How To Pay Zero Taxes On Your Tax Deferred Retirement Accounts

Scott A. T.: Broadcasting from One Dallas Tower. Welcome to the Financial Rock Star Show. I'm your host, Scott Alan Turner, we're going to help you get out of debt, save more money and retire early. In the studio with me is producer Katie. On the show today. I'll be answering your questions about money, business and life. If you have a question you'd like answered on the show, visit go askscott.com. We're still in tax mode so we're just building and building and building. If you haven't listened to the previous few episodes, I highly suggest you go back and check those out first.

If you didn't listen to that, start there where I break down tax rates brackets, marginal tax rates, effective tax rates. Having that simple foundation and knowledge about taxes, again, makes you smarter than most politicians and smarter than the Kardashians who are quite smart, very business savvy. If you don't understand the tax brackets, you're just going to be lounging down there on Kanye's level.

I got question from Wayne in Hamilton, Montana, which prompted a lot of this series so I have to give the background knowledge on it just in order to get to Wayne's question. He says, "Through Fidelity, I have rolled over a traditional IRA from a former 401k plan, a $60,000. I also have the Roth IRA that has a whopping $100 in them but that is about to change since I just have paid off all my consumer debt and will start contributing into my retirement as I also build my emergency fund. My question is, can I reroll my rollover into my Roth? If so, how do I go about paying those lovely taxes? Do I have to pay them at April or can I pay them with part of my traditional IRA balance? How much taxes are we talking about roughly? Is it even worth it or should I just begin to fund my Roth and my rolled-over traditional sit where it is?"

There are many online calculators you can use to do some of this and figure out, including one in the show notes pop up on the first page of Google, so that's the one that I use and looked decent. In order to use these calculators, make them worthwhile you got to know a couple of things. You've got to know your projected tax rate in retirement and you got to know your current tax rate or the current year. Those are important numbers as well as the money that you're going to convert.

If I plug in $10,000 to convert, or in the 25% marginal tax bracket right now. In retirement, I expect it to be in the identical tax bracket and I'm just assuming an 8% return. Everything else being identical, identical investment options, expense fees all that stuff. If I do not convert it to Roth IRA at retirement, after tax, I'll have $34,957. If I do convert into a Roth IRA pay the taxes this year on it after taxes on retirement, I'll have $34,622, a difference of a couple of bucks.

What many people don't realize is if you are in an identical tax bracket between where you are now and in retirement, the amount you'll have between a traditional Roth compared to a Roth IRA, it's the same. It's pay taxes now or pay taxes later. If your tax bracket it identical it's the same. You're going to end up with the same amount of money. To confirm that, just go find one of these calculators and plug in the numbers, use the same tax bracket and it will spit out the same amount. Net at retirement after tax is pretty much the same.

What if I think I'm going to be in a lower tax bracket at retirement? Using the calculator again, figure my current tax bracket now 25% in retirement, I'm going to go down to the next lower tax bracket of 15%. If I don't convert it after tax, my net is 39 grand. If I do convert it, my net after retirement is 34 grand. If I think I'm going to be in a lower tax bracket in retirement, it make sense to not do the conversion. I'll come out with more money in retirement. If I think, well there's a final one. If I'm … What do I think if I'm going to be in a higher tax bracket at retirement. I

choose 25% now, again, 30% tax bracket in retirement. I don't convert it to a Roth, I end up with 32 net after taxes and if I convert it to a Roth, I end up with 34. I end up with a couple of thousand dollars more if I start out with $10,000.

If I think I'm going to be in a higher tax bracket in retirement, it makes more sense to do the conversion and pay the taxes now. What are a few key points to keep in mind? Number 1, you do not have to convert a 100% of your traditional IRA through your Roth at one time. This is why I just had the big old discussion on the previous episodes about tax brackets. If you're a single filer in the 15% tax bracket, let's say you converted your full weighing $60,000 at once. You would have jumped up 2 tax brackets for some of that income.

You pay 25% taxes on somewhat of the $60,000 and 28% on a small portion that falls into the 28% tax bracket for $91,000 and above. Not a 100% accurate because you deductions, exemptions, all that stuff. You're probably not in the 15% tax bracket but say here's a different scenario. You're in the 25% tax bracket right now and you're on the border line of 28, border line being $91,000 because we're using nice round numbers. Your average gross income is 85,000. You got 50 grand in an IRA.

If you convert it all at once, 6000 that will taxed at 25% because 85 plus 6 keeps you in the 25% tax bracket. Forty-four thousand is going to be taxed at 28% because your income is going to show as a $135,000. You got your regular income and then the $50,000 traditional IRA is going to show as ordinary income. Puts you up at 135. Any dollars over 91,000 are going to be taxed at 28% in that higher tax bracket. You're paying at 28% in taxes on the $44,000. How can you avoid that if you didn't want to pay 28% in taxes? How can you it? You'd convert $5000 a year from your traditional IRA to Roth IRA over a period of 10 years.

That's assuming you're making the same $85,000 in income each year, so you'd convert $5000 a year, bumps your taxable income up to 90 but it keeps that 90s in the 25% tax bracket. You'd never pay 28% on the dollars over that. You just keep doing the same thing year after year after year until you have it all converted and that entire time you paid 25% in taxes on converting from the traditional to the Roth, instead of paying 28% on the whole thing if you did it all at one time. You'd saved $1500 in taxes by doing it over a span of 10 years and that's very rudimentary. It's still challenging to explain the concept. Ignores a lot of things like deduction all that. You just start by doing your taxes first and seeing where you are determining how much you should convert if any for any given year.

The next thing. The best time to do a conversion is when your income is low. Say you decide to take a year off, go back to school, maybe travel the world, you have a year where you're just living off savings and have zero income or very little income. Maybe you got property taxes on your house. Some other itemized deductions or you can look at the standard deduction on your taxes. Just keep it simple. Let's say we're married finally jointly. We're going to travel the world from January 1st to December 31st. Our income is zero. Standard deduction for married couples is $12,600 on taxes.

On top of that, there's a personal exemption for current tax year of let's just call it 4 grand for rounding. If you're married, you get another 4 grand on top of that. You get 2 exemptions, $8000. Married couple then can earn up to the standard deduction of $12,600 plus $4000 each in exemptions which is $20,600 tax free. Repeat that real quick again. Standard deduction on taxes is $12,600. If you married, you get 2 exemptions of $4000 each so that's another 8000. Add those together, $20,600. That's automatic deduction from the IRS are going to give you. You can earn up to that amount and not pay any taxes on it.

If you have no income, $20,600 in deductions and exemptions are useless because you have no income. If I roll $20,600 to make traditional IRA which I have not paid any taxes on yet to a Roth, the traditional is going to show up on my taxes as income. My taxes for the year are going to be $20,600. That puts me in the 15% tax bracket. I'll pay taxes on that rollover but because a married couple can earn up to $20,600 before paying taxes, the conversion is tax free. Zero taxes. I took that $20,600 which I've never paid taxes on in an IRA because of standard deductions and exemptions, pay zero taxes on it.

A very good example, uses nice round numbers, not getting into the tax brackets out of deductions, sources of income, trying to sum up 8 hours of tax playing and half dozen IRS in 2 minutes which is why you need a good tax planner or go out and read more about this stuff but it's a starting point.

Last thing I mentioned, all things being equal if you're in the same tax bracket and retirement is now, the taxes you pay are the same. There's lots of assumptions built-in there. We don't know what taxes are going to be in the future but if you're considering a conversion from a traditional IRA to a Roth IRA, the timing of it is crucial and the tax savings can be substantial. Thanks, Wayne, for the question.

Today's tip comes from Brian. He says, "I did some digging into my USAA membership and actually just started offering a free credit score exactly the same as Discover uses. One caveat is you have to be within USAA's membership law," good to know, "or other USAA members out there." Thank you, Brian, for the tip. If you're with USAA, you can get a free credit score from their service. Discover card also has a free option. Just google Discover free credit report. You can sign up for free. It doesn't obligate you to get a Discover card or anything like that. It doesn't ding your credit report, but it gives you a nice output of what your current credit score is according to Experian, one of the 3 major credit card bureaus or rather 3 main credit bureaus. Correction there.

Kevin from sunny Puerto Rico. That was terrible, Puerto Rico.

Kevin: "I'm currently investing in my 401k through my employer. Betterment to or am I not allowed to invest twice in my 401k or since I'm already investing my 401k, will you recommend me to invest in something different?"

Scott A. T.: Betterment, Vanguard, Fidelity, TD Ameritrade, Schwab Wealth Fund, any of them when you sign up from them, you are not getting into a 401k. You can do an individual brokerage account through them or you can invest in an IRA.

Now for you, you wanted to do the Roth IRA. That's what you're after tax money. Do your 401k first up until the company match and you go over to one of these other places, Betterment is fine as we mentioned. Start a Roth there and you can max that out up to $5500 a year. Why do you want to do that? Roth money grows tax free. You're paying, buying into it with money you've already paid taxes on now, of course, tax free when you hit retirement. You pull it out, pay no taxes on it which is awesome.

Yeah, you can go with Betterment, any of those other ones I just mentioned. Vanguard, they require a minimum of a $1000 to get started with their Roth. If you got a $1000 that's a perfectly fine way to go. Any of those options, you could start out simply by picking a target date fund or just pick a low cost index fund, S&P 500 is one. It lead total stock market index fund is another one that's buying a little piece of every stock in the US Stock Market. Both of those are good choices.

Now when you go with Betterment, you're not going to see those choices. With Vanguard you will. Betterment is going to get you into a targeted date fund based on your risk and your target retirement date. Slightly different. It's

more about, they're more of a robo advisor. You will be investing outside of your employer, but it will not be in a second 401k. It will be one of these other investment vehicles and it's certainly the way to go and build wealth. Thank you, Kevin, for the question.

April asked,

April: "Why chose a Roth IRA over a traditional one?" A Roth IRA is paid with your after tax dollars. You've already paid the taxes in the current calendar year so you don't get a tax deduction on your yearly taxes. The Roth IRA then grows tax free. You put it in $10,000, it grows to $25,000, you don't pay any taxes on the $15,000 made whenever you pull it out. With the traditional, you get the tax deduction right now. Now the traditional IRA contributions are tax deductible in both state and federal tax returns for the year you make the contribution. While the withdrawals in retirement are taxed at your ordinary income tax rates. Same $10,000, it grows to $25,000, you pay taxes on the 15 as you withdraw it at your tax rate in retirement.

Scott A. T.: With the traditional IRA, you're avoid taxes when you put the money in, with the Roth IRA, you avoid the taxes when you take them out. Now what you want to do, decide on whether you're contribute to one or the other if you have to start thinking about what your taxes are going to be like in your retirement. Are they going to be higher or lower than what you're currently paying?

Now, what is going to determine that ... Now, it's hard to project what taxes are going to be in 10, 20, 40 years from now. We can look at our situation and ask ourselves, "You know what's my tax bracket right now? Am I going to get some income from Social Security which is going to change my income during a retirement?" You would normally think that, "All right. I'm in retirement, I don't have a job anymore. My taxes are going to be lower." You also have to remember some of the tax deductions you get today, you're not going to have in retirement. Your kids, if you're getting any type of deduction on them, I mean they're going to be out of the house. Your mortgage will hopefully be paid off so you're not going to have any mortgage interest deduction there.

Your taxable income might be higher. You also have to ask yourself what about just the general tax rates, what's going on in the world. Do you think they're going to be lower or higher? Here's what I ask myself. Given what I know about the imperial federal government, how it blows money, has no concept of a balanced budget, and programs such as social insecurity and Medicare, that they can't cover their future expenses, we've also got a huge aging baby boomer generation that are going to suck their blood out of programs, where is the government going to get the money to pay for that stuff?

Now, I'm not an economist but I play one on the radio. Taxes are going up. Someone is going to pay the piper and the biggest pool of money to tax is in people's 401Ks and IRAs. I'm going with Roth given the choice. You can call me a negative Nelly, I don't mind. I just call it like I see it. Bottom line is nobody knows, and while I'm just guessing, I'm taking the safer bet, I don't want to pay taxes in the future if I can pay them now. Thanks for the question, April.

Janesta spends all her money and needs a good hiding place. She writes,

Janesta: "I'm struggling with saving money. Every time I try to save, something comes up and I'm forced to spend it. I need to find a way to hide it where I cannot touch it." Now, in my own life, if there is a cookie in the house, I am going to eat it. If there are potato chips in the house, Katie is going to eat them. The kids, they can't reach the pantry shelves yet so we don't have to worry about them. The point is if it's around, more than likely, we're going to

munch on it but if it's not in the house, you usually don't think about it. Out of sight, out of mind.

Scott A. T.: Relating that to your personal finances, you got to find a way to get that money out of your sight, out of your mind and then, you won't end up spending it. If you automate your savings taking out of each of paycheck periodically throughout the month before you even see it, before it hits the checking account, much less likely to end up spending that on just frivolous things, things that you don't need.

Here's an example. I've recently sold some stuff on eBay after cleaning out my house. When you sell something in eBay, that money goes into your PayPal account. Normally, it does anyway. In the PayPal account, I don't see that. It's not on my savings chart. I'm not looking at PayPal. I'm not logged in at PayPal all the day. I'm not thinking about PayPal so there's money in there but I forget about it until I think, "Oh I've got money in my PayPal account. I need to transfer it over to a checking account." That's a great example of money just coming in. I don't see it. I don't think about it. I'm not apt to do anything with it.

Digit.co is a great app that you should look into. Every few days, this app will look into your spending habits and it will remove a few dollars from your checking account if you can afford it. It has this algorithm and rules that they use. It allows you to take money out without you ever seeing it and they're putting into a separate savings account. Then, you can withdraw your money at anytime, easy with no fees. It's a forced savings account that works behind the scenes based on your spending habits, easy to get started and it stocks away a little money. If you have a savings account, just set up and automate withdrawal to pull out 10 bucks once a week or every pay check, some dollar amount that you're comfortable with that fits your financial situation.

I'd rather you be putting away money for retirement if you have all your debts paid off. Then, you go with a brokerage firm and you can set up automatic savings the same way. If you have access to employers sponsored 401K plan. Another great way to start by saving 1% of every paycheck, pulling it out, sticking it into a retirement plan. It's a great way to get started. If you automate, it becomes part of your life. You don't even think about it because the money is not there for you to touch. You won't be apt to spend it.

Thanks, Janesta. Don't procrastinate. Take 10 minutes right now. Make decision on which route you want to go and then just go do it whether that's the 401K, looking at digit.co, logging into your bank and setting up some automated savings right there.

Quick break, back in a few seconds. You're listening to Scott Alan Turner. Hey, nation. Scott Alan Turner here. Now, for those of you that are my long-time listeners, you know I'm not one of those guys in the radio shows up on their desks. You're never going to hear me trying to get you to buy high fructose corn syrup or recommending you buy the DVD collection for Star Trek: Deep Space Nine. No, I have a name to uphold to you, The Rock Star Nation. If I were to recommend something to you, I would tell you about Spoon City.

Many of you who are sitting there right now listening to this mindless at home eating a bowl of cereal for breakfast. Unless you're like my 2-year-old using their hands, you're using a spoon to shove on those chocolate marshmallow sugar roast. Spoon design has remained unchanged for hundreds of years until now. The fine folks at Spoon City have come up with a first ergonomic spoon to take your eating experience and health to a whole new level. Eating with a non-ergonomic spoon can cause side effects such as headaches, nausea, cramping, bloating, lightheadedness, stuffy runny noses, chest pain and in some rare cases, spontaneous combustion. Head down to your local Spoon City today. Your mouth deserves the best.

We are ripping up nirvana. Nisha writes,

Nisha: "I'm 34 years old and somehow seem to find myself in an extreme amount of debt." Not unusual. "However, I'm about to get a settlement that is worth $9100 and I have a loan that I owe $3600 on and credit card debt is around $7000." Then Nisha shared with me those different balances in cards. Continuous, "I got myself into a mess. Should I pay up as much debt as I can with the $9100 settlement or do I keep some money to survive? I make about 30 grand a year and barely enough to survive right now. I'm really starting to feel overwhelmed with this debt. Should I pay up small balances first or what should I do?"

Scott A. T.: First you want to check to make sure you don't have to pay any taxes on the settlement that you're getting. That's going to be a rude awakening if you do when you spend it all. That's going to vary depending on type of settlement. If you already need to put away that amount so you have it next year come tax time, for example, if you're in a 25% tax bracket, your choices are to save 2250 for next year's taxes or use all the settlement towards the debt. If you do, use it all towards the debt. In 12 months, you're going to have to come up with that 2250 to pay the IRS.

The IRS, they like their money. Unlike the credit card companies where you can tell say to shut it. You're going to be there a while. IRS not so nice. Next step is I'm going to be cutting up all these credit cards and not using them anymore, but I think you figured that part out. That's our starting point for clearing up as you called it a mess. Put aside $1000 of that settlement for your emergency fund. That's going to help you break the credit card habits for any emergency that might come up, you have a little bit set aside for those small things, car breaks down, water heater breaks, whatever goes on.

In your case, you got a loan at $3600 at 25% interest. I'm knocking that out first because of what your balances are and how much you have to pay down on the debt, I'm going to pay off the rest based on their interest rates. I'm doing the loan first since this got this massive interest rate. For everything else, I'm going from highest interest rates to lowest not by the size of the balances. Now some of you thinking, "Hold up, Turner. That's not normally what you'd recommend." You would be correct, sir, and you would be correct, madam.

Nisha's situation is unique because she's got a windfall. Normally, you would have the greatest success by working your loans or debts from smallest to largest ignoring the interest rate by using momentum. You guys, you can't see all her individual debts and her balances like I can, I'm not going to off. She pays off the loan, applies the rest to the credit cards. She's going to have 2 or 3 small debts left totalling about $1200. It makes more sense to save money on interest. Otherwise, she'll have that loan left over with $1200 at 25% interest which is highway robbery.

Save the taxes if you need to. Save a grand for emergencies, pay off the loan, then each credit card balance starting with the highest interest rate the lowest as much as you can get paid off. Then, you take what you are paying towards the minimums on all your current payments and debts that you just paid off. You apply those towards the remaining credit cards until they're 100% paid off. Paying off your debts would be a great decision.

You won't need a debt consolidation company. That has not worked in most number scammers. You'd probably pay more than you're going to save if you save anything at all. Nisha, just by acknowledging you made a mess as you did. You're taking personal responsibility. Some people they cry, "it's me." They refused to alter their life to make it better. You're at $9100 settlement, that is rare. That is a get out of jail free card. You can wipe off nearly all your debts in one swoop. Be very thankful and then commit to not going back to the way things were. That's

not a good place for anyone.

The good place is how you're going to feel when you start writing the checks and get the letters back that say you have a zero balance one after the other after the other. No amount of buying stuff can beat that. You should be debt free in a few months. Think about that. Thanks for the question.

Taylor from Birmingham, Alabama wants to minimize the burden of student loans after graduation. Say,

Taylor: "Of course, I can't eliminate student loan debt all together but is there anything I can do now to minimize the burden after I graduate?" One of the first things you can do is visit the student loan officer at your school since you're probably on the campus every day or a few days a week, sit down with them and look over the various repayment plans that are going to be available to you. Those are going to be IBR which is income-based repayment, PAYE which is PAYE. It's Pay As You Earn and a new one which is we just rolled out in December, only a few months ago, it's called REPAYE, Revised Pay As You Earn.

Scott A. T.: It's important to do that as soon as you graduate getting set up for that time when you're getting out because each of these income-based repayment programs is based on your income from the previous tax year. If you graduate in June and you work, assuming you're going to get job immediately out of school, it's not always the case, it didn't happen to me, but if you graduate in June and then you start working and you work 6 months of the year, what is your income going to be for the entire year? Not a whole lot because one, you're just out of school so you're not earning much as a starting salary. Two, you are capped for the year. Each of these income-based repayment programs are based on the salary for the prior year.

If you got a low salary, your loan payments per month are going to be very small. If you don't start working until September, they could be next to nothing for the following year and they get revised every year based on your previous year's taxable income. Now, do you want to pay the minimums? No. Of course, not because that stretches your payments out as far as you can possibly see into the future. You don't want that. You want the flexibility to have a very low monthly payment. Then if you do have those little minimums, you can take any extra you've got and apply it towards a loan paying down more principal.

Any time you're trying to get a lower payment, a lower interest rate, the goal is always the same. It's to be able to pay a less interests so you can pay more in principal. It's never to stretch out the payments. It's okay if you do stretch out the payment as long as you have the intent of paying off the debt faster. Same thing if you're going from a 20-year mortgage to a 30-year mortgage because you want to get a lower interest rate.

You just pretend that you still have a 20-year mortgage keep paying it like you were before and you're paying more in principal less in interest, same with the thing with the income-based repayment programs. Get them to a point where you have low payments right off the bat. It gives you more flexibility to either put more money towards the principal because you have lower minimum monthly payments or you just stockpile it into a savings account if there's any type of prepayment penalty and just save up a bunch of moneys that you can dump a huge chunk of it at one time at a later date.

I'm always going to recommend to in school, pick up a side job or a part-time, earn some extra money, do whatever you can to be saving money now, earning money now so that when you get out, you'll have again more flexibility, more cash that you can throw at that student loan. Get it knocked out. You want to get it knocked out as soon as possible because those interest payments, they're a killer. They irritated me and once you see all the

interest you're paying, you're like, "That's just money you're throwing away." You got an education but it's not a money that you can buy anything with, can't buy house with your interest payments on a student loan. You can't buy a car with the interest payments on your student loan. You got the education but that money is just gone and it is sickening so you want to get rid of it as quickly as possible. Thanks, Taylor, for the question.

Just got a text from one of my old band mates. Facebook sometimes you get those alerts to say, "Here's what happened one year ago today or 2 years ago today or however long ago it was." Anyway, my old band mate, Ryan, he texted all of us photo of when we played the House of Blues. It was 3 years ago as time that I'm recording this right now. Then, shortly after that, the twins are born. I had to go on hiatus from, A, being at a band, and B, just playing as much guitar as I was, but I am back in a band now and up on Spotify. They'll be a link on the show notes. You can see our current set list what we're practicing and working on lot of 90s radio tunes. Pretty cool.

Final words for the day, when beginning anything new, the number 1 priority is to get a small win ASAP, as soon as possible. When you do that, it builds critical self-confidence and lets you know I can. Those are the words. That's it for this episode. I'm your host, Scott Alan Turner. Rock Star Katie is my producer. All links mentioned in the show are available on the shows notes on scottalanturner.com. If you have a question you'd like answered on the show, visit goaskscott.com. Thanks for listening.