Qualified Plan Questions (401k, IRA, SEP, Pension, etc.)

1. Are qualified plans meant for everyone?
2. Is a qualified plan a tax savings event?
3. Are taxes going to be higher or lower in the future?
4. What are the two guarantees in a qualified plan?
5. When do you want to take money out of a qualified plan?
6. When you signed up for your qualified plan, did you check the 30% or 40% guaranteed loss box?
7. If I could tell you the exact day your qualified plan would suffer its greatest loss, would you want to know that day?
8. What are the guarantees that the government receives in a qualified plan?
9. Do you have a 401(k) or 401(g)?
10. Are you penalized and taxed for early withdrawals?

You may be surprised at some of the answers to these questions. *If something you thought was true turned out not to be true, when would you want to know?*

Answers

1. NO
2. NO, you postpone the taxes and the tax calculation (see explanation below).
3. HIGHER, based on demographics and what is going on with the government there is no escaping their going up.
4. You are the only one at risk and that it will be taxed.
5. When taxes are at their lowest.
6. It depends on the tax rate when you start withdrawing the money.
7. It is the day you start withdrawing the money – it will be taxed.
8. They will get their share (taxes), they have no risk and they contribute nothing.
9. Are you funding your plan or the governments?
10. YES. You will be taxed anyway, but at what rate? It may be less expensive to take the money out early rather than paying a higher tax rate in the future.

Of all of the questions above, #2 seems to be the one that confuses people the most. Why? Because we have been indoctrinated into thinking that these qualified plans save taxes. But do they?

Let's look at an example of a 45 year-old person who was told they should have an IRA so they could generate tax savings. The question was this: If a 45 year-old person, in a 28% tax bracket that qualified for an IRA put $2,000 into an IRA, what would the tax savings be for that person? (I know the amount that can be deposited into IRAs has changed, just bear with me for the sake of the example). The answer is $560 ($2,000 x 28%). Is this savings real or imagined? That is the question.

By simply using the Rule of 72, at a 10% rate of return the money would double about every seven years (remember, this is just an example). If this person could invest the $560 tax savings, what would that look like, assuming he could get a 10% rate of return on that money. We will use this rule for both the IRA funds and the savings. The IRA will grow to $16,000 and the savings to $4,480

Age	IRA Growth at 10%	Tax savings growth at 10%
45	$2,000	$ 560
52	$4,000	$1,120
59	$8,000	$2,240
66	$16,000	$4,480

Now this person turns 66 years old and wishes to withdraw the $16,000. Miraculously, they are still in a 28% tax bracket at the time of withdrawal. His accountant reminds him that he has to pay taxes on it at withdrawal. Interestingly, the tax due on that $16,000 withdrawn is $4,480. Exactly what we thought was saved in the tax savings account. Where is the tax savings? To make matters worse, there is another problem: Capital gains on the tax savings account.

Over the 21 years of saving in my example, $784 had to be paid in capital gains taxes. This lowers the tax savings account to $3,696. Now this person had a tax due of $4,480 and had only $3,696 to pay the tax. Where is the tax savings?

If you understand the demographics of the country, you will come to the conclusion that you will very likely retire to a higher tax bracket. Look what happens to the apparent savings now:

Capital Gains Tax -$ 784

Savings after tax $3,696

Tax due at withdrawal:
28% tax bracket= $4,480
35% tax bracket= $5,600
40% tax bracket= $6,400

Hocus Pocus, Poof! The tax savings disappears! So I ask you, "Where is the tax savings?" This is a very simple example, but if you did the same type math with your qualified plan I think you would see that it doesn't save taxes, it only postpones them to a later date when taxes could be higher. Unfortunately, the government gets to decide the rate.

This can be even more devastating for people just coming out of college since they are probably in the lowest tax bracket and have to wait the longest to get at their money without penalty.

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