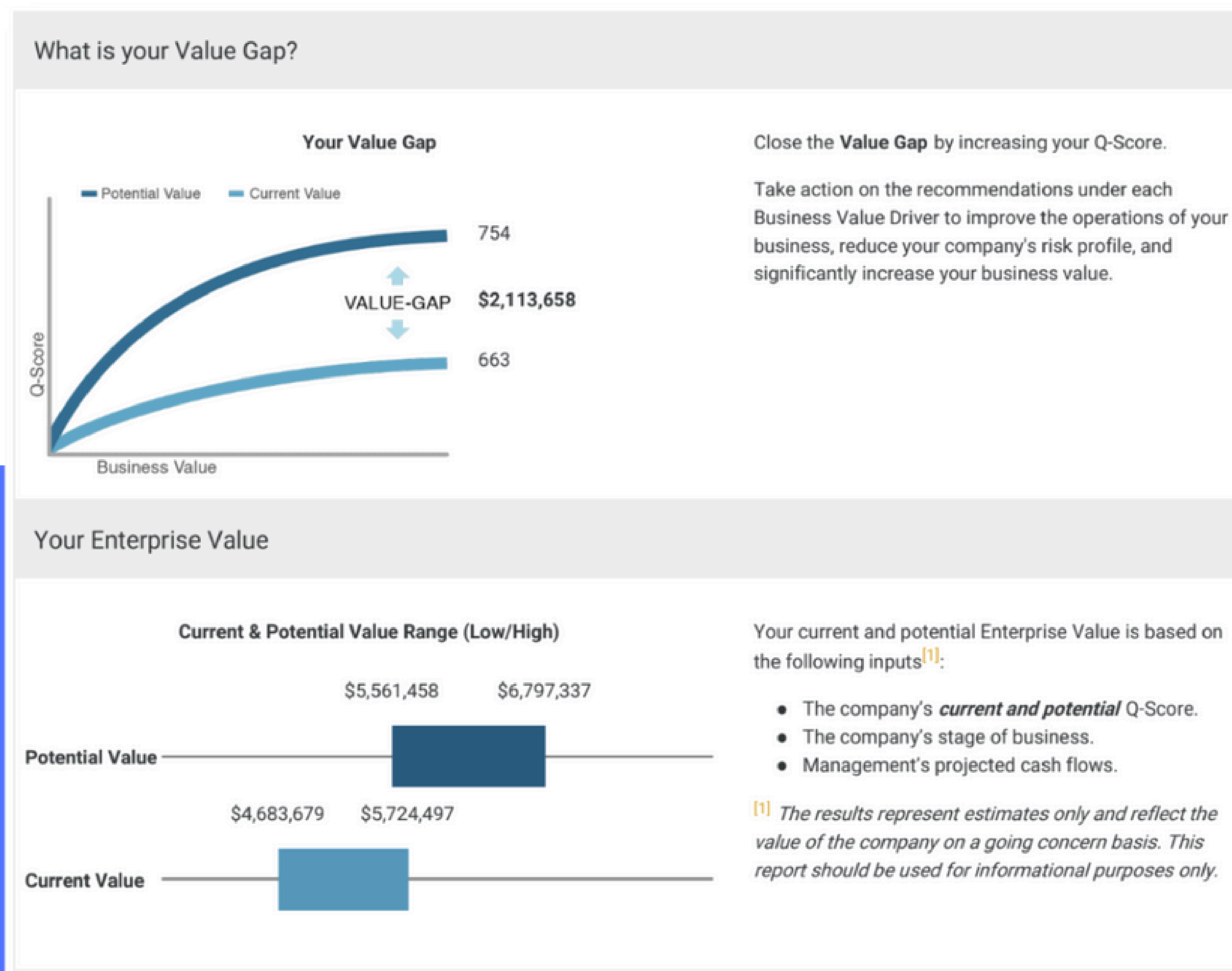
6. Tax Planning For Business Owners

Although this guide isn't specifically for business owners (that is coming soon), all of this becomes exponentially more complicated for them.

- **Entity Selection**
  - An LLC is the most common form of entity, and the simplest. This entity makes the most use of the Qualified Business Income (QBI) deduction, and makes the most sense for businesses making less than $100k (per owner).
  - Once a business gets past $100k in profits, an S-Corp starts to make more sense. Owners only pay the 15.3% self employment taxes on their own salary, potentially allowing for $10k or more in tax savings. However, those taxes would have gone toward increasing your Social Security payments, so if you don't save/invest those tax savings, you will actually be worse off in retirement!
  - Since C-Corps are subject to double taxation (both on profits and distributions), there are only very specific situations where a business would choose this entity type. The most common use case is when taking on investors of significant size. It makes sense to use this structure somewhere between $500k and $1m in income (per owner).

- **Retirement Plans**
  - There are many retirement plan types available to business owners, but usually a 401k makes the most sense, and is relatively cheap/easy to administer. Once profits get past $500k and the owner is getting closer to retirement, a Cash Balance Plan can also make sense. This gives the owner the ability to defer $300k or more in income!

- **Exit Planning (Lifestyle vs Enterprise)**
  - Like it or not, one day you will exit your business. How you do so is based on how well you plan, and planning should start the moment you start your business. How you plan depends on the type of business you run, lifestyle or enterprise. Lifestyle businesses are run with the needs of the owner in mind, enterprise businesses are run with the needs of a future buyer in mind. There is absolutely nothing wrong with either one of these kinds of businesses, but the planning is very different for each one. Exit Planning is outside the scope of this guide, but look for another one soon!



7. Putting It All Together

After taking all the different account types into consideration, which should you use? The real answer- all of them. There is no way to know your future income or what tax laws there will be, so the only responsible answer is to have some money in each of the different tax buckets (pretax, after-tax/Roth, taxable). Just like how you want your investment portfolio to be diversified, you want your tax buckets diversified as well. In a perfect world, you would enter retirement with equal balances in each bucket. However, since a perfect world doesn't exist, here are some good rules of thumb.

- **If you are retiring close to age 70 or after,** you should probably prioritize Roth savings. The reason for this is because you will have very little time before RMDs kick in, and having a substantial pretax balance could end up costing you a ton of tax dollars.
  - Exception: if you started saving late in life (age 45 or after), it can still make sense to use pretax accounts, since your withdrawals should be more than RMDs.
- **If you are retiring around age 62-65,** you should prioritize pretax accounts. At this age, there is plenty of time to do Roth conversions to minimize or eliminate RMDs.
- **If you are retiring at 62 or before,** focus on taxable accounts. Since you can't withdraw from retirement accounts before age 59.5 without penalty (barring certain exceptions), your only choice is a taxable account. The capital gains tax you pay will be minimal, and in some cases can be $0!
- **Regardless of when you plan to retire,** your goal is to have as little money in pretax accounts as possible by RMD age, either throw withdrawals or Roth conversions.

Asset location can also make a huge difference. Investments with high dividends or interest payments can end up costing you 40% or more if you are high income and hold them in a taxable account, but if you are in the 10% bracket, it is functionally a non-issue. The key is knowing where you are now, and where you will likely be in the future. This can also be affected by another factor, withdrawal sequencing.

Withdrawal sequencing is one of the most important factors once you actually get to retirement. Assuming you do have a decent balance in all three tax buckets, which should you draw from? Should you draw from one account type over another, or should it be a combination? As usual, the answer is- it depends. However, there are some pretty straightforward guidelines:

- If you are trying to optimize for your own taxability, take your retirement income from your taxable accounts first, then pretax accounts.
- If you are optimizing to minimize taxes for your heirs, taking from pretax accounts and being aggressive about Roth conversions will create the lowest tax friction for their inheritance.
- Regardless of which is your priority, Roth accounts will always be last to be liquidated.
- If you have minor children, make sure you have a revocable trust with conduit language. We .

Once again, these are just guidelines. Your particular situation may end up being wildly different!

8. Case Studies

Let's look at how tax planning works in the "real world." Keep in mind that these situations are oversimplified, and the real world will always end up being more complicated.

Couple #1 - 40 year old Millennials

Since the majority of our clients are high income Millennials, let's look at a typical situation that we deal with on a daily basis. Here are the facts:

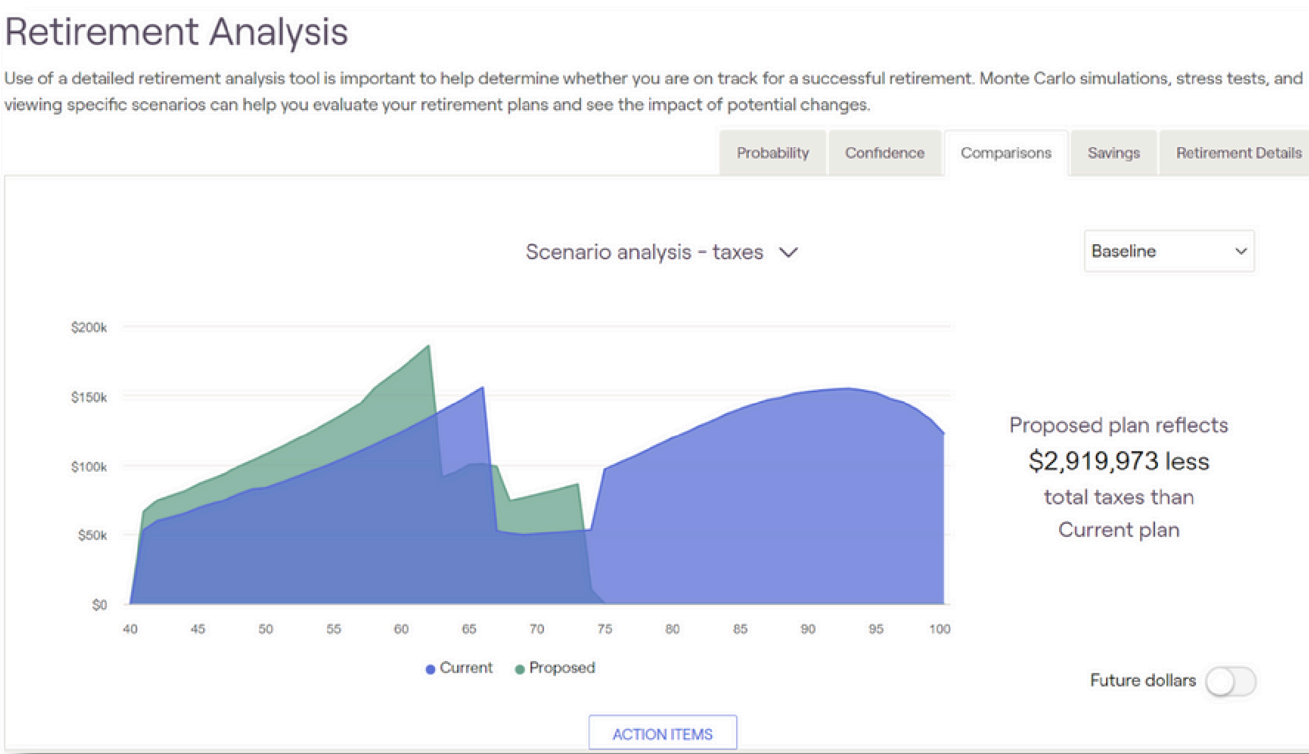
- 40 year old couple, each making $125k
- $500k saved already in pretax 401k
- Maxing out 401k contributions (plus 3% match)
- Needs $10k per month in retirement (in today's dollars)
- Life expectancy of 100, with long term care the last 4 years of their life

Here are the changes we made:

- Delay Social Security to age 70
- Reduce 401k contributions to 10%, switch to Roth (the match will still be pretax)
- Save 10% of income into taxable account
- Optimize asset location and allocation glidepath to match assets with spending
- Fill up the 22/25% tax bracket with Roth conversions starting in retirement

With those changes, here is what were were able to accomplish:

- First and foremost, we reduced target retirement age from 67 to 63, without saving any more than they did before
- They will save nearly $3 million in taxes, not including tax loss harvesting
- They will never pay taxes at all after age 75
- Their kids will never pay taxes on the money they inherit



Couple #2- 60 year old pre retirees

Some of you reading this may be much closer to retirement than the previous example, and don't have the time to implement the same level of changes. Don't worry, there is still plenty you can do! Here is a real client situation we ran into:

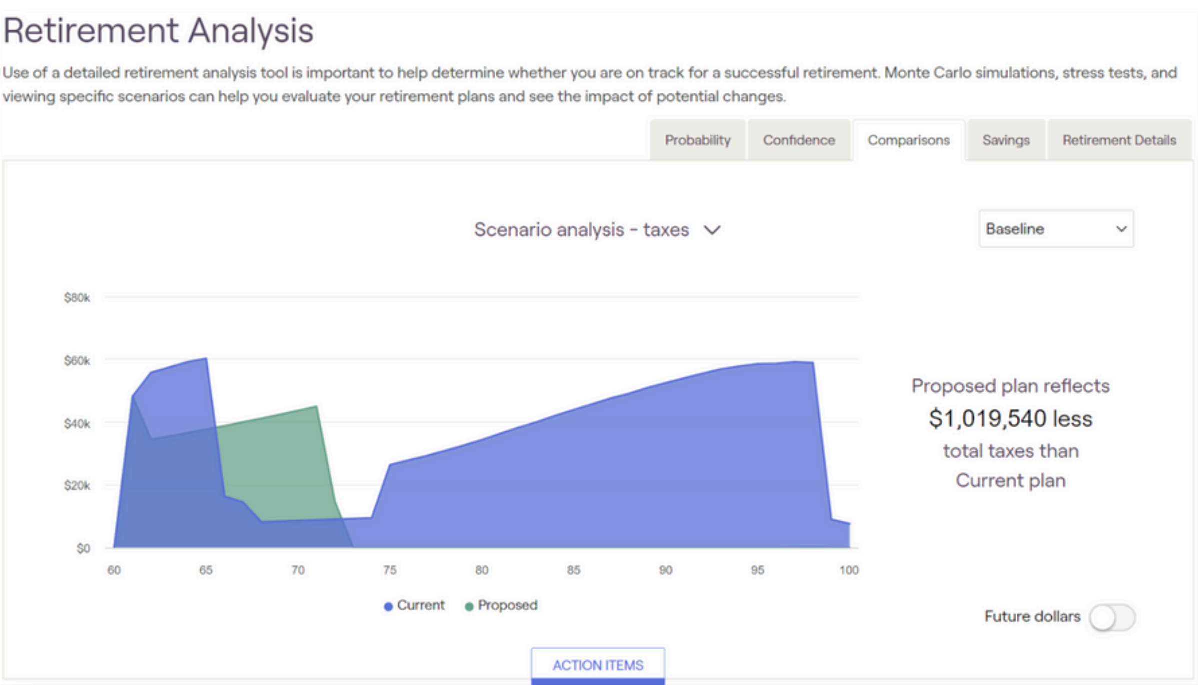
- 60 year old couple, making $120k/80k
- $1.5 millions saved in pretax 401k
- Needs $8k per month in retirement
- Assumed same life expectancy and LTC as previous example

Now, here are the minor changes we made:

- Delay SS to 70
- Optimize asset allocation glidepath to fit spending goals (daughter's wedding, RV purchase)
- Don't change retirement contributions at all!
- Fill up 24/28% tax brackets with Roth conversions

As a result, we were able to:

- Reduce target retirement age from 66 to 62
- Save over $1m on taxes throughout retirement
- Eliminate estate taxes
- Eliminate income taxes entirely after age 72



9. Beyond Tax Planning

This has been a high level overview of tax planning, and we barely scratched the surface (I didn't want this to turn into a textbook). Tax planning is also only one piece of the puzzle. It fits in alongside the rest of financial planning-

Investments

- Specifically, making sure your assets match your liabilities. This means your long term goals are funded by stocks, and short term goals are funded by bonds or other conservative instruments. This does not mean a generic 60/40 portfolio like most advisors do.

Retirement Planning

- Beyond the boring decisions around Medicare and Social Security, we have ongoing conversations about what you will actually do with your life. This can include a sunset career (part time or full), starting a small business, or just volunteering and travel. All these things affect your income and spending, which mean they also affect your portfolio.

Estate Planning

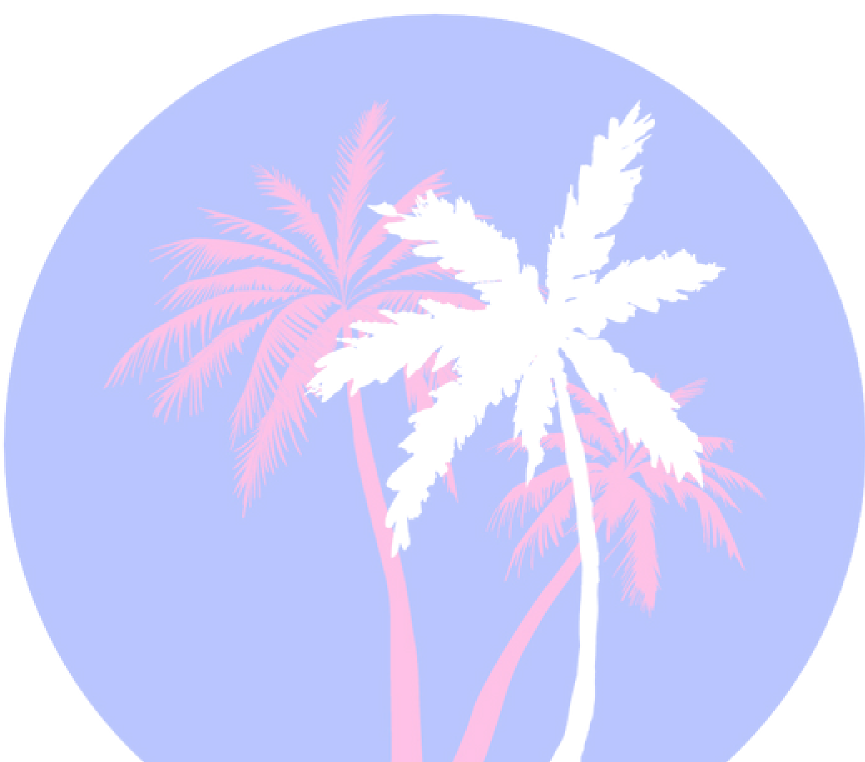
- Like it or not, your time on this earth is finite, and you never know when your time will come to an end. Planning for this event, along with the medical, mental, and financial events that precede it, is best done sooner rather than later. We help clients get these documents in place at a fraction of the cost of a traditional attorney.

Education Planning

- If you have kids, you are probably aware that they are expensive as hell. And just when you thought they were out of the house... you have to pay for college. Most parents are not aware that students are limited on how much they can borrow, and the balance falls on the parents. If you are reading this, you probably don't qualify for need-based aid, so your kids' education can have a big impact on your own financial picture.

Insurance/Risk Management

- The biggest risks to a financial plan are the things you never expect to happen, and hope never will. Whether these are medical, environmental, or legal events, accidents happen, and bad luck doesn't discriminate. We make sure that you are covered, but because we are fiduciaries that don't accept commissions for products, you know you won't be sold something you don't need.



Leetown Advisors is a small firm, and that is intentional. We only take 5-10 new clients per year, because we are focused on giving the best customer experience possible and focus on the relationship. Since our launch in 2017, I have seen clients get married, have kids/grandkids, start/sell businesses, get promotions, and retire. My favorite part of what I do is cheering people on and seeing them grow through life. Unfortunately, there have been plenty of personal tragedies as well, because like I said before, bad luck doesn't discriminate. Supporting clients through these events is just as important and rewarding to me. If this sounds like what you are looking for, please don't hesitate to **schedule a consultation**.

There are two ways to work with us: full Wealth Management, or A La Carte:

- Wealth Management gives you full access to all our services, with no minimum investment. This comes at a minimum fee of $3,000 to $12,000 per year, depending on the complexity of your situation.
- A La Carte lets you choose what you want and when, and you are only billed for the hours we put into the project.

That's it. There's no hidden fees, commissions, or sales pitches. We are committed to helping our clients live their best lives, and to use their money to Make Life Your Beach.

All the best,

Kyle Thompson

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