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What Do Qualified Plans Really Do?

In 1492, the common belief was that the world was flat; Christopher Columbus proved that common thinking was flawed.

To put this into context, what do most people believe about Qualified Plans?

Most people would like to keep as much money as possible in their own pockets and out of government's hands. So many affluent Americans often look for legal ways to minimize taxes.

One popular belief for keeping the money is paying it into qualified plans (IRA, 401(k), 403(b), SEP, etc.).

Qualified Plans are **tax postponed** retirement 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.**
  and
- **They postpone the tax calculation.**

Your tax bracket plays a very important role in your decision to make contributions. Many Americans focus on today's tax bracket, rather than the one they will be in when they withdraw the money in retirement. The truth is they are both important.

Many advisors recommend hefty contributions to these accounts, suggesting you will "save" taxes. The truth is, these accounts are **not tax savings accounts** but rather **tax postponed retirement accounts**. You do not receive a tax *deduction* for the contributions only a tax *postponement*. When filing your taxes, you are allowed to take a deduction against the contribution, so you will pay tax on fewer taxable dollars.

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

What tax bracket will you be in at retirement?

If you take the money out in a lower tax bracket, you come out ahead; you did save on taxes. However, if the tax rate is higher, then there will be tax consequences. You may not have saved on taxes, and you may have lost **liquidity, use, and control** of your money along the way.

In your qualified plan, a portion of that money will end up in your hands, and the other portion may ultimately end up with the government in the form of income taxes owed on withdrawals.

In retirement, if your account grew to $500,000 and you made a qualified withdrawal of the entire balance, and you remain in the 35% tax bracket; then $325,000 is your portion while $175,000 is owed to the federal government. The amount owed the government would likely increase as the entire account balance increases. Keep in in mind, additional state income taxes may also be owed depending upon your state tax laws.

There may be wealth transferred to the government **unnecessarily** if taxes are deferred and paid at the time of withdrawal, if one also assumes higher tax rates in the future.

The idea of stockpiling your money into a qualified plan deserves to be seriously reconsidered; like in the Columbus's day, the popular belief may have its faults.

If what you thought to be true about your Qualified Plan turned out not to be true, when would you want to know?

To review your unique financial situation, call us today 814-539-8661!