WHY DO WE PAY MORE THAN WE SHOULD?

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Tax deferral in one's 401ks and retirement savings are often a case of "out of sight, out of mind". Automated savings is understandably easy to do but, as always, there's often a critical catch: will your nest egg be worth what it should be in real, spendable, after tax dollars when you need it?

It happens to the best and even the most educated of us. We were recently referred an Ivy League educated client who was diligent in her savings and keeping to a plan. When she talked about having a goal of X dollars for her annual retirement income, she came in for a reality adjustment when she realized that her actual income was $X minus taxes.

Baby boomers began the move to retirement in 2008. Their numbers are growing dramatically each year with an estimated 10,000 boomers retiring every day. Many are realizing their retirement plans need readjusting in part because (1) they didn't save enough and (2) they come to realize that tax deferral on savings was only deferred by kicking a can down the road to an eventual tax bill. They then realize the can can't be kicked any further when they are forced, either for lifestyle expenses or IRS rules that require taxable distributions, to pay what is due.

The math is simple: if most of one's savings are tied up in tax deferral plans – the traditional IRA or $401(k) vehicles – boomers will now pay income taxes on that income withdrawn. This means a person wanting to live on $50,000 would need to draw on their nest egg to the tune of $67,000 to $68,000 from tax deferred accounts if they properly account for taxes. Another example is a family with a baseline of $170,000 in lifestyle expenses would need to draw up to $250,000 on their balance sheet with a significant contribution going to Uncle Sam.

The shock is real, but the hard lessons experienced by one generation will be wisdom for another. There have always been options. When Congress passed the first Individual Retirement Account legislation in the 1970s, the goal was to prompt us to save more for retirement, shift responsibilities from corporations, and reduce dependence on Social Security. Tax deferral was an incentive to boost savings and in once sense it worked. According to a 2015 Investment Company Institute report, Americans had saved almost $7 trillion in defined contribution plans which include 401ks and IRAs.

But the $7 trillion is not nearly enough.

Not unlike investing itself, diversity and tax planning must be discussed early and often. Educating the investing public about a more-diversified saving strategy has become a front and center approach in our practice and for generations of clients. It's important to consider the unknowns of the future tax environment. Of course, it would be smart to take a tax deferral avenue if we knew that future tax rates would be lower or if the cash accumulation phase of one's career favors it. Anyone who has studied the history of entitlements, budgets, and tax policy as we have might suggest that future tax rates will be higher, not lower, in the future.

The reality is that there is no long history of "retirement" to learn from. Until the late 19th Century, when a few outlier companies began to offer pension plans to their workers, most people worked until they were infirmed or died. And they rarely lived into their 90's as many do today. Yet, as fast as defined benefit plans (or traditional company pensions plans) emerged, they were left behind by the familiar defined contribution plan era. The retirement of the baby boom generation will be a much different experience than that of their parents. The same will apply for succeeding generations.

But you do have choices and being an educated investor makes is the difference. Today, a competent and qualified fiduciary together with a skilled tax practitioner can structure a plan that includes tax efficiency at its core. This does not mean buying the high commission "tax deferred annuity", however. A fiduciary, in partnership with a client's tax counsel, will determine the best mix of taxable, tax deferred, and tax-free assets to help achieve their client's long-term goals.

A plan, not a product, helps assure success over time.

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