WHAT'S HOT?

- A 401(k) can cost you extra taxes in the long run.
- Why plan to be poor when you can plan to be rich?
- Tax later or tax never ... which plan would you prefer?

A 401(k) can cost you extra taxes in the long run

A 401(k) works by deferring the taxes that you pay. Every dollar that you put into your 401(k) is before-tax money, meaning that you deduct it from your income before you calculate how much tax you owe. That money is then invested into mutual funds and other stocks, where hopefully it will appreciate over time. Eventually, you hope that it will appreciate into a substantial fund for your retirement.

But what happens when you try to draw that income out of your 401(k)? All of that deferred tax catches up to you. You pay tax on every dollar that you take out – those that you invested and those that were created through appreciation. Even worse, you'll be paying that tax at the highest possible tax rate!

The IRS has three defined categories of income. The first is earned income, which is income you work for; the second is portfolio income, where your money works for you; and the third is passive income, where your business or real estate works for you. Each of those categories is taxed differently, with earned income being taxed at the highest rate – which can be as high as thirty-five percent! Portfolio income pays tax at a maximum rate of fifteen percent. Best of all is passive income, because if it's set up properly, it isn't taxed at all. So, think about this for a minute. The appreciation on your 401(k) plan, which should really be considered portfolio income and taxed at fifteen percent, is instead going to be treated as earned income and taxed at a much higher rate!

Here's something else to think about – what if earned income tax rates increase in the future? You might wind up paying a higher earned income rate when you take taxes out than you would have paid when you put them in.

Given all that, why would you want to use a 401(k) as your main retirement savings tool? You're planning for your future, not the government's!

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Why plan to be poor when you can plan to be rich?

Another reason I don't like 401(k) plans as a retirement planning tool is that they are set up under the assumption that your standard of living is going to go down after you retire – and that you will live on less income than you do now. You see, a 401(k) plan is only as valuable as the stocks it has invested in. A radical change in the market conditions can send plan values plunging; leaving you with considerably less income than you had planned – and that's before the IRS takes taxes out.

How many stories have you read in the newspaper about people who had their life savings invested in Enron, WorldCom or Adelphia and watched their retirement dreams evaporate as each company imploded? In many instances, the employee 401(k) plan had a matching provision, where the company would match each employee's contributions – as long 100 percent of those contributions went to purchasing company stock. That left employees with dangerously undiversified 401(k) portfolios, which couldn't survive the drop in value of the company's stock. Employees wound up losing – big.

Real estate, on the other hand, doesn't work that way! Real estate values have and will continue to increase – they have to. There is only so much land to be had and the population of America is continuing to rise as well. At the end of the day, everybody has to live somewhere. Logically then, real estate cannot be subject to the same fluctuations that the stock market can. Besides, when was the last time you saw the real estate market devalue by as much as 78 percent?

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