Casey Mullooly: Welcome back to the Mullooly Asset podcast. This is your host, Casey Mullooly, And this is episode 375. In this week's episode, we talk about tax planning and why it's so much more than just figuring out how to pay the least amount of tax on a yearly basis. Thanks as always for listening, and we hope you enjoy.

Casey Mullooly: I'm here with Brendan and Tom this week. Got the usual suspects here. We're going to talk about a thread that we saw on Twitter recently from Mitchell Baldridge, who is a CFP and CPA down in Texas. We came across this during the week, and we thought it was a good jumping off point for a conversation. The main point of the thread was to focus on what Mitchell referred to as a lifetime effective tax rate. So his main point of the thread was that your highest earning years are really concentrated in a narrow band of your lifetime. He estimates it to be about 30% of your time. So he talks about different strategies for doing that. But first before we go any further, I want to talk about the difference between a marginal and an effective tax rate.

Tom Mullooly: Yeah. I think that's so important, and a discussion that a lot of people, a lot of non CPAs to this day still don't understand the difference between marginal and effective.

Brendan Mullooly: Yeah. So, marginal rate is in reference to which tax bracket you fall into. I think the mistake that you'll often hear is somebody saying, "Hey, I'm in the 32% tax bracket," like the federal government's taking 32% of my money. The marginal rate refers to the amount of tax on the last dollar of your earnings that falls in that band, that the tax bracket specifically refers to. All of the brackets leading up to there have their own separate rates, which are also subject to, but they're lower than that top one. So your effective rate is the blend of all of that. It basically just says, hey, what was your tax bill like federally? What did you pay in any income tax and what was your gross income before anything came out of it, setting aside things like the standard deduction or your itemized deductions, but even setting aside things like your 401(k) contributions or health savings account contributions, health premiums, things that you pay pre-tax out of your check.

Brendan Mullooly: So very, very top line gross income before anything else comes out. Take those two numbers, put the tax bill over the gross income, and that's going to spit out the actual percentage of what you're paying in tax. And it's often very different than what your marginal rate is.

Casey Mullooly: Right. So your effective rate is your actual rate.

Brendan Mullooly: Yeah.

Casey Mullooly: Essentially.

Brendan Mullooly: You've got to do some work to get to it, so it's a lot easier to just say, "Hey, I'm in the 32% bracket."

Casey Mullooly: I mean, those numbers are right on your tax return though. So I mean, it should be pretty easy to find.

Tom Mullooly: It's a good back of the envelope way to find it is just go to the line on your tax return that says this is your total tax. Not refund, not what you owe. This is your total tax. There's a line on there. I forget the number, but this is your total tax. Take that number and divide it into the income that's on the first line. I mean if you own a business, it's going to be different, if you're contributing to a 401(k), it's going to be different, but it gets you close.

Brendan Mullooly: It gets you closer than citing your marginal rate. So it's an improvement, but I mean, most people know their gross income. So if you can get the tax number from your return and then divide it by the gross number. Because the gross number is not always on ... You can find your gross number on your W2.

Tom Mullooly: W2, right.

Brendan Mullooly: But it's even tricky to find there because you have to find the correct line. Usually the one that you could look at that would make sense is the Medicare line.

Tom Mullooly: Medicare.

Brendan Mullooly: Because there's no cap on that. So that'll give you the ... It's going to be the highest number that's on there, and that's going to be the number you want to divide it into to get to your effective rate. It's a useful number.

Tom Mullooly: And that's your effective rate. It's important to know that because there's a lot of folks that we've talked to who say, like you just mentioned, "Hey, I'm in a 32% tax bracket," but their effective rate may be 19.

Casey Mullooly: Right. Yeah.

Brendan Mullooly: Obviously zero would be preferable, but hey, that's not the world we live in. So yeah, it's helpful to know the effective rate. I also think that, just a gripe I have, instead of this whole convoluted, like how many exemptions are you claiming nonsense when you've got to fill out your W4 for withholdings, it would be great if we just taught everybody, hey, here's how you calculate even your anticipated effective rate. And you could say, "All right, I just backed in using last year's numbers and said hey, it's 14% or something. And I want to be safe. So I'm just going to say withhold 16% from every check." And that would be better than having people do these insane worksheets where you try to get them to the correct withholding because-

Tom Mullooly: It's ridiculous.

Brendan Mullooly: ... people don't do it. They redid the W4, like the worksheet that gets you to the withholding in the last couple years, and I think they made it worse. It's terrible. So then people don't withhold the correct amount and everybody's pissed off because they're trying to do the right thing and they think they are, and then they get to the end of the year and they didn't and it's too late.

Tom Mullooly: So this is actually a shortcut, a trick that I learned from my dad when I had my first W2 job in 1979. He was like, "No, no, no." He goes, "Just figure out what your taxes are going to be and we'll divide it into what you made, and that's the percentage. Just tell the payroll guy that this is what you want taken out of your check." And I was like ... That's the way I've done it now for 40 something years.

Casey Mullooly: So I inadvertently cited grandpa on the podcast is what you're saying. So, but we can-

Tom Mullooly: We'll link to his MySpace page.

Brendan Mullooly: And I do that internally. That's how we withhold here, but that's because it's a family business and we're allowed to. You can't do that at HR with a big company. They're going to tell you no, fill out this worksheet, and it sucks. I don't think anybody enjoys doing it, and it doesn't often yield the results that I think people are looking for, which is just, hey, I'd like to satisfy my tax liability and not be surprised. And I don't think that that's too much to ask. So somebody should fix that. Above my pay grade though.

Casey Mullooly: So this might be an obvious question, but how does the marginal versus effective come into the equation when we're building out a financial plan for someone or projecting out their retirement?

Tom Mullooly: I can answer through an example if that helps, and Brendan feel free to clarify on this. But suppose you are going through the math with a client and they're discussing doing a Roth conversion. They're converting some of their money that's in their IRA into a Roth IRA, but they have to pay the taxes this year. So they may be in a situation where they're in the 28% tax bracket, but doing that Roth conversion will bump them into the 32% bracket. Now the marginal rate really does matter because now you're paying 32 cents on every dollar of that Roth conversion to just do this. You'd be better off waiting until you're in a lower bracket.

Brendan Mullooly: Yeah. So you want to be aware of the thresholds where the marginal rates kick into new levels because those are often places in planning work where if you're wary of them, you can maximize using empty space that's left in a bracket without going over into a new one. Those are often thresholds too for things like Medicare premiums. They kick in, in some of these higher tax brackets. So yeah, I would say that's probably the biggest situation in planning for the marginal rates to be wary of. Effective rates is, I think you use that more in planning work because that's how, if you have money in pre-tax retirement account, like a 401(k), IRA, and you want to figure out how much you need to withdraw to fulfill your needs on a month to month basis, you've got to factor in your effective rate, because that's what you're going to want to withhold. So, you need to know your effective rate so you can effectively set aside-

Casey Mullooly: Back into a withdrawal rate and then just go from there.

Brendan Mullooly: Yeah. So it's integral to know that information.

Casey Mullooly: Yeah, that makes sense. So back to the thread from Mitchell Baldridge, one of the things that stood out to me was he suggested to folks that they don't start saving in a pre-tax account until they're in the 32% marginal bracket. So the 32% bracket is, I mean, that's the third highest one. So people like me and you, Brendan, in our 20s, 30s, maybe even into their 40s, he's saying don't start saving in an account like a 401(k). He suggested to use this time to really maximize the Roth, pay down student debt and to get your foundation in order. But how do we-

Tom Mullooly: So, so important.

Casey Mullooly: Yeah, it is important. I know we always say the time in the market, get started investing as early as you can. The 401(k) is usually the easiest way for people because it's through work. It's the easiest way for people to start getting invested in the market. So how do we balance those two things out?

Tom Mullooly: Well the first thing I'll say, and it's probably like the eighth or ninth most important thing, but I think more than 50% of 401k() plans today offer a Roth option in their 401(k). We've done almost reverse planning with a few special situations where folks have come to us and they said, "I've got $40,000 tucked away in a 401(k) that I no longer work at that company," or, "It's sitting in an IRA," or wherever the money is. It's in a pre-tax account. But I've got 25 or $30,000 of credit card debt and I'm having trouble making ends meet. Now, this is someone who got the message that saving for retirement is very important, but they are not using the proper path for this.

Tom Mullooly: So to even talk about Roth versus pre-tax contributions, you have to even go a further back and just say, where are you with debt and debt management? Let's talk about student loans. Let's talk about saving money for buying your first home. Let's talk about things like that, which are going to become, those events are going to happen before your retirement. So you're putting the cart a little before the horse when it comes to things like that.

Brendan Mullooly: I think too that you don't have to do one or the other here. So if you want to get started saving in your 401(k) and it doesn't offer a Roth option, you can do so, but maybe think about how to right size that in comparison to something like, so do do your pre-tax 401(k) contributions maybe to get a company match, which are always pre-tax dollars too. So do it up to that, and then consider from there maybe, if you're eligible based on your income, doing a Roth IRA if you can't do the Roth 401(k) through work, or depending on the flexibility you need from the money, maybe you do a brokerage account, and build the base. But I think the goal should be to get that time in the market and to do that as soon as possible to the extent that your cashflow allows you to. But yeah, I mean, you want to carefully consider where you're sending the dollars to. It doesn't just have to be one or the other. You can spread things around a little bit.

Casey Mullooly: Alongside talking about getting your foundation in order, part of the thread was that he works with people who weren't as tax efficient as they could have been, meaning that they put all or a good chunk of their money in pre-tax accounts and then ended up paying for it later, meaning down the road when they were maybe in higher tax brackets. So he says, "I meet lots of people who tried to be tax efficient here that ended up paying for it tenfold." What does he mean by that?

Tom Mullooly: So, we see this from time to time in our practice, where folks have been really diligent about socking money away in their retirement plan. Maybe they've been maxing their contributions out year after year after year, but they just don't have any resources outside of that plan. So they're in a situation where they're saying, "Hey, you know what, maybe I can retire at 52 or 53," or at some young age, but they can't tap into the resources in a 401(k) or an IRA, but they don't have cash on hand either. They're stuck between a rock and a hard place.

Brendan Mullooly: Well, yeah. So if you don't diversify your tax base and you just throw everything into a pre-tax, you're basically, inadvertently I guess, whether you realize it or not, you're pre-setting your tax rates from RMD age through the end of your lifetime, because you're going to reach a threshold eventually with all those pre-tax dollars where your distribution each year is mandated by the IRS via your required minimum distribution, now age 72 and beyond for folks. So if you have X ... You can basically do the math, if you are able to assume whatever rate of return you think you're going to have and take a look at what your future RMD's projected to be, and you might reach a point based on what your needs are going to be in the future, at least as things exist today, where you might want to think about channeling the same dollars that you've been maxing your 401(k) with, into something else like a brokerage account, because it at least gives you some flexibility of saying, "Hey, I'm going use these dollars and pay these taxes when I want."

Brendan Mullooly: Your tax bills for age 72 through whenever are basically set in stone more or less at that point in time, once you've sent the dollars into the retirement account, unless you're going to do a Roth conversion at some point.

Tom Mullooly: I think, to expand on that point, is if you have been really diligent about channeling all this money into a pre-tax account and it has compounded well over time, Brendan, you and I have sat with folks here and just the look on their face when we tell them, "Yeah, your required minimum distribution at age 72 is going to be $100,000 a year," and they fall out of their chair. They're like, "Oh my God. I'm going to be paying so much in taxes. I don't need the money. What do I do?"

Brendan Mullooly: There's nothing to do about it. You take your distribution, you pay the tax and that's it. And if there's surplus left over, then obviously you channel that to the brokerage account then. So you're going to do that at some point, unless your needs are higher than the RMD amounts project to be in the future, in which case, then no big deal. You would've withdrawn the money based on what you needed anyway. But if it's not that and you're going to diversify by paying tax on the RMD, taking what you need and sending the surplus to a brokerage account, let's say, you could try to begin to ... It's going to be a little bit like turning the Titanic, so to speak. We're not saying stop saving into your 401(k), but you could start saving into your Roth 401(k) with the same amount of dollars, or you could start saving into a brokerage account and continue to invest it, so your nest egg will project to be the same in the future.

Brendan Mullooly: In fact, it might even be more valuable even if on paper, it doesn't look the same because realistically the after tax amount of your nest egg in retirement is what you eat. So if you've got a million dollars in a 401(k), it's not actually a million dollars because sooner or later the taxes are going to have to come out of that since they've never been taken before. So you could just use as a simple measure what your effective rate is today and do the math to lop off that at the federal and state level and say, "Hey, it's actually 800,000. It's not a million." And that would probably be a better way to look at it because that 800,000 is what you're actually going to be able to spend, which is, I think all we should really care about.

Tom Mullooly: That also blends in with the, along the same lines, a similar discussion that we have with folks where we point out to them that every dollar that comes out of your pre-tax retirement plan, whether it's 401(k) or IRA, that is taxed dollar one as ordinary income, versus having some money in an investment account, a taxable brokerage account, where you're only responsible to pay tax on the gain. And you may be actually in a lower bracket paying a long term capital gain on an investment in a taxable account than every single dollar coming out of your retirement account is ordinary income.

Brendan Mullooly: It just gives you some control back if you have other buckets, whether they're tax-free Roth dollars or brokerage account dollars. Then that's again where we can tie that back into remaining cognizant of marginal tax thresholds to say, "Hey, we need to get X out of our investments this year. Where can we draw from to make sure that we're paying as little tax as possible, but still getting what we need?" But if everything's in one pile, then it's very straightforward how you get there, and there's no decisions for you to make.

Casey Mullooly: Right. So the idea with that is you're already above a certain tax threshold. The idea is to fill up that bucket as much as possible without bumping you up into the next bracket. So that makes sense. And what you're really doing with these strategies is it sounds like you're giving yourself building in some flexibility and you're giving yourself options.

Brendan Mullooly: So you can make decisions. It's basically taken out of your hands if you only have pre-tax dollars. It's eventually going to be mandated to you, so it's outside of your control. There's nothing to do at that point. I appreciate the topic of tax planning, because I think that a lot of ideas that we hear around taxes, whether it comes from a tax preparer or an idea that a client has, are often focused myopically on reducing taxes right now for this year specifically. And just this thread in general, it's talking about your lifetime effective rate. Basically tax planning is all about making sure you pay the least amount of tax possible over your lifetime, and that might mean in any individual year doing something that isn't the lowest tax proposition for right now.

Brendan Mullooly: We have to talk this sort of thing through with clients on our end, in a lot of cases, when it comes to taking distributions from accounts or making decisions to buy or sell investments when they're in taxable accounts. We have to consider not only how do we fulfill the need that the client has right now today with the lowest tax bill possible, but how does that impact their plan moving forward? And how do we make sure that they're not just kicking the can and eventually ending up in a situation where the tax bill comes due eventually? So it's a balancing act and you have to, I think, pay attention to that sort of thing. And Mitchell speaks to that well in some of these topics on Twitter. This is true tax planning and not just vacuum 2021, like how do I pay as little tax right now as possible-

Tom Mullooly: Here's a trick before-

Brendan Mullooly: ... with no regard for 2022 or '23 or any year in the future.

Tom Mullooly: Right. Yeah.

Casey Mullooly: I mean, that's a really good point because I think we talk about that a lot on the investment planning side, where we're telling folks to not focus on just the next day, week, month or year. It's really just about thinking long term and not being focused on the short term, as hard as that is. It might mean doing some things harder upfront, maybe paying more tax than you air quote should-

Brendan Mullooly: Or have to right now.

Casey Mullooly: ... or have to.

Brendan Mullooly: Or choosing to spread a bill out over 10 years as opposed to kick the can to year eight and then pay it all at one time. Those are the sort of things that we have control over, but it's a matter of thinking in decades instead of minutes, and that's easier said than done.

Casey Mullooly: Yeah. That's going to wrap up episode 375 of the podcast. We hope you got good takeaways and maybe think about tax planning differently this time around. So thanks as always for listening, and we will see you on episode 376.