

## TAX RISK

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In my June 2007 article entitled *Inflation Risk*, I explained how inflation erodes the buying power of your money over time. But inflation is only one of two evils impacting your financial security. The other is taxes, and they also must be accounted for in your financial plan.

For years you have been advised to maximize pre-tax contributions to your company retirement plan. But is this good advice? If you are in a higher tax bracket, it makes sense to want to lower your tax rate today by deferring those dollars (and taxes) to the future. But could a good thing today be a bad thing tomorrow? As a nation, we are facing shortages in Medicare funding, social security, rising budget deficits, and increased security costs. As a result, do you believe tax rates will increase, decrease, or stay the same over the next twenty years? What can you do to help lower your future taxes and maximize your retirement income? Consider the story of two brothers, Thomas and James, for illustration.

Thomas saved diligently during his life and used the traditional strategy of maximizing his pre-tax contributions into his company retirement plan. Now, at age 60, he has accumulated \$2,000,000 in savings and is ready to retire. He needs \$80,000 (pre-tax) to maintain his current lifestyle. His only choice is to remove the money from his retirement plan which is fully taxable as ordinary income. Based on 2006 tax tables this could equate to \$22,400 paid in Federal and State taxes, leaving him with \$57,600. Could there be a better way?

James, unlike his brother, took a non-traditional approach to saving for his future. He began by making contributions to his company retirement plan in an amount that maximized his company matching contribution. He then funded a Roth IRA until he reached the annual contribution limit. He then returned to his company retirement plan and made contributions until he reached the annual limit. Finally, he saved and invested in after-tax investment accounts. By age 60, he also is ready to retire and has accumulated \$2,000,000 in savings, but through a different composition. He has \$1,000,000 in his company retirement plan, \$800,000 in after-tax investment accounts, and \$200,000 in his Roth IRA. If James also needs \$80,000 to maintain his lifestyle, what is preventing him from taking \$40,000 from his company retirement plan, \$20,000 from his investment account, and \$20,000 from his Roth IRA? Nothing! Assuming his investment account is taxed at the long-term tax rate and the distribution from his Roth IRA is a qualified distribution, he could pay \$13,600 in Federal and State taxes, leaving him with \$66,400!

In other words, both Thomas and James removed \$80,000 from their accounts, but James was left with \$8,800, or 15% more, as a result of having choices from where to remove his money. Not only could this provide him with more money each year than Thomas, but it also gives him more latitude to remove less total dollars each year to maintain the

same lifestyle. This can be especially crucial during years when markets underperform, leaving less money available for distribution.

Having choices when you are in the distribution phase of your life is critical. The scenario above is only one of many strategies that can be used to maximize your income during retirement. Based on this scenario, would you rather be Thomas or James? If your answer is James, when was the last time you reviewed your retirement accumulation and income distribution strategy?

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*Sources:*

*[www.irs.gov](http://www.irs.gov)*

*[www.dor.state.nc.us/taxes/individual](http://www.dor.state.nc.us/taxes/individual)*