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Client Therapy

# The Retirement Account Time Bomb

John E. Girouard 04.07.09, 12:10 PM ET

Accountants, investment advisors and financial planners are robotically programmed to manage clients' income to reduce the taxes they pay today because a dollar of tax-deferred income is likely to grow over time, increasing the chance they will have plenty of money to live on in their golden years.

But what happens when people reach retirement age after years of maxing out their 401(k)s or similar accounts and find themselves sitting on more money than they really need? The law requires them to start taking the money out, and Uncle Sam scores a fat payday because many of the tax breaks we enjoy during our working years go away when we retire. Thus retirees can wind up paying more taxes than they saved when they were working. They risk being taxed to death, literally as well as figuratively.

This phenomenon is likely to become more common as the number of people reaching retirement age swells, with many having dutifully followed the advice year in and year out to sock away as much tax-deferred income as possible. Without realizing it, clients and their advisors tend to over-estimate how much will actually be needed to live on in retirement. Thus a dollar in taxes saved today can become many dollars in taxes that will have to be paid later.

This problem is compounded by the mistaken idea that a big retirement fund of tax-deferred income means you have created wealth. Instead, you have created a tax liability over which you will have little if any control. Wealth is not created within tax-deferred retirement accounts. It is created by investing after-tax dollars in assets such as the stock market, or growing a business, or any other activity where the government cannot dictate how much you have to take out each year and thus how much you'll have to pay in taxes.

The root of this misconception can be found in stale ideas left over from the Great Depression--work hard, save up, pay down debt, pay off your mortgage. Also, the financial services industry makes a good living selling tax-deferred retirement products. Too often, though, the assumptions on which those products are sold ignore the tax implications many years down the road.

In my practice, I frequently have to explain to clients that their retirement income goals are mathematically inaccurate. For example, a client who earns $100,000 a year typically thinks he or she needs a retirement fund of $1 million or more to maintain their lifestyle when they quit working. But the numbers don't work that way.

First of all, they forget that they will no longer be contributing to a 401(k) or other retirement account. They don't realize that they will no longer be paying Social Security taxes. The idea most people have that they should be trying to pay off the principal on their mortgage is misguided because doing so robs them of one of the few tax breaks available in their post-career years--the mortgage interest deduction.

By the time I get done crunching the numbers, I may have knocked 40% off the $100,000 a year income they think they need. Then I back out the Social Security income they'll be receiving, and suddenly that $100,000 a year they thought they needed from a retirement account can drop to as low as $30,000.

So if a person really needs only $30,000 of retirement account income but has an account that requires taking out and paying taxes on $100,000 a year, Uncle Sam makes out like a bandit. It's a tax time bomb that could be avoided with a little forethought.

Instead of creating $70,000 of excess taxable income, it makes more sense to put that money to work creating wealth over which you have control, or putting it in a low-risk vehicle such as an untaxed dividend-paying mutual whole life insurance policy where you have access to the cash value and you benefit from the effect of compound growth in dividends.

The key concept that the financial industry fails to communicate is that control over how much we pay in taxes effectively ends at retirement. As long as you are working and earning a living, you have a lot of options in addition to tax-deductible or deferred retirement accounts. Instead of a 15-year mortgage or paying down your principal, a 30-year mortgage on which you make the minimum payment gives you the maximum mortgage interest deduction. If you have children, you enjoy the dependent deduction.

By the time you stop working, you have given up most of the tax control to Uncle Sam. If, like many people, you retire and sell your home, even if you don't incur a taxable gain you will likely put the money in a safe place like a bank CD where it generates taxable income.

Finally, an oversized retirement account can be a nightmare for heirs if it isn't handled carefully. I have known people who retired with tax-deferred accounts in the millions but lived on their after-tax income from other sources because their accountants advised them to avoid withdrawing more than they had to in order to limit the tax bite.

When they died, taxes had to be paid on the tax-deferred income and then there were estate taxes to boot. It is possible to die with a large retirement account that would be almost completely devoured by taxes. You would literally have been taxed to death. There are alternative solutions, including what's known as a stretch IRA that passes your tax-deferred account to your children, effectively postponing the income tax liability to the next generation. But even that provision requires planning ahead.

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