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EDITORIAL & OPINION

A tax delayed is often a tax that is higher

WEALTH MANAGEMENT

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What if everything you believed about saving up a retirement fund was actually wrong? Your company offers you a retirement program and encourages you to take advantage of it. All the other employees are doing it. It must be right. What else would you do anyway?

Let's look at some real numbers to see just what the problem is. If Sandy were to contribute only $200 a month into a retirement account over a 30-year period, she would have contributed $72,000. If we project an 8% growth rate into the future, that $72,000 would have grown into a whopping $298,072–a 314% total return!

If Sandy had been contributing to a tax-qualified retirement plan she would have delayed (not saved) the tax on her $72,000 contribution. Generally speaking, wage earners' net taxable income will be lowest in the early years of their career, not just because they are earning less, but also because they generally have the most tax deductions (the two major deductions being mortgage interest and children in the home.) So even for fairly high income earners, their net tax rate might end up being as low as 15-20% due to the effect of itemized write-offs.

So let's calculate the current tax delay for Sandy's $72,000 contribution, using a 20% net tax rate, just to be conservative. Twenty percent of $72,000 is a total tax deferral of $14,400 during all the accumulation years.

Well now, that's not bad. We would all like to save $14,400. But let's not forget, that tax was never saved; it was just delayed.

As mentioned, if we apply an 8% growth rate to her savings, Sandy would end up with around $298,072 in her retirement account. Though we don't know what tax rate Sandy can expect to pay at retirement, we do know that, in retirement, she has likely lost her primary tax deductions of mortgage interest and dependents.

Before we look at the probable tax picture Sandy will face in retirement, we need to make an assumption; we need to guess what her net tax rate will be in retirement. For simplicity, let's be generous and assume the same low net tax rate of only 20% in retirement. If we apply that rate to the total balance of the tax-qualified plan, you get a whopping tax liability of $59,614. Ouch! That doesn't sound very appealing. So much for the benefits of the $14,400 tax deferral. That deferral just cost Sandy over four times more in actual taxes to be paid over the life of withdrawals from her account. And the death-tax picture is even worse.

The reality, however, is that the net tax rate in retirement will often be higher than the net tax during the accumulation years, even if an individual's gross income is exactly the same, or even less. Again, this is due to the loss of some key tax write-offs that were available before. Realistically, Sandy's combined net tax rate could easily be 30% to 40%, especially if she lives in a state with a moderately high state income tax. If the net tax rate was 30%, then the total tax liability would be $89,422 instead of the $59,614. At 40%, the tax liability jumps to $119,229.

Would any of us really trade $59,614, $89,422, or $119,229 for a delay of paying a small $14,400? No, of course not! But, unfortunately, that is what millions of Americans are doing every day as they contribute to their tax-qualified plans. And remember, these numbers are based on the small savings of only $200 per month. If a person were to save $2,000 per month, or more, as allowed by most tax-qualified plans (for a married couple), then the problem becomes ten times worse. That appealing deduction on taxes today might end up costing $596,140, $894,220, $1,192,290, or more.

What people fail to realize is that tax-qualified plans do not avoid tax, they simply delay tax. And by delaying tax, these plans compound tax, making the tax burden worse–much, much worse. Think about it like this: if you were to be taxed on your garden in some way, and you had a choice, would you rather pay tax on the seed or on the harvest?

Step back for a minute and consider whose retirement you are planning. Is there any question why the government promotes tax-qualified programs? Uncle Sam is building his retirement at your expense. What's the alternative? Keep reading my columns here in the Business Journal, I'll be sharing some ideas with you.

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