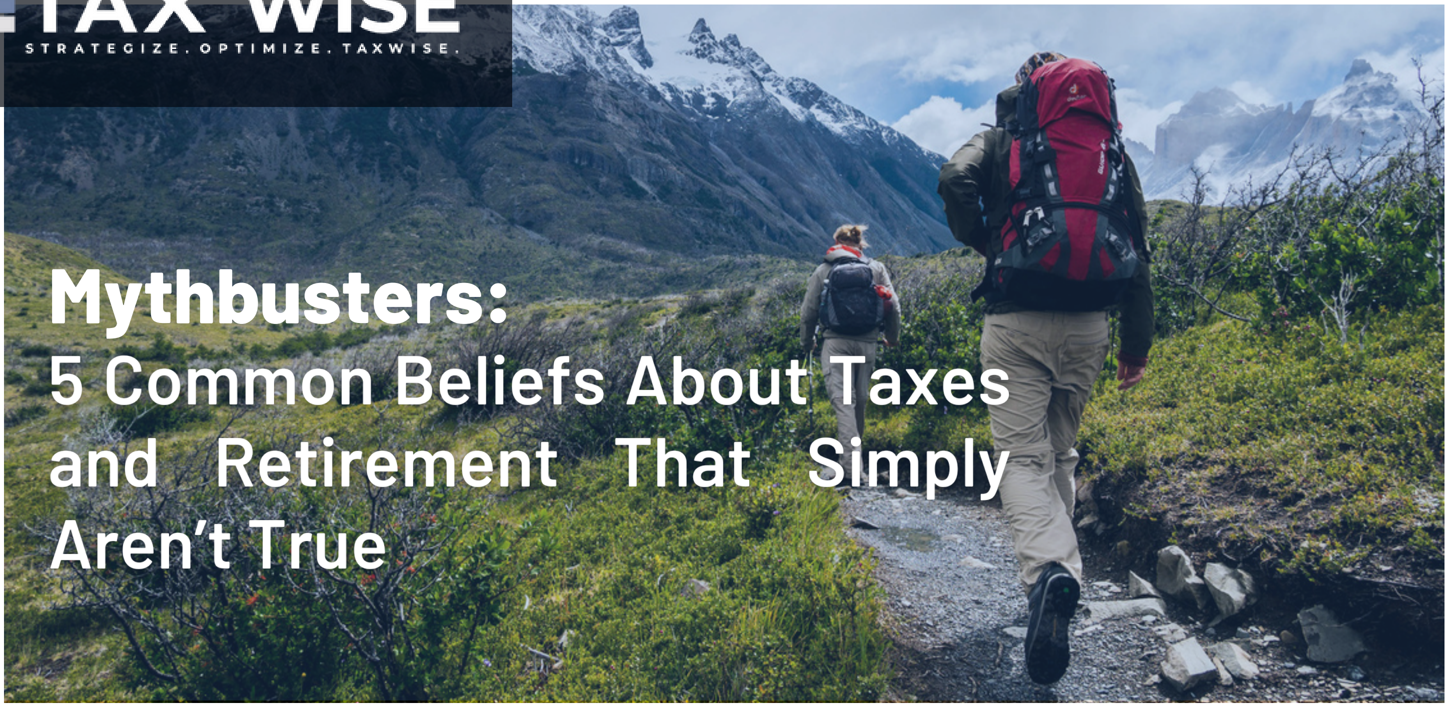

Mythbusters:
5 Common Beliefs About Taxes and Retirement That Simply Aren't True

Stubborn misconceptions and misperceptions about retirement and taxes continue to linger.

Some of these myths lead Americans to make fiscal decisions that negatively impact the value of their retirement–and even threaten the longevity of their money. Below are a handful of common beliefs about retirement and taxes that simply are not true. It's important to carefully consider the truth about these myths when crafting your retirement income strategy.

MYTH #1: I WILL HAVE LOWER TAXES IN RETIREMENT

The modern retirement mindset–defer taxes until later–was propagated by a hypothesis that you will somehow magically be in a lower tax-bracket when you retire. As millions of retirees have discovered, this simply isn't the case for the vast majority of Americans. Why not? The fact is you *might* be in a lower tax-*bracket*, but your tax situation will likely see you paying about the same or more in taxes in retirement. There are 3 main reasons for this: 1. Loss of deductions in retirement; 2. Unexpected taxes (social security, Medicare premium surcharges, etc.); and 3. Taxes trend up over time, not down. It was a great idea, but deferring taxes has created a tax-bomb for most Americans.

MYTH #2: PRE-TAX VEHICLES ARE TAX-EFFICIENT

Pre-tax retirement plans, such as 401Ks and Traditional IRAs, maximize your taxes over your lifetime in exchange for the ability to use pre-tax deposits. This is short-term-gain for long-term-pain. Putting off taxes until the future has the same effect most experience when procrastinating anything important: a detrimental endgame. In fact, many retirees end up paying back all the tax-savings they achieved through decades of pre-tax investing in the first 3-6 years of retirement. Further, these types of plans cause additional taxes on other assets, such as social security benefits, and surcharges on Medicare premiums. Finally, these plans do not enjoy the benefit of long-term capital gains taxes, no matter how long you hold the assets inside them. Pre-tax vehicles become tax-hostile when you begin to use them in retirement.

Famed economist Teresa Ghilarducci has done an incredible volume of work and analysis on the 401K (and, by extension, other qualified retirement plans). She calls the 401K a "failed experiment" and asserts that "the structure [of the 401K] was always set up against lower-paid or middle-class workers from the very beginning...". It is simple mathematical truth that 401Ks and IRAs maximize taxes over your lifetime in exchange for upfront, temporary tax-savings from pre-tax deposits. These types of plans have been one of the best investments the federal government has ever made.

MYTH #3: I WILL NEED LESS MONEY IN RETIREMENT

This seems to make sense at first glance. Conventional wisdom would see your home paid off, kids grown and college expenses paid. Fixed expenses do tend to fall, but overall expenses stay about the same. This is because retirees simply spend *differently* than when they were working, not less. Travel as well as new hobbies and business ventures make up for the decline in fixed expenses as first. Medical expenses also have a major impact in retirement, and tend to be many times more than those in the working years. Planning on having less income in retirement is a risky proposition for most.

> *In America, there are two tax systems: one for the informed and one for the uninformed. Both systems are legal.*
>
> *— Learned Hand*
> *Former Judge of the United States District Court for the Southern District of New York*

MYTH #4: DELAYING TAXES AS LONG AS POSSIBLE IS A WISE TAX STRATEGY

The national debt is currently above $33 trillion. The debt to GDP ration is roughly 120% and expected to rise to 195% by 2053. An introspective question that should cause honest reflection is, "Will the government need more or less money in the future?" If you truly believe that taxes will be lower in the future, then putting as much money as possible into pre-tax vehicles would be your move. However, if you "follow the money" and conclude, as many economists and financial experts have, that taxes will rise sharply in the future, procrastinating the day you pay the piper could prove challenging to your retirement, costing you tens of thousands to hundreds of thousands in unnecessary taxes. Consider the following example of a 62 year old who has $500,000 traditional IRA. In the first scenario, the decision is made to defer as long as possible. In the second scenario, a decision is made to convert to a tax-efficient strategy.

Maximum Defer Strategy	
Current balance	$500,000
Age Range	62 to 95
Tax Rate	20%
Total Taxes	**$678,563**

Conversion Strategy	
Conversion Period	5 Years
Age Range	62 to 95
Tax Rate	20%
Total Taxes	**$111,038**

$567,626 Taxes Saved

Deferring taxes caused unnecessary taxes on RMDs, the gains on reinvested RMDs, social security, and incomes taxes to the heirs. None of those taxes exist in the conversion strategy. Taxes during the conversion period do occur, but at an **83% discount**. One final note: this assumes taxes *do not rise* in the future. If they do (a near certainty), the tax savings are even greater.

MYTH #5: IF I ONLY WITHDRAW 4% OF MY NEST EGG, I WON'T RUN OUT MONEY

The 4% withdrawal rule was developed in the 1990s and recently debunked by the same mathematician who pioneered it. He revised it down to a withdrawal rate of only 2.5%. More recently, Vanguard's own study showed an even further downgrade to a 1.9% withdrawal rate in order not to run out of money. On a $1 million portfolio, that's only $19,000 a year! And that doesn't include taxes. Of course, this assumes a traditional "buy, hold, and pray" approach. Using alternative approaches has been shown to increase the withdrawal rate to 5-7% with less risk, especially when done in a tax-efficient environment.