Retirement Tax Traps

#1: The Tax Trap – Deduct Now, Pay Later

What I'm going to write is similar to what I recorded in my video on our Facebook page at www.facebook.com/insurance.az but it worth repeating…

We are a nation of Now. What I mean by that is we tend to focus on the Now instead of the future – especially when it comes to our retirement. Worry about it later, it's a long way off, I have lots of time. Heard it before? Said it yourself?

Uncle Sam is more than happy for that mentality. Why? Because they know that the majority of money in your retirement is not going to be your cost basis, that is that cash that you put in, but the earnings. They are more than happy to wait to tax you on the crop instead of the seed.

Let's look at some real numbers as an example. In 2011, according to Wikipedia, the average US income was just over $31,000/year. Joe Investor has a company retirement plan, or 401k, and they are contributing $100 per paycheck or $200 per month over a 30 year accumulation period.

$2400/year, 6%/year return for argument purposes, over 30 years = $201,000

But, this money was invested in a qualified account. That means that you are allowed to "Deduct" that amount from your taxes. Other types of qualified accounts are IRA's, 403b's, 457's, SEP's, SIMPLE's, HR10's or Keogh's.

To keep the math simple, let's assume that Joe Investor is in a 20% tax bracket during their accumulation years as well as their distribution or retirement years. Why do I say this? It's because that while we are investing or accumulating our retirement, we typically have the two biggest write-offs that we will ever have – our home and our children. So, when we are in retirement, we may have less income, but we also have lost those two deductions. I don't think many people in their 60's want to have more kids, do you? We invested $2400/year for 30 years or $72,000. We received a tax deduction of 20% of that or $14,400. Not too shabby…maybe.

Now let's look at your distribution years. Remember that you received a total deduction of just over $14,000 and because you received that deduction you now have to pay the taxes based on your tax bracket in your distribution years. Again, to keep it simple you are in a 20% tax bracket because of the kids and your home. Twenty percent of your total accumulated amount or $201,000. I'm sure you have already done the math in your head to figure out that it works out to be over $40,000. Was the 'Now' deduction of $14,000 worth the end result of over $40,000? Probably not. But, this is what we do every day. We spend our lives accumulating as much money as possible so we can have a comfortable retirement only to give a good chunk of it back to the government. It just doesn't seem right, does it?

Is it time to re-think where you are investing your hard-earned money?