Podcast Transcript: What do I do with significant change in Income?

Kim Insley:

Hi. I'm Kim Insley, and I want to thank you for joining us for Navigating Life Transitions, a podcast where we bring together advisors experienced in financial life planning, to talk about ways to navigate life's biggest changes, challenges, opportunities, and decisions. We cover life milestones, everything from growing a family, to losing a loved one, promotions to retirement, marriage to divorce, anything that could benefit from the guidance that a financial advisory team can provide.

And today we're talking about changes in income. Maybe you got a new promotion recently, and with that, a bigger paycheck. Let's hope, right? It's exciting. So now what? Let's find out.

Joining me today are two advisors from JNBA Financial Advisors, serving clients in Minnesota, Florida, and throughout the U.S. and that is Elise Huston and Nick Scheibel, who both work with people who commonly experience changes in their income. Also joining us is their professional colleague, Andy Knutson, who works as a CPA and partner with JAK & Company, certified public accountants in Minneapolis.

Elise Huston:

Yes. I just want to quickly say thank you to Andy for joining us today, just to expand on why we like collaborating with various tax professionals. Really appreciate you being here to add your perspective.

Andrew Knutson:

Thanks for having me.

Kim Insley:

So, one of the first things someone might think about after an increase in income is the tax implication of that, Elise. There's always a tax implication

Elise Huston:

Yeah, that tends to be a common topic of conversation, especially for high-income earners. But when there's a change to income, it's trying to understand, maybe that take home pay that they just got into their account, their bank account was less than they were anticipating because you're withholding some tax on that increased income. But there's also other opportunities to try to think through how to optimize this opportunity further. How do we tax efficiently, continue to build towards future goals, which could include retirement, gifting, and the like?

Kim Insley:

Yeah, and I always think, when I think of taxes, I just think, "Oh, Uncle Sam's going to take a bigger bite out of that." Bigger paycheck, bigger bite, right? So how do I think about that?

Andrew Knutson:

Well, it's important to understand that when you look at the tax brackets, it's more of a ladder. It's not just all of a sudden you jump into a deeper pool. You work your way into it. So, if that next dollar of income puts you in a 24% tax bracket, it's 24% of that dollar. It doesn't change how your dollars were getting taxed before that.

Kim Insley:

Well, that's a little reassuring. It's okay. And then, it's not just the money that you're getting, right, Nick? There are other things that go... This is not my world. I just want to point that out.

Nick Scheibel:

Absolutely, yeah.

Kim Insley:

Stocks and things like that that the bigger bucks people get.

Nick Scheibel:

Yeah. Well, one of the things we see as people get increases to income is they're much more likely to receive some of their income as restricted stock, equity in their company, and there's different tax consequences of that as well. It's a good opportunity to work with a tax professional or a financial advisor just to understand, you don't always get all that money at once. Sometimes it vests over time, and that can have different tax consequences.

And also, withholding is something to think about. We work with clients who, all of a sudden, they've maybe been used to getting a refund because they've been withholding from their paychecks, and now that one of them has a higher income, especially if they're receiving restricted stock, they may not be withholding enough. And that can cause a bit of a surprise. It's not the end of the world, but it is a good opportunity to work with your advisors and your tax professional to make sure. You might want to start making quarterly estimated tax payments or just make sure withholding is sufficient, so you don't get that big surprise in April, enough to come up with the cash.

Kim Insley:

Can I dip into that just a little bit?

Nick Scheibel:

Yeah.

Kim Insley:

Why is it that stock tends to trigger not withholding enough from your company? What's going on there?

Nick Scheibel:

A lot of times when stock vests, that means that net of you own it, and that's taxable to you. Your company will usually withhold some for taxes, so they'll sell some of the stock to pay the taxes. But a lot of times they just do that at a fixed rate for all of their employees. If you're a higher earner. Or if you're in a two-income household, that might not actually be enough to cover the tax you owe. That's where, again, just doing a quarterly estimated payment is often the easiest way to handle it.

Kim Insley:

And it's less paperwork, right?

Andrew Knutson:

Yeah, I think it's good to understand that the withholding system is imperfect. It's based on employees filling out forms to help set up withholding. If you're a married couple, your spouse's income factors into it. And then when you get things like large bonuses, or you get stock compensation-

Kim Insley:

Oh, darn.

Andrew Knutson:

Right, it's the good and the bad, but it changes all of that, and it all factors in. So, you might've filled out that withholding form when you just started, and you haven't changed it for three years, and now your income has tripled. That withholding form is incorrect.

And the withholding is just a starting point. That's a computer's estimate of what your tax will be. When you actually fill out your tax return, that's what your tax is. So, whether you pay or whether you get a refund is the difference between that estimate that the computer calculated and what your actual return has. So quarterly estimates are just balancing that out. If you don't want to change your withholding, and you're working with a tax professional, frankly, it's a lot easier for us to tell you exactly what your tax is going to owe than how to fill out that withholding.

Kim Insley:

Nobody wants to go back to HR to do that, right?

Andrew Knutson:

Right.

Elise Huston:

Well, and Kim too, another thing to mention is oftentimes with this change, the tax you're withholding or that you might owe is just one component of it. In lieu of just thinking about, "Okay, now what else do I need to pay in tax?", there might actually be some strategies, new opportunities that allow you to potentially defer income in a way that you can reduce the tax owed currently.

Kim Insley:

One thing that changes your taxes is if you have an IRA versus a Roth IRA, and when I'm thinking of a Roth IRA, there's a reason in your life circumstance why you would do that as opposed to a regular IRA. So, these are things to think about as well, right?

Andrew Knutson:

Absolutely yeah. Considering the Roth is an after-tax deduction, the traditional is a pre-tax deduction, so if you're in a higher tax bracket, it might make sense to switch if you were doing after-tax withholding to switch to pre-tax withholding to help drop that taxable income amount. There still might be reasons to have some of both, depending on lifetime goals, where your income is projected to end up at retirement, what you want to leave to heirs, children, whoever that may be. Those are all things to factor into it.

Kim Insley:

Nick, I imagine when someone gets a big bump in pay, they immediately turn to, "Ooh, what can I do with this money?" And it's not always feather my nest. Sometimes it's buy the cabin at the lake, right? So how do you work with clients on that?

Nick Scheibel:

Yeah, buy the cabin at the lake is the Minnesota dream.

Kim Insley:

It sure is.

Nick Scheibel:

It's certainly something when people, they see an increase in income, you immediately start thinking about the bucket list. It might be a cabin, it might be an RV, it might be the big trip you've always wanted to take. But one of the things we really want to help people understand is that it's not a one-time expense. You might say, "Hey, I've got this extra money. I got a big bonus." Or even just thinking about a second home. It's like, "Well, I can afford a second mortgage payment." But that comes with additional maintenance costs. That comes with additional property taxes. That comes with a lot of changes to your insurance, and it can really surprise people sometimes.

So, one of the things we like to do, and we've worked with a number of clients on, is just remodeling that. Not remodeling the cabin, that probably comes later. But modeling the cashflow and helping understand, what are the expenses now? What are the expenses in the future? And probably most importantly, how does it affect your long-term retirement plan? Because all of us want to stop working at some point, even if we now have our dream job, and we're making way more money. The goal is you probably have to save that money and eventually get to enjoy all your life at the lake.

So, helping people understand, "How does adding another expense now affect my long-term retirement projections, because my life might actually be a little more expensive than I thought it would ever be. I've been very successful in my career, hit a lot of those milestones." But you start adding, it might be a house, it might be a country club membership, various other things that become long-term expenses, you're not going to give those up when you retire. So, we do need to look at the long-term and how that all fits into your plan.

Kim Insley:

And if your life is getting bigger like that, your ability to retire might change.

Nick Scheibel:

It might. And for some people, and I know we'll talk about this later, retiring early might be a goal, even with this kind of advancement in your career. That might actually say you could retire earlier than you ever thought. But what you spend now and what you expect to spend in retirement will certainly affect that.

Kim Insley:

So early retirement is “the” dream, I think, for a lot of people. How do you start strategizing for that? Because as your pay raises, you can start to think about these other things.

Elise Huston:

Yeah, I think when we start to talk with individuals or couples about retiring early, let's say in your fifties or early sixties, there's a couple of factors that play probably a larger role in the conversation financially. And that really comes down to access to financial resources. How are we going to get you the income you need, replace that paycheck to fund your retirement goals? And then also insurance. But really knowing that if you've been spending a lot of your working life just saving to that 401K, you might not be able to access those accounts if you retire in your early fifties.

Kim Insley:

It's 59 and a half before you can get there?

Elise Huston:

Yeah, most commonly 59 and a half is when you can access those retirement accounts. Sometimes you can get access a little bit earlier, but yes, it is really waiting until most commonly your sixties to access those. So, what other financial resources or other savings should we prioritize and focus on to make sure you have access to those different pools of money?

Kim Insley:

Yeah, a lot of people probably don't think about that when they think about early retirement. And you also mentioned insurance. If you are under the age of 65, you're not going to have that sweet, sweet Medicare, right? Health insurance, Andy, is a big one.

Andrew Knutson:

It is. Sometimes an employee can stay on a little longer on an employer plan or a former employee, but there's lots of subsidies that you could qualify for, or even when you get into Medicare, all those costs though are largely based on your income and your taxable income.

Like Elise mentioned, it's good to have these different buckets of money to be able to pull from, so you can strategically target your taxable income. It sounds crazy, but income taxes is not a lot different than any other home project. The more tools you have, the more likely you're going to get it done. Having, whether it's after-tax dollars, whether it's Roth dollars, whether it's traditional IRA dollars, we kind of touched on potentially if you're a CEO-type level, you may have non-qualified plans, so other non-traditional retirement plan options at an employer, if you've deferred into that, they all have different payouts, different timing. But those are all things and levers that you can pull at different points and try to target taxable income for certain areas or certain times of your life.

Kim Insley:

So, if you're in a position to negotiate a pay raise or negotiate a new job, these are some of the tools you might want to pull into your compensation package, not just, "I want this much every year."

Andrew Knutson:

Absolutely. Yeah, for sure. Tax planning is really just deferring taxes and trying the best option when you're going to have to pay the tax. There's no way out of it. You have got to pay taxes.

Kim Insley:

Because you're going to have to pay.

Andrew Knutson:

You have to pay. If you can defer it to a spot when you've got standard living of maybe is less and your income is lower, you'll save a few percentage points on those dollars. And it could help with other things, like the insurance payments.

Kim Insley:

And some people, when they get additional money, start thinking about how can I put that money to work in other ways to help my community? Charitable giving. What would be your advice for that?

Andrew Knutson:

Yeah. When you're looking at dropping your taxable income, and if you're a traditional W-2 employee, regardless of your income size, there's really only three buckets to pull from, if you look at your itemized deduction possibilities. You've got your state tax deduction, but that's capped at $10,000. It includes property taxes. We live in Minnesota, high income tax state, you're at $10,000.

Then you've got your mortgage interest deduction, that is if you have a home mortgage or a mortgage on a second property, you can take that, but only to certain debt limits. It's capped at... I'm sorry, $750,000 of debt.

Your last one is your charitable deduction bucket, and that's the most flexible. So, if you're charitably inclined, deductions given in a year of high income is going to give you a bigger bang for your buck. One of the things we advise clients to do, and I know JNBA does as well, is potentially use tools like a donor-advised fund where you may bunch deductions. You may look, "I'm going to get a very large bonus this year. I'm going to be at a higher tax bracket than normal. If I throw three years of giving into that donor-advised fund, I'm going to get a big deduction this year, but then I can actually do my giving over a period of time."

Kim Insley:

Oh, interesting. I never thought about that.

Nick Scheibel:

And it's really, we always say taxes are not the reason to give charitably. Most of our clients don't give charitably to save on their taxes. They do it because they're active members of their community, and they want to give back. And particularly, as your income increases, you're more likely to find yourself in a position where you are expected to be a visible member of your community and to give back. And that's not an every three years thing, to Andy's point. It's probably every year. You might be asked to chair the United Way campaign at your work. You might be asked to serve on a charitable board, where there's some expectation that you give charitably. And honestly, you probably just want to give back to the community you're from.

So, we really work with people to help identify those goals, what they want to accomplish with their charitable dollars, and separate the tax piece out, to Andy's point, so that you're getting the best tax benefit for your charitable giving, but also have the resources available to do the giving that you want to do every year.

Kim Insley:

So, plan for that.

Nick Scheibel:

Absolutely.

Kim Insley:

Okay. So, the raise happened, whatever happened, and you're excited to share that, of course, with the loved ones in your life, but don't keep it a secret from your financial advisor.

Nick Scheibel:

Often, when we start working with people is when they've reached a stage in their life where things get more complex. There are more levers to pull. You're starting to see some of those longer-term goals become realities. And what we really think we're able to do as an advisor is lead that team and be the core, be there for you, work with your tax professionals, your legal professionals, your insurance professionals, because a lot more goes into it when you have a higher income and a little more responsibility. But what you often have less of is time. A lot of people we work with probably were doing their own taxes and were managing their own 401K investments and were doing all of those things because that's what you do. But now they have more responsibilities, more income, and far less time to do that. And that's where we really want to make it easy and just lead that team.

Kim Insley:

And it keeps changing. If you have “the” team, you can offload that responsibility.

Elise Huston:

Exactly. I know for us at JNBA, as holistic life planners, that is what we believe our role to be is to help you navigate the changes and challenges that life throws your way as tax laws will likely continue to change, as the environment continues to change, as their own working careers and opportunities continue to change. How can we help position them for success, realize maybe some of those dreams further, but continue to ensure that these new resources, this increase of income is aligning with their values and their goals and helping them to live a much fuller life.

Kim Insley:

I have to ask, when the three of you get these humongous raises, do you at least enjoy them? Or are you immediately back to the spreadsheet? How can I deal with this?

Elise Huston:

Yeah, it's a balancing act. Again, it's a little bit of, "What can I do today?" Maybe there's some conveniences that you've had on the wish list. "I'd love to have somebody come mow the lawn." Or "I'd love to, if I had the resources, I would do this." It's a great opportunity to look for that because, to Nick's point, oftentimes, as you progress through your career and maybe you have kids and activities and your schedule is quite busy, paying for those conveniences can create a lot of joy and satisfaction today. So, it should be a balance. It's a balancing act between saving for your future self but enjoying today and all the hard work that has brought you to this point.

Kim Insley:

Spoken like a mother of two.

Elise Huston:

Yes, exactly.

Kim Insley:

You need those conveniences.

Elise Huston:

Yes.

Kim Insley:

Well, Nick, Elise, and Andy, I want to thank you. Those of you who know and understand taxes, my hat is off to you because that has never been my realm.

We hope that you'll tune into our other Navigating Life Transitions podcasts and help yourself to all the free resources on JNBA's website, which is jnba.com. If you have questions about any changes to your income, or you just want to learn more about how JNBA can help you with your financial life goals, give them a call, 952-844-0995, or use the contact form on jnba.com to schedule a complimentary, no-obligation call with their experienced and multi-generational team.

Thank you for listening. I'm Kim Insley, and I look forward to navigating more life transitions with you on our next podcast.

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