

What Do Qualified Plans Really Do?

Galileo was held under house arrest, by the Catholic Church, until his death. The Church said he was a lunatic because he believed the planet earth revolved around the sun rather the sun revolving around the earth. The Catholic Church contended the earth was stationary. It wasn't until 1992 when Pope John Paul II conceded that Galileo was right.

April 15th is D Day for many tax payers. Affluent Americans spend much of their time during the year working on legal ways to avoid taxes. The goal is to keep as much money out of government hands and keep it in our own pocket.

One popular belief for keeping the money is to put it into qualified plans (IRA, 401K, SEP etc.).

Qualified Plans are taxed postponed savings accounts sanctioned by the federal government.

So what do qualified plans really do?

The number one response is that they defer taxes. That answer is only half correct.

Qualified Plans do two things:

- **They postpone the tax.**
- **The postpone the tax calculation.**

Your tax bracket plays a very important role in your decision to make contributions. Many Americans focus on the tax bracket they are in today, and not the one they will be in when they withdrawal the money. The truth is they are both important. However, most people focus their attention only on today's tax bracket.

Many advisors say you should make hefty contributions to these accounts because you will "save" taxes.

The truth is these accounts are not tax savings accounts but tax **postponed** savings accounts. You don't receive a tax deduction for the contributions only a tax postponement.

When you are filing your taxes you are allowed to take an income reduction for the contribution. This means you will pay tax on fewer taxable dollars.

The government is not concerned about the tax bracket at the time of your contribution. Their only concern is what bracket you are in at the time of withdrawal.

What tax bracket will you be in at the time of retirement?

If you take the money out in a lower tax bracket then you are a winner. You did save on taxes. However, if the tax rate is the same or higher than you are a loser. You didn't save on taxes, and you lost liquidity use and control of the money along the way.

The highest marginal tax bracket is expected to be at 39.6% next year, in comparison to 35% this year. Contributions made at this high level this year will incur a 5% penalty if withdrawn at the same tax bracket.

Your qualified money has two sub-accounts. One account is yours and the other is the governments. If you deposited \$10,000 into that account this year, and you are in the 35% tax bracket, then \$6,500 went into your account and \$3,500 went into the government's account.

If you have \$500,000 in your account, and you are still in the 35% tax bracket then \$325,000 is yours and \$175,000 is the governments. The government's portion grows along with your portion.

Dr. Howard Farran in his presentation to the Sarasota Dental Association last month claimed "taxes are going to skyrocket."

I believe government will be taking a greater portion of our earned dollars in the future because they are being called upon to do more. A great potential source of revenue will be qualified money sitting totally under their control.

If you also believe this to be true than you should ask yourself several questions.

- What is my exit strategy?
- Will I have to pay the entire tax?
- Can I develop strategies that help minimize or eliminate these taxes?
- Should I put anymore of my hard earned dollars under government control?
- Should I bite the bullet and pay the tax today?

There could be a lot of wealth transferred to the government unnecessarily due to the probability of higher tax rates in the future, and that taxes are paid at the time of withdrawal.

The popular belief of loading our money into qualified plans might have similar flaws like the belief once held by the Catholic Church of the earth being stationary.

There is more to be gained by avoiding the losses than picking the winners.

Happy tax day.