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The Two Faces of Debt

Understanding Good Versus Bad Debt Can Help You Make Smart Financial Moves

Credit card debt is a huge challenge for many people. According to Debt.org, Americans owe $986 billion on credit cards, surpassing the prepandemic high of $927 billion. While credit card debt is considered "bad debt," it's important to understand other types of debt and the important role it can play in your financial plan.

Good Debt: A Building Block for Growing Your Wealth

Good debt refers to borrowing money for investments that have the potential to grow in value or provide future benefits. It focuses on investments that enhance your financial position in the long run. For example:

- Taking out a loan to finance your education can increase your earning potential and open up career opportunities.
- Using a mortgage for a reasonably priced home can help equity and provide shelter.
- Taking a loan to buy a used car in great shape that enables you to get to and from work. However, going into debt on a luxury vehicle is going to be mostly bad debt.
- Getting a home equity loan to do repairs or upgrades on your residence.

Bad Debt: A Stumbling Block To Achieving Your Financial Goals

Bad debt involves borrowing money for purchases that quickly lose value or do not generate income. Credit card debt that piles up from impulsive shopping sprees or luxury vacations falls into this category.

Whether you are considering good debt or bad debt, you want to be wise about your borrowing practices. Here are some key rules to follow when borrowing responsibly:

Necessity. Evaluate whether the debt is for an essential need or an investment that will improve your financial situation in the long run.

Affordability. Avoid taking on debt that stretches your finances to the breaking point. You may want to evaluate your debt-to-income ratio:

- The debt-to-income ratio compares an individual's monthly debt payment to their monthly gross income.
- According to Investopedia, 43% is the highest debt-to-income ratio a borrower can have and still qualify for a mortgage.
- Lenders prefer a debt-to-income ratio lower than 36%.

Research and Compare. It's a good idea to shop around for the best loan terms. Compare interest rates, fees and repayment terms from different lenders or financial institutions to secure the most favorable terms and save money in the long run.

Repayment. Stay on top of your repayment obligations and make payments on time. Late payments can lead to additional fees, higher interest rates and a negative impact on your credit score.

Communication. If you're facing financial difficulties or anticipate challenges in making payments, reach out to your lenders proactively. They may offer assistance, such as revised repayment plans or hardship programs.

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Maximizing Your Retirement Income

Doing Some Tax Planning Now Can Pay Off Later in Retirement

For many people, retirement is not a time to slow down and stop. It's a time to explore the next great chapters of your life and build upon everything you've learned and experienced so far. Another thing that doesn't slow down or stop is taxes. Understanding how taxes could affect your future cash flow will help you create an effective retirement income strategy.

Know How Your Retirement Savings Accounts Are Taxed

Withdrawals from traditional 401(k) plan accounts and certain other employer-sponsored plans, as well as traditional individual retirement accounts (IRAs), will generally be subject to federal and state ordinary income taxes upon withdrawal. On the other hand, contributions to a designated Roth 401(k) account or Roth IRA are federally tax-free when you withdraw those funds, as are the earnings, assuming the withdrawal is a qualified distribution, which generally means it is made after a five-year waiting period and the account owner is 59½ years or older.

As for your nonretirement accounts, bond income and some of the dividends you receive from stocks and mutual funds may be taxed at your federal ordinary income rate, but qualified dividends and long-term investment gains are generally taxed at lower long-term capital gains rates. State and local tax treatment may vary.

It's prudent to consult with an advisor or tax professional regarding retirement income and tax planning strategies.

Develop a Thoughtful Distribution Strategy

For some people, it will make sense to consider tapping taxable accounts first, then tax-deferred. But, depending on the circumstances, this order may not be right for every person. If most of your investment gains are from long-term assets held outside of a traditional 401(k), IRA or other similar tax-deferred accounts, you'll likely pay long-term capital gains taxes, which are generally lower than what you pay on distributions taxed as ordinary income from your tax-deferred retirement accounts.

You'll also need to consider the impact of your retirement savings on your taxes once you reach age 73 (or age 75 after 2032). That's when you must begin taking required minimum distributions (RMDs) from some of your retirement accounts, which is likely to boost your taxable income.

Avoid Moves That Could Put You in a Higher Tax Bracket

RMDs and other changes that bump up your income can result in what's called "bracket creep," which is unintentionally slipping into a higher tax bracket. For example, you might receive an inheritance or sell some real estate. You might also slip into a higher tax bracket by taking a large distribution from a taxable account to renovate your home or buy a new car. A higher income can also affect the taxability of your Social Security benefits and increase your Medicare premiums.

This is one reason you may want to consider funding different kinds of retirement accounts during your working years. For instance, you could diversify your retirement contributions and split them between a Roth and traditional (pretax) allocation. During retirement, you can manage the amount of taxable income you receive and make adjustments when necessary. You can also pay for qualified medical expenses during retirement with any health savings account savings you may have. Those qualified withdrawals are tax-free and won't affect your taxable income.

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