August 22nd, 2021

Dear Brandon & Sarah,

Thank you for using our financial planning services. We discussed several topics on our recent call.

You are 64 and 62, with no dependents or heirs. As the Owner-Operator of BBQ Empire, Inc., Brandon earns $142,800 annually in W2 income. As an administrator at Chickens "R" Us, Sarah earns $30,000. In addition to Brandon's wage income, you have an annual business distribution of $220,000. Your investment properties provide $160,000, net of the mortgage payments. You estimate your living expenses at $201,000 per year – excluding taxes.

You have $2MM+ in investment accounts. $1.6MM of this is in tax-advantaged accounts. You own your home ($2.3MM), with a $1MM mortgage. You have another $2.7MM in commercial property (that you lease to your business). These properties have a mortgage balance of almost $1MM.

You anticipate selling your business ($3MM) next year. You are looking for help with investing, and retirement planning. Here are your financial planning *To-Dos* in light of your goals from our call:

- ☐ **RAINY DAY FUND:** You have $126,000+ in cash savings. (This does not include $468,000+ in Sarah's rollover IRA at Vanguard – discussed in the *Investments* section.) Continue maintaining at least six months of living expenses in cash as your rainy day fund. Learn more here. To be conservative, holding up to one year in cash is also appropriate.

  You are earning 0.02% on your Wells Fargo "High Yield Savings" account. You can earn a slightly higher interest rate (~0.5%) with an online savings account.

Tax-Advantaged Investment Accounts

One of your biggest challenges is managing the tax impacts of investments in your taxable account. Therefore, you want to take advantage of tax-sheltered investment accounts where possible.

- ☐ **TAX PROFESSIONAL:** Confer with your tax professional before moving forward on the below.

- ☐ **HIGH-DEDUCTIBLE HEALTH PLAN HEALTH SAVINGS ACCOUNT (HSA):** If you decide that a high-deductible health plan (HDHP) meets your health care goals for Sarah, contribute the maximum to an HSA annually - $3,600 + $1,000 catch-up for 2021. Invest in low-cost stock funds, such as the Vanguard Total World Stock ETF (VTWAX/VT). Pay for medical expenses with cash, letting HSA investments grow tax-deferred. Save all receipts for qualified medical expenses forever. Learn more here.

Your Retirement Plan at Work

☐ **BRANDON'S TRADITIONAL 401(K) CONTRIBUTIONS**: Brandon should continue to contribute the maximum annually to his traditional 401(k) ($19,500 + $6,500 catch-up for 2021) to take advantage of the tax savings available by using this account.

☐ **SARAH'S TRADITIONAL 401(K) CONTRIBUTIONS**: Sarah should contribute the amount to her 401(k) that qualifies her for the full employer match. Past that amount, Sarah should only contribute to her 401(k) if the all-in fees for Sarah's 401(k) are reasonable: 0.5%, when adding together both mutual fund expense ratios *and* any administrative fees that may be charged. (No information on Sarah's 401(k) fees was provided before or during our call.) If the all-in fees for Sarah's 401(k) are less than 0.5%, Sarah should make the full traditional 401(k) contribution ($19,500 + $6,500 catch-up for 2021). This $26,000 contribution is in addition to any after-tax contributions, discussed next.

If the all-in fees are greater than 0.5%, contribute only enough to Sarah's 401(k) to qualify for the full employer match.

☐ **SARAH'S MEGA BACK-DOOR ROTH 401(K) RESEARCH:** A mega back-door Roth utilizes a retirement plan's unused contribution limit ($58,000 + $6,500 catch-up in 2021) to make a Roth contribution. Not all plans offer this feature. Ask your Human Resources Department if your plan has the two following features:

1. Non-deductible voluntary after-tax contributions. These "voluntary after-tax" contributions are ***not*** the same thing as post-tax, or Roth contributions.

2. Either in-plan Roth conversions, or in-service distributions.

If these features are available in your plan, then, in addition to contributing the maximum $19,500+ $6,500 catch-up to your employer plan, contribute the maximum annually in voluntary after-tax dollars – up to $4,000 – given Sarah's income of $30,000.

Convert voluntary after-tax contributions to Roth dollars via either an in-plan Roth conversion, or an in-service distribution to your Roth IRA. Learn more here.

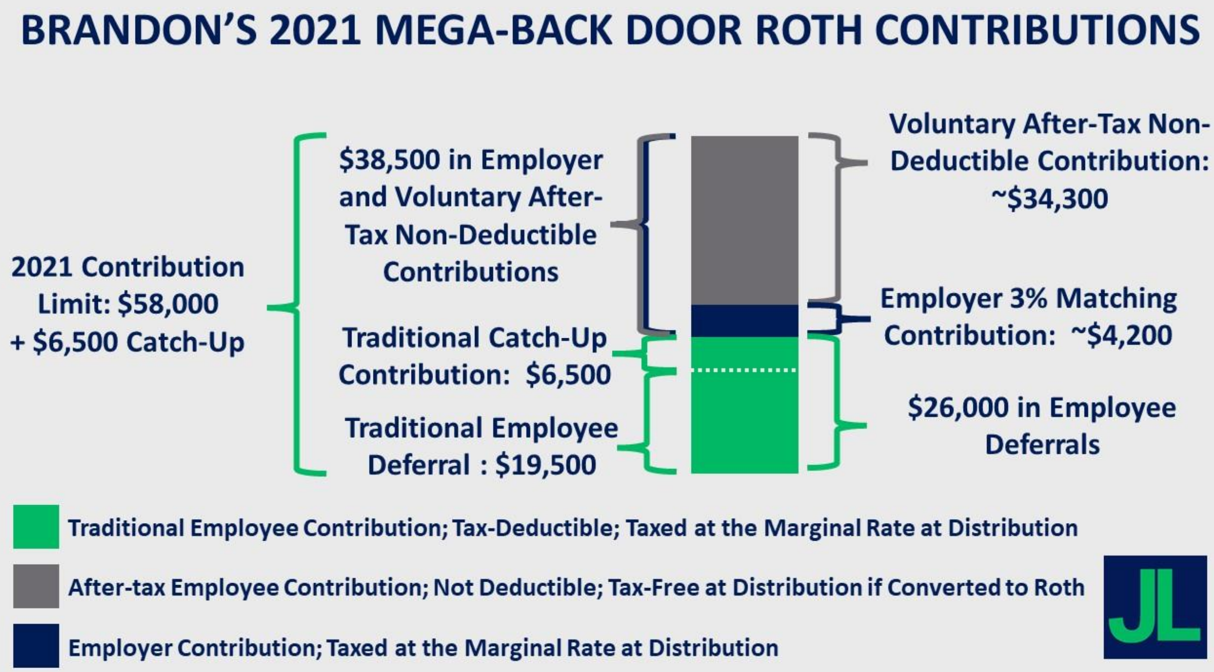
If the second feature (in-plan Roth conversions, or in-service distributions) is not available, making non-deductible voluntary after-tax contributions is still worthwhile. That's because extra contribution dollars:

- provide tax deferral;
- helps keep your income lower for longer for future tax planning, leaving more room in lower tax brackets to make partial Roth conversions and do tax-gain harvesting at the 0% long-term capital gains rate;
- allows you to qualify for other tax credits without hitting phaseouts;
- helps avoid stealth taxes – such as the Social Security tax torpedo; and
- permits more dollars to be converted to Roth dollars tax-free in the future.

SARAH'S 2021 MEGA-BACK DOOR ROTH CONTRIBUTIONS

☐ **BRANDON'S MEGA BACK-DOOR ROTH 401(K):** Brandon should work with his 401(k) plan provider to make mega-back door Roth features available in his 401(k). Learn more here. Then, execute mega back-door Roth contributions annually.

Assuming employer contributions of ~$4,200 annually, Brandon should be able to contribute an *additional* $34,300 to his 401(k) in voluntary after-tax contributions *each* year he will have earned income (this year and next year).



Individual Retirement Arrangement (IRA) Accounts

☐ **BRANDON'S IRA-TO-401(K) TRANSFER AND SUCCESSIVE BACK-DOOR ROTH IRA CONTRIBUTIONS:** Using a back-door Roth IRA allows you to save more money in tax-advantaged accounts. Once Brandon transfers his traditional IRAs and rollover IRAs to his 401(K)s, make back-door Roth IRA contributions.

Brandon transferring his traditional and rollover IRAs to his 401(k) is appropriate in light of the low-cost investment options available in his 401(k) plan.

As discussed on our call, the ability to accept IRA dollars with basis (non-deductible dollars) may not be an existing feature with Brandon's 401(k). Of course, Brandon can work with his retirement plan provider to add this feature – and the feature for mega-back door Roth contributions.

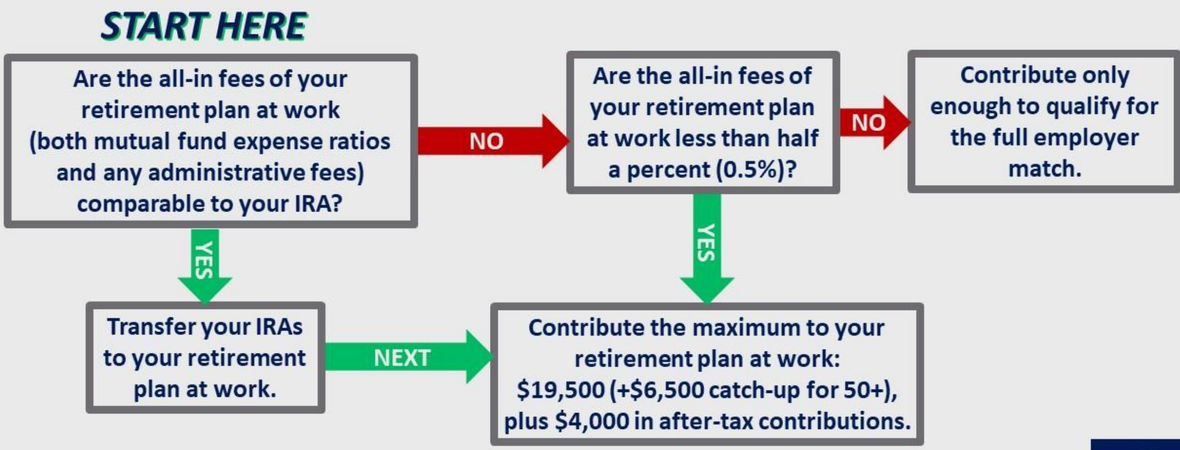
☐ **SARAH'S IRA-TO-401(K) TRANSFER AND SUCCESSIVE BACK-DOOR ROTH IRA CONTRIBUTIONS:** Transfers of IRAs with basis may not be permitted by Sarah's 401(k). If they are, **Sarah should only proceed with a similar plan to Brandon's outlined above *if* the investment options in her 401(k) are low-cost.** If the all-in fees in Sarah's retirement plan are more than the fees she is paying in her IRAs today at Vanguard, do not make this transfer.

Note that a different threshold applies in the decision to transfer Sarah's IRAs to her 401(k) – fees similar to IRAs – than the decision to contribute to her 401(k): less than 0.5%.

To summarize, if the all-in fees (both mutual fund expense ratios *and* any administrative fees that may be charged) for Sarah's 401(k) are:

- comparable to your IRAs at Vanguard:
    - Contribute the maximum to Sarah's 401(k), *and*
    - Transfer Sarah's IRAs to Sarah's 401(k) – if possible.
- 0.5% or less:
    - Contribute the maximum to Sarah's 401(k).
    - Do ***not*** transfer Sarah's IRAs to Sarah's 401(k).
- greater than 0.5%:
    - Contribute only enough to Sarah's 401(k) to qualify for the full employer match.
    - Do ***not*** transfer Sarah's IRAs to Sarah's 401(k).

SARAH'S IRA-TO-401(K) PLAN TRANSFER & CONTRIBUTIONS



☐ **BACK-DOOR ROTH IRA CONTRIBUTION:** Having completed the IRA-to-401(k) transfers above, you can make a back-door Roth IRA contribution *without* generating an extra tax bill.

Each year you have earned income (this year and next), contribute the maximum ($7,000 for 2021) to your now-empty traditional IRA. Then, convert that $7,000 to your Roth IRA. Invest the $7,000 conversion for long-term growth. Do not claim a deduction for this contribution on your tax return.

In your first year doing this, you may wish to leave $1 in your traditional IRA – so that Vanguard does not close what would otherwise be an account with a $0 balance.

To take advantage of future tax planning opportunities, avoid rolling over workplace retirement plans to a traditional/rollover IRA. Learn more here.

If Sarah cannot (or should not, because of high plan fees) transfer her traditional and rollover IRAs into her 401(k), she should continue making non-deductible IRA contributions to her traditional IRA.

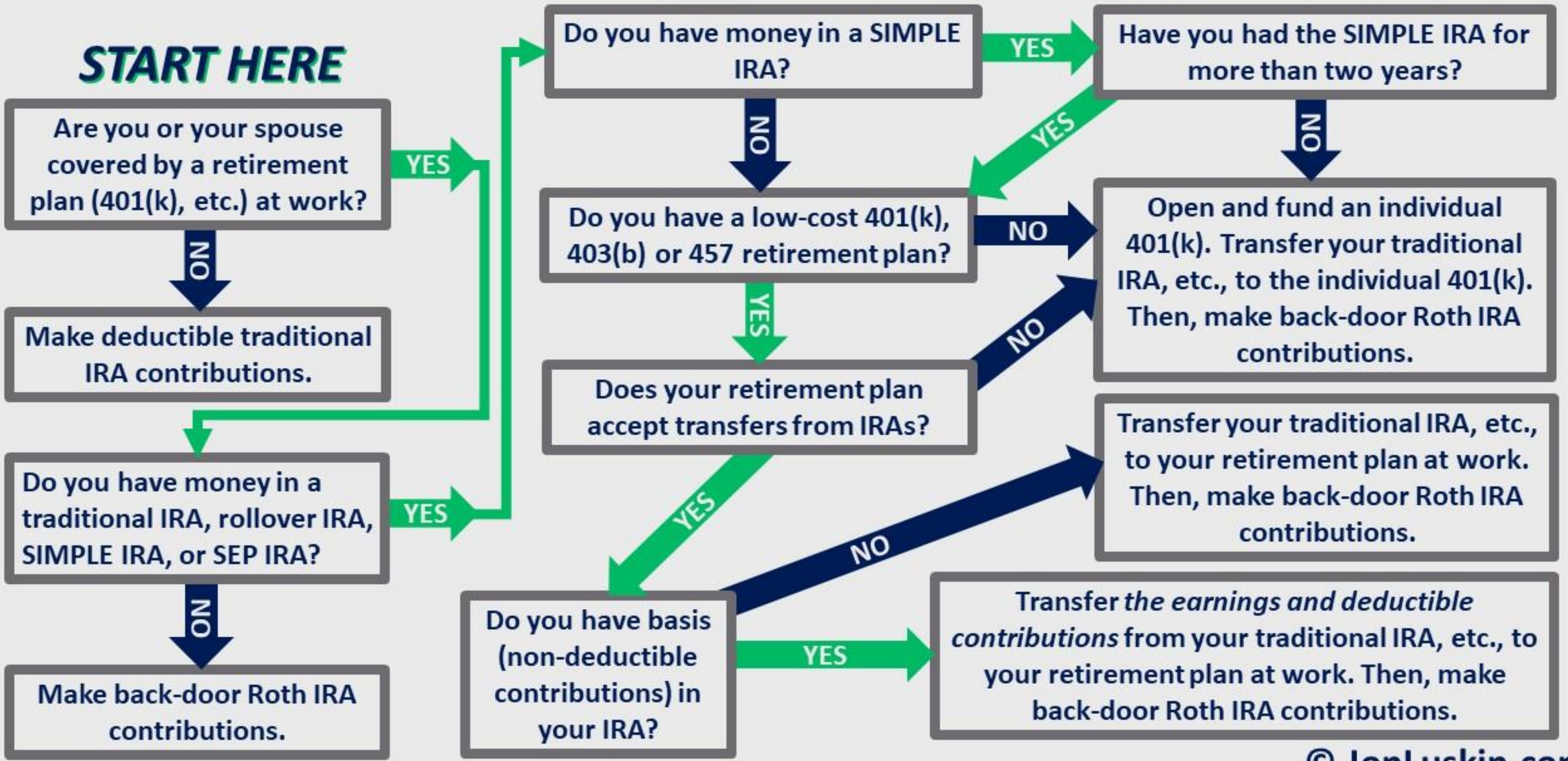
☐ **IN-PLAN ROTH CONVERSIONS OF TRADITIONAL IRA BASIS:** During our call, you estimated that you might have ~$24,000 in basis in Brandon's traditional IRA. *Basis* is the amount of the after-tax dollars contributed to the account, those contributions for which you did not claim a tax deduction.

Once you have transferred Brandon's traditional IRA to Brandon's 401(k), make a Roth conversion of the basis (the after-tax dollars).

If this option is available to Sarah (and she transferred her IRAs to her 401(k)s since the fees in her 401(k) are comparable to her IRA), she should do the same in-plan Roth conversions on the traditional IRA basis.

☐ **SARAH'S INDIVIDUAL 401(K)**: If Sarah cannot (or should not, because of high plan fees), transfer her traditional and rollover IRAs to her 401(k), to an individual 401(k). If so, you'll need to have a tiny amount of legitimate self-employment income (at least $10) for the year, contributing to that individual 401(k). Learn more here and here.

IRA CONTRIBUTIONS FOR HIGH EARNERS



Future Tax Planning

- ☐ **FUTURE PARTIAL ROTH CONVERSIONS & TAX GAIN HARVESTING:** You plan to work this year and next. Therefore, you may expect to be in a lower bracket in three years. In three years, consider doing partial Roth conversions and/or tax-gain harvesting. Learn more here. Consider that strategy annually in the years before you claim Social Security benefits. Learn more here. Work with a financial professional.

Investments

- ☐ **ALLOCATION**: You are currently using Vanguard's low-cost target-date retirement funds (2020 & 2025) to invest. Given your low initial distribution rate (discussed next), this is appropriate. You do not need to make any changes to your investment portfolio.

- ☐ **RETIREMENT DISTRIBUTIONS:** While previous research suggested sustainable distribution rates of 3% over 40 years, more recent research suggests even lower rates over shorter periods: 2.4% over 30 years. You may be able to achieve a higher distribution rate by being flexible with your spending – reducing distributions in the event of market corrections. Learn more here. Lastly, these historic and suggested distribution rates can serve as a guideline, and **not** as a guarantee.

  At a ~2% initial distribution rate (ignoring both the value of Social Security income *and* your business liquidation), this suggests you are on a great track. You do not need to make any lifestyle changes or change your retirement date.

- ☐ **ASSET LOCATION:** To get the most out of the tax-free growth of your Roth and HSA accounts, hold only stock funds in these accounts. You can use the Vanguard Total World Stock ETF (VTWAX/VT). Do not hold bonds or cash in your HSA or Roth accounts. Similarly, do not leave uninvested cash in *any* tax-advantaged investment account, such as a traditional IRA. Put the cash in Sarah's rollover IRA at Vanguard to work – investing in your target-date fund of choice.

Social Security

- ☐ **DELAY FILING RETIREMENT BENEFITS:** Each of you should wait to claim benefits until age 70. Delaying filing for Social Security retirement payments provides more than one benefit. Firstly, this strategy allows you to collect a higher benefit (generating higher lifetime income – assuming above-average life expectancy). Secondly, delaying Social Security is helpful for tax planning (when performing partial Roth conversions and/or tax-gain harvesting). Learn more here.

Liabilities & Home Equity

- ☐ **MORTGAGE DEBT:** Pay off the mortgage of your primary residence. Use the proceeds from your business sale.

  It can make sense for investors with 100% stock allocations to leverage their investment portfolio by not pre-paying their debt. However, for investors with relatively less aggressive allocations (those holding *any* amount of bonds), holding debt means settling for a smaller investment return while bearing the same amount of risk as their 100% stock allocation peers.

Said simply: holding debt while investing in bonds means enduring the same risk for less return. That's why pre-paying debt can make sense for investors who don't have 100% stock allocations. Learn more here.

Estate Planning & Asset Protection

- ☐ **ESTATE DOCUMENTS:** Work with an estate attorney to create Wills, Power of Attorneys, and Advanced Health Care Directives. An estate attorney can help you determine if a trust is the right estate planning tool for your situation.

- ☐ **BENEFICIARY DESIGNATIONS:** Review the beneficiary designations on your investment and retirement accounts and bank accounts to determine if they still reflect your goals.

- ☐ **SIDE LETTER:** Complete a Side Letter of Instruction listing professionals and account login information. Share this information securely with the appropriate parties (trustees, executor, attorneys-in-fact) via a password manager, such as LastPass or 1Password. Alternatively, store a hard copy of this information along with your estate planning documents. You can use this template. Learn more here.

Insurance Planning

- ☐ **LIFE INSURANCE WITH NO DEPENDENTS**: Life insurance can replace the lost income from the death of a loved one. Given your ample savings, and no dependents, you do not need life insurance.

- ☐ **SELF-INSURING DISABILITY INSURANCE:** Disability insurance replaces a part of your income when you cannot work from illness or injury. Given your assets and timeline to retirement, you can self-insure in the event of disability.

- ☐ **SWITCH TO AN HIGH-DEDUCTIBLE HEALTH PLAN (HDHP) AT OPEN ENROLLMENT:** Though Brandon will be eligible for Medicare shortly, Sarah has at least a couple of years to take advantage of an HDHP. Only opt for an HSA-eligible HDHP if it meets your health insurance goals. The lower premiums of an HDHP can save you money. Learn more here.

- ☐ **UMBRELLA INSURANCE INCREASE:** Great job getting a $2MM umbrella insurance policy for yourselves, and another $3MM policy for your business! Umbrella insurance increases the liability coverage of your auto and homeowner's insurance. Increase your business's umbrella policy coverage to $5MM to better protect your assets. Remember to maintain your underlying liability coverages at $300,000 – or the amount required by your umbrella policy – on your various underlying policies (auto insurance, etc.). Make sure this increased coverage amount is per *occurrence*, and *not* just an annual aggregate limit.

- ☐ **HOMEOWNER'S INSURANCE:** To save money, consider increasing the deductible on your homeowner's insurance policy. Learn about optimizing your homeowner's insurance here.
    - "Additional Coverages:" Consider stripping additional coverages to save money via self-insurance, such as jewelry and fur endorsements, and sewer drain back up.

☐ **FLOOD INSURANCE:** A homeowners policy alone won't cover all potential damage to your home. Flood insurance can help protect the value of your home. You may be able to purchase a separate flood insurance policy through the National Flood Insurance Program. If a flood risk is low in your area, then the policy will be relatively inexpensive. This makes insuring your expensive home worth the price.

☐ **EARTHQUAKE:** Purchase Earthquake insurance to protect the value of your home.

☐ **AUTO INSURANCE:** To save money, consider declining Comprehensive & Collision coverage on your automobile policy. You have sufficient assets to self-insure. At the very least, consider raising your deductible to the maximum allowable. Learn more here.

- Underinsured/Uninsured: Opt for the highest Underinsured/Uninsured coverage.
- "Additional Coverages:" Consider stripping additional coverages to save money via self-insurance, such as rental car reimbursement, or windshield glass replacement.

☐ **ROADSIDE ASSISTANCE:** To keep your auto insurance cost lower, only purchase roadside assistance through a provider that is not your automobile insurance company, such as AAA. Using roadside assistance provided by your insurance company may count as an at-fault claim.

☐ **RE-SHOP YOUR POLICIES:** Re-shop property and casualty (auto, homeowners, umbrella) insurance policies at least every three years to ensure you are paying a competitive rate.

Cyber Security

☐ **PASSWORD MANAGER:** Store account logins and other sensitive information in a password manager. Consider LastPass, Dashlane, or 1Password. Learn more here. Do not store your passwords unsecurely, such as with an unencrypted spreadsheet, unencrypted Word document, or written down or printed on paper held outside of a physical safe.

☐ **FREEZE YOUR CREDIT:** To protect against identity theft, freeze your credit with all three credit agencies. Learn more here.

☐ **TWO-FACTOR AUTHENTICATION (2FA):** If available, enable 2FA with the various financial institutions you use: your bank, your investment custodian, for example. Learn more here.

☐ **VIRTUAL PRIVATE NETWORK (VPN):** Install a VPN on all your devices (computer, cell phone, tablet, etc.), especially those you use to access financial accounts. It almost always makes sense to leave your VPN on all the time. Learn more here.

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This covers most of our discussion and a little more. Your spending in light of your savings puts you on a great track. Congratulate yourself on being such great savers.

Your urgent projects are:

- your partially uninsured net worth (solved by increasing umbrella insurance coverage), and

- estate planning documents (solved by working with an estate attorney).

Please send me an email at hello@jonluskin.com if you have any questions.

Good luck!

Best regards,

Jon Luskin, CFP®

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Also, be sure to check out *Bogleheads Live*, where I ask your questions to subject matter experts live. Get the dates and times for the next *Bogleheads® Live* by following the John C. Bogle Center for Financial Literacy (@bogleheads) on Twitter.