MATHENY
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leading by example

Dear Friends,

This article is about your Qualified Plan- The Grand Illusion

IRAs, SEPs, Keogh's, 401(k)s, defined benefit plans and profit-sharing plans are all IRS/Government-sponsored retirement schemes that "pretend" to save you taxes. The operative word here is "pretend" because the purported savings are an illusion.

This illusion is then propagated by short-sighted, micro-thinkers who say, "Invest your money in a qualified plan to save 30 to 40% of your contribution in taxes this year." After closer analysis of the true long-term cost of this approach, why so many accountants and attorneys recommend these plans is beyond rational thought. They have obviously not thought about the shortfalls, inefficiencies and destructiveness of this financial strategy as they are so often the not so bright soldiers of the financial institutions that gain tremendously from the influx of pre-tax dollars these plans create.

Are you thinking micro or macro when it comes to qualified plans? Macro-thinking says structure your contributions, look at all the pieces and players in your financial plan and create more wealth by eliminating, rather than deferring the lions-share of the tax.

Outrageous Still Sells

Ask yourself this question, "Would I still contribute to a 401(k) or other qualified tax-deferred scheme if I knew the IRS/Government was going to get back 10 to 20 times more than it gave me in benefits?" Your answer is undoubtedly a resounding "NO!", yet a macro-thinker will discover that this is the case.

Now it is time to put on your critical thinking cap.

Why do you think the government created tax-deferred plans? If the purpose of the IRS/Government is to collect as much tax as they possibly can, then do you actually believe that they will volunteer to fore-go the collection of immediate tax revenue out of the kindness of their heart? While these plans do "encourage" Americans to save for retirement it behooves us to remember the IRS/Government has unilaterally"negotiated" this arrangement. What at first glance appears to be a win-win, positions them to become the ultimate benefactors of your tax-deferred plan to the tune of 10 to 20 times what they gave you. Say it isn't so!

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Unraveling the Grand Illusion

There is no better way to dispel disbelief than to spell things out in cold, hard numbers.

Let's go through a small illustration and assume the following:

- You are 35 years old.
- You begin contributing $40,000 annually to a 401(k)/PROFIT SHARING plan.
- You are going to continue your contributions for 30 years until you are age 65.
- You have a combined 41% tax rate (6% state and 35% federal) on the dollars going into this plan

With these assumptions you are looking at an annual tax savings of $16,400 each year ($40,000 x 41% = $16,400). Over a 30 year period of time, you will have contributed a combined total of $1,200,000 and you will have saved $492,000 in taxes.

Now Watch Your Money Grow... Then Disappear

At this point let's assume:

- Your 401(k) compounds at 10% per year in a well-managed portfolio

Over 30 years your total $1,200,000 in contributions has grown to $7,237,737 assuming a consistent 10% rate of return.

Not bad! You have worked hard so it is now time to have a little (conservative) fun. To finance your adventures you decide to withdraw the interest only that is being generated by your 401(k), an amount of $723,773 annually ($7,237,737 x 10% = $723,773).

Special Note: This $723,773 has not yet been taxed and will be taxed at the prevailing tax rate at the time. At this writing it's anyone's guess what that rate might be but it is highly unlikely it will be less than what it is right now. Especially as we watch our government accumulate debt at a record rate.

For our illustration we'll be conservative and use our original assumed 41% federal and state tax. Therefore, in your first year of taking distributions you'll pay $296,746 in taxes.

Now take a moment to recall the $492,000 of tax-deferred savings the government so graciously gave you over a 30 year time frame, as you funded your plan. Note: Once you begin distributions the government will recoup $593,492 in only two years. More than $100,000 over the amount you saved by deferring the tax!

Now this wouldn't be such a negative thing if you were to depart this planet after the second year, since taxes would be of little concern to you at that point. Then again, the $7,237,737 you have left in your 401(k) wouldn't matter much either so for the sake of our illustration we are going to make one more assumption:

- You take the interest-only distributions of $723,773 for 20 years.

This results in taxes being paid to the IRS/Government of $5,934,920!

This is more than 10 times the temporary benefit the government gave you!

Are you feeling those little knots in a pit of your stomach yet? Could it get any worse? Well, the price tag gets even bigger!

Continuing with the assumption that you are taking your distributions for 20 years and live to age 85, when you depart this earth there will still be $7,237,737 left in the pot.

So at that point we would assume you that would like to leave that remaining asset to your heirs or to the charities of your choice. However, someone still has their hand in your pocket and the IRS/Government becomes the biggest benefactor again!

Here's what they get, from the $7,237,737 they take an ADDITIONAL $5,240,000, an amount comprised of state, federal income tax and estate tax.

When you add this amount to the $5,934,920 they have already collected, the IRS/Government has traded $492,000 of temporarily "lost" tax revenues for $11,175,066. In other words, you have paid 22 times what you originally saved in taxes!

Combined 30 year 401(k) contribution $1,200,000
30 year tax deferral (41% combined tax rate) $492,000
401(k) value end of year 30 (10% compounding) $7,237,737
Annual distribution at retirement (interest only) $723,773
Annual tax on distributed amount $296,746
20 year combined taxes on distributions $5,934,920
Tax due on 401(k) remaining in estate $5,240,000
Total taxes collected by IRS/Government on 401(k) $11,175,066

<u>More Disturbing News</u>

Did you know that in the early 90s, a proposed bill was put before Congress that would tax all qualified plans and extract 15% of their current value? In other words, since tax had not yet been paid on the money, the government has the power to dictate how the money is to be taxed. Fortunately the bill did not pass. Nevertheless, the IRS/Government is still in the driver's seat and we may soon find that tomorrow's laws are very different and less favorable than today's. Since 401(k) money is not accessible until age 59 ½ (without a steep penalty) the ability to quickly move funds is not a viable option. Should the political climate change your 401(k) is at the mercy of the government policymakers.

The Bottom Line

The macro-thinker looks beyond conventional financial "wisdom" and explores creative, intelligent approaches designed to accelerate long-term wealth. The immediate tax-savings offered by qualified plans are enticing to the masses but the macro-thinker always looks at the big picture and when possible uses financial engineering to generate an infinitely more favorable outcome. Such financial technology is at our disposal, but only a handful will stray from the cookie-cutter financial fare offered to the population at large. Of course, if your objective is to provide wealth for the IRS/Government rather than yourself and your family, by all means continue funding tax-deferred plans.

I encourage you to pick up the phone and find out how you can enjoy the powerful benefits of the strategies our clients are counting on right now for a secure and happy retirement. I look forward to helping you.

Sincerely,

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