SHOULD I PAY DOWN MY DEBT?

A 2020 study by Experian shows the average Boomer has $97,290 in debt. As Boomers head into retirement, the question becomes should they be paying that debt off? Well, the safest answer is: it depends. That's a cute answer, but what does it depend on?

The first thing to consider is the type of debt. Any high interest debt is definitely something that should be paid down. The most common example of this is credit card debt. The same Experian study showed Baby Boomers have on average $6,043 in credit card debt. Boomers are the second largest age group, with Generation X topping the list at $7,155. If you carry credit card debt, it should be the highest priority in paying off.   Credit cards are likely to have high interest rates and you typically don't have anything to show for the debt. On the contrary, with a mortgage at least you have a house as an asset for the loan. Credit card debt can come from any number of things such as medical bills, unexpected car expenses or home repairs, but the pizza you purchased has long been digested before the balance is paid off.

You might be surprised to learn Boomers have significant student loan debt; on average, $40,512. Presumably this isn't their student loan debt but what they cosigned for their children or grandchildren. The best advice for this kind of debt is to lovingly force the student to take responsibility for the debt. Help them construct a budget, help them find a better job, and refinance the debt out of your name. If you don't see that as an option look at paying it down yourself before retirement. Stay tuned for our next newsletter where we will discuss whether you should co-sign in the first place!

Many financial gurus consider auto loan debt as "acceptable" debt. Why use cash or investable assets as a way to buy a car outright? Interest rates are low and in some cases 0%. Historically, the market have perform better than that, so keep your money invested! With comprehensive financial planning software we can show you whether it makes sense to keep the payment, accelerate debt reduction, or take out a lump sum to purchase. There is no one size fits all approach, as each situation and person is different. Not having any debt can provide a sense of freedom. Sometimes people may find themselves broke and struggling to make car payments each month. This may scare some and make them not want to enter retirement with an auto payment. However, it is not uncommon for financial planners to have opposing views. Some may assume a client will always have a car payment. There are lots of people who will pay off a car and immediately go out and purchase a new one on credit. That is beauty of financial planning. No matter your preference, we can provide you with the best advice for your unique situation.

Debt for each generation may not always look different. For example, when you look at auto loan debt by generation, the amount didn't vary. The average for Boomers was $19,306. The highest auto loan debt was carried by Generation X at $22,307 and the lowest by the Silent Generation at $14,750. This shows people do carry auto loan debt, and they do so for their whole lives.

The last type of debt this article will address is mortgage debt. According to Experian, 44% of homeowners have mortgages. Of those 44%, the Boomer's average balance is $178,688. This is a hot button issue for financial planners. The interest you pay on your home loan is tax deductible on the first $750,000 borrowed if you itemize. Many argue that it's okay to pay mortgage interest because you get a tax deduction. However, some argue many people lost the ability to itemize after the income tax overhaul under the Tax Cuts and Jobs Act (TCJA) in 2017. Under TCJA, a married couple's standard deduction went from $13,000 to $24,000. In 2022, the standard deduction for a married couple is $25,900. That means you need more than $25,900 in itemized deductions before you can claim the mortgage interest deduction. Some examples of itemized deductions are charitable contributions, medical expenses, other taxes, and mortgage interest. The Tax Foundation did a study and found on average 31.1% of people itemized their deductions before the tax changes. In 2019, the percent of people claiming itemized deductions fell to 13.7%. Less than half the people who itemized before are itemizing now.

One way for those closest to retirement consider paying off debt is by using their accumulated investments. Maybe they inherited money or perhaps they are looking at their 401(k) balance. As we see it, there are two main concerns when using investments to pay off debt. The first is taxes. However, before taking a deeper dive into taxes it is important to take into consideration capital gains. The IRS wants to encourage people to invest in the stock market. One of the ways to do this is by reducing the tax rate for those making money from investments gaining in value, hence the label capital gains. Depending on how you've accumulated the assets, capital gains could be large or small. If you inherited assets, the capital gains tax might not be much depending on how long ago the asset was inherited. If you saved the money in a non-retirement account over the years, the capital gains could be much higher depending on your initial investment amount and current value.

If instead of using non-retirement assets to pay down debt you consider pulling money from your traditional IRA or 401(k), you are taxed at your higher ordinary income tax rate. This can become especially painful if you are considering paying off the average mortgage balance of $178,688. At a minimum you would add approximately $178,000 to your income for that year and the amount you withdraw will likely be higher because you have to also withdraw money to pay the income tax. Yikes! Now, let's put some dollars and cents to this situation.

If you and your spouse file married filing jointly and made $150,000 from your salaries, you would be placed in the 22% tax bracket before considering the mortgage payoff. Adding another $178,000 to your income will bump you up a tax bracket to 24%. So you would need to make sure you withhold 24% tax on the withdrawal. Which means you would need to withdraw more than $234,000 to pay both the 24% tax as well as the $178,000 mortgage payoff. For those of you not fond of math, that is a $56,000 cost to pay off your mortgage from a 401(k). If we took this same amount from a non-retirement account the tax and investment withdrawal are less. If over the years you put $125,000 in a non-retirement account and it is now worth $190,000, you would have $65,000 in capital gains. If use the same assumptions as above, a couple who file married filing jointly wtih $150,000 in salaries, you would pay 15% tax on the $65,000 gain, or $9,750. You can see there is a huge difference; $56,000 in taxes or $9,750! You would have to pull $234,000 from a retirement account or $190,000 from a non-retirement account to pay off your mortgage. It is important to note these are appoximate numbers used to illustrate the difference in methods. If you want to know how this would apply to your individual situation, reach out to the team at James Investment as this is one of the many services we provide to our clients.

Enough about taxes. The other reason you might not want to withdraw money from your investments is lost returns. If you were to pull $234,000 from your 401(k) it is no longer invested in the market. You would be sacrificing the growth the market provides. Now, some may be thinking that the market doesn't always go straight up. You are right. If the market goes down after you pull out the money you were lucky and didn't suffer those losses. However, one thing to know about investing is there are days the market will go up and there are days the market will go down. Historically though, the stock market advances, especially over long periods of time. The market generally returns a higher percentange than the interest rate on most mortgages.

One of the best parts of working with a financial planner is their expertise in this area. At James we can look at the impact on your finances if you pay off the debt or keep the money invested, or we may be able to suggest other ways to use the money you were thinking of putting towards your mortgage. Perhaps the extra money is better used making contributions to a retirement account. With professional guidance there may be more strategic ways to use those extra dollars, which are generally only suggested after a comprehensive review of your specific situation and analyzing the numbers.   Whether you want a simple payoff strategy or a strategic way to use debt to your advantage, we have the tools and expertise to help you!

Sources: Experian & Tax Foundation