FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

Issue #31
September 10, 2021

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Retirement Plans

For decades, employees and other individuals have been saving for their retirement by contributing to retirement plans such as Individual Retirement Accounts (IRAs) and 401(k) plans (which are named after the code section that created them). Their decision to participate in these plans was probably based on most if not all of these assumptions:

- retirement is a desirable aspiration
- you can't save for retirement unless it's within something called a retirement plan
- retirement plans have more income tax benefits than a plain old taxable account
- retirement plans have the same estate tax exposure as a taxable account
- retirement plans have the same political risk as taxable accounts

I will show that all of these assumptions are false, and that generally, a taxable account is preferable to a retirement plan.

First, the factor that is the most highly correlated with premature death is retirement age (younger = earlier death). Work provides purpose and dignity. If you are still serving your fellow man in some way, you still are needed, you still have value, and you're a contributing member of society. You're not just a pensioner waiting to be put on an ice floe. Now if you want to be able to leave the cube farm of some unethical and/or soul-killing company because you have a horrible boss or terrible working conditions or chronic stress, that doesn't mean you have to retire and stop serving your fellow man. If you want to retire so you can sit in a chair and watch TV, then you should go ahead and work on your long-term care and estate plan, because you'll be needing them sooner than you think.

Second, I will concede the advantages that retirement plans have over taxable accounts:

- About half of 401(k) plans have matching employer contributions. About 70% of companies have a 50% match, up to 6% of the employee's pay. But these contributions don't actually belong to you until and unless you vest in them before you leave the company, which could take as long as six years, depending on the plan's vesting schedule.
- Retirement plans grow tax-deferred (or tax-free in the case of Roth plans).
- Retirement plans are a good vehicle to use to invest in asset classes that generate ordinary income each year, such as bonds and REITs.
- Retirement plans are more difficult for a creditor (such as a litigant who has won a judgement against you in court) to attach.

Now I'll discuss the advantages that taxable accounts have over retirement plans.

- In a taxable account, long-term capital gains and qualified dividends are taxed at lower rates (for Married Filing Jointly, 0% for taxable income below $80,000, 15% for taxable income between $80,000 and $501,600, and 20% above that). Taxable distributions from traditional (non-Roth) retirement plans are taxed as ordinary income at your highest marginal rate (see this table). If your taxable income is above $81,050, that could be 22%, 24%, 32%, 35%, or 37%.

- If you invest a taxable account in foreign stocks that pay a dividend and those foreign countries withhold tax (at a rate as high as 35%) on your dividend payments, you can usually claim a U.S. Foreign Tax Credit on your income tax return that reduces your U.S. income tax liability dollar for dollar. If you invest in foreign dividend-paying stocks in a retirement plan, you cannot claim that tax credit.

- You can invest a “taxable account” in anything, including physical precious metals or cash in your mattress. Generally, you can invest retirement plans only in products that Wall Street offers (and Wall Street likes it that way). Most 401(k) plans have limited, fairly crude and paternalistic options. Generally, they are required to offer only a stock fund, a bond fund and a money market fund. Yes, if you have a self-directed IRA, you may be able to put a house, precious metals, etc. in it, but that can be a hassle and an additional expense.

- Generally (with some exceptions), if you want to withdraw money from a retirement plan before age 59½, you have to pay a 10% early withdrawal penalty.

- You can gift shares in which you have an unrealized long-term capital gain to someone else (say, an adult child) who is in a lower tax bracket. They could then sell the shares and pay a lower tax rate on the realized capital gain. You can't do that with a retirement plan.

- You can gift shares in which you have an unrealized long-term capital gain to a charity, which can then sell the shares, in which case no one would have to pay tax on the realized capital gain. If you still itemize your deductions, you could also claim a charitable deduction for the fair market value of the shares at the time of your donation.

- You have to start taking required minimum distributions (RMDs) from a traditional (non-Roth) retirement plan every year starting at age 70.5 (or age 72, if you turn 72 after 1/1/20), whether you need/want the income or not, at whatever income tax rates and brackets are in effect at that time (I predict that the income tax burden will only increase in the future). If you fail to take the RMD, the penalty is 50% of the amount that you should have withdrawn but did not. See, the government just wanted to help you save for your retirement.

- When you die owning an asset in a taxable account, your heirs receive a step-up in tax basis to the fair market value at the time of your death. For example, let's say you own stock for which you paid $100,000. At the time of your death, it was worth $500,000. Your heirs could sell it immediately but would not have to pay tax on the realized capital gain since their tax basis would be $500,000. Although Biden has proposed to eliminate the step-up in basis at death (after an exclusion of $1 million per person or $2 million per couple), it has been around for a long time and solves several problems.

- With an exemption of $11.7 million per person (or $23.4 million per couple), the federal estate tax is currently not an issue. However, that exemption amount is scheduled to expire in 2026, and Biden has proposed a significant reduction (when Clinton was president, he wanted to lower it to $200,000). If the estate tax does come back, a taxable account is the ideal asset to use to fund the credit shelter trust of the first spouse to die (for many years, this has been a standard way to minimize estate tax exposure for married couples).

- Now consider a traditional (non-Roth) retirement plan in a taxable estate. Even though a significant portion of the value of that account (say, one third) is simply a deferred income tax liability (since the beneficiary will eventually have to pay income tax on those distributions), *the entire value* of the retirement plan is includable in the decedent's gross estate. So your estate might have to pay estate tax *on that deferred income tax liability* (so a tax on a tax). Current federal estate tax rates range from 18% to 40%, but generally, due to small brackets, you can count on a tax rate of 34% or above. After your estate paid estate tax on the retirement plan and the beneficiaries paid income tax on the distributions from it, they might be left with a third or less of your plan. Some retirement plan!

- The SECURE Act, which became law at the end of 2019, eliminated the "stretch" distributions for non-spouse IRA beneficiaries that allowed them to take required minimum distributions over a period as long as the beneficiary's remaining life expectancy. Now (with a few exceptions), a non-spouse IRA beneficiary must withdraw the entire balance within 10 years of the IRA owner's death, when the beneficiary will probably be in his/her peak earning years, thus bunching up that income and subjecting it to higher tax rates. The SECURE Act secured your retirement plan, all right—for the government!

- A taxable account is simple, but the rules and regulations for retirement plans are voluminous, ever-changing and mind-numbingly complex (I have an entire book about them that was written by a tax attorney). If you do something a little out of the ordinary (such as naming your estate as the beneficiary, or naming a charity as a partial beneficiary) and you (or your advisor) don't know what you're doing, it could have severe negative tax consequences. If you want to spend your limited time on Earth poring over the rat's nest of retirement plan rules and regulations to ensure that you didn't engage in a "prohibited transaction," "excess contribution," etc., then knock yourself out.

- It's possible that you have some tax basis either in (1) a traditional 401(k) to which after-tax contributions were made before 1987, or (2) a traditional IRA to which you made non-deductible (after-tax) contributions, or into which your rolled a 401(k) that contained some after-tax contributions. When you take distributions from such an IRA, a small part of them should be a non-taxable return of those after-tax contributions. However, if you don't know what your tax basis is or can't prove it due to poor record keeping (which is likely), then those after-tax contributions will be taxed ***a second time*** when you withdraw them from the IRA. Yeah, nice retirement plan.

- Before 1996, there was a 15% excise tax on "excess accumulations" (imposed at death) and "excess distributions" from an IRA. Similar taxes (at any tax rate) could be reimposed on retirement plans at any time.

- As far as I know, the value and holdings of taxable financial accounts don't (yet) get reported to the federal government, though I'm sure that if the surveillance state wanted to drill down and see what you owned, a (regulated) bank would roll over and tell it everything it wanted to know. However, you can still (for now) withdraw cash from a bank or credit union or sell shares in a taxable account and have the proceeds two business days later. Contrast that with a retirement plan: the plan custodian reports the value of your account to the government every year *even if there were no reportable taxable events*. (BTW, if you have an individual 401(k) plan with a value that exceeds $100,000 and you fail to file an annual information return with the Department of Labor, the penalty for failing to do so is something like $10,000.) Why does the government want to know how much you have in your retirement plan? Well, why did Willie Sutton rob banks? Because that's where the money was, which brings me to my last point.

- Politicians and the elite 1% who increasingly run the show (and who will dominate it in the future) don't have their wealth in retirement plans. They did not contribute their bribes, kickbacks, government contracts and sweetheart deals to a 401(k) or an IRA. Their wealth is in taxable accounts (which includes hedge funds, private equity, etc.), offshore accounts and trusts, property (e.g., Bill Gates is now the largest owner of farmland in the U.S.), precious metals, art, collectibles, etc. When the federal government becomes desperate enough (say, when interest rates spike or we have hyperinflation or the dollar collapses), I believe it is likely if not certain that politicians (and the elite 1%) will nationalize retirement plans to "shore up" Social Security by creating Guaranteed Retirement Accounts (which would be forced to buy the government's worthless debt). After the next stock market crash (which I believe will be the worst in at least our lifetime), an account that yields a guaranteed return of say 3% will seem very attractive, even if that is far less than the real rate of inflation. The federal government has stolen massive wealth from its citizens on a number of occasions throughout its history (the Continental during the Revolutionary War, the Greenback during the War Between the States, FDR's confiscation of gold in 1933, Nixon's taking the U.S. off the gold standard internationally in 1971, and the Federal Reserve's operations since 1913. The federal government and the elite 1% will do ***anything*** to save themselves and preserve their lifestyle.

What about Roth IRAs and Roth 401(k)s, which grow tax-free and don't require RMDs during the life of the participant? What's that saying? "If it sounds too good to be true....?" Yes, currently, distributions from Roth IRAs are tax-free and there are no RMDs. However, given the federal government's increasingly desperate financial condition and the current popularity of notions such as "equity" and "social justice," I don't see how that can last. Beware government promises of good things that it will do in the future.

What You Should Be Doing Now

I plan to cover the why and how of these in future issues (if I haven't already), but here are some actions I recommend you take (or at least start thinking about) now:

1. Stop contributing to retirement plans (especially traditional, non-Roth plans) unless you receive a generous employer matching contribution in your 401(k) that you are fairly certain you will actually vest in by the time you leave (which may be sooner than you think).

2. If the vast majority of your portfolio is in traditional retirement plans, start taking annual distributions if you're older than 59.5, especially if you're currently in a lower tax bracket. If you currently have to take RMDs, you can certainly take more than the minimum amount.

3. If you want to obtain exposure to foreign dividend-paying stocks, use taxable accounts instead of retirement plans.

4. If you have named someone other than individuals as a beneficiary of a retirement plan, ensure that you have not created a mistake that will result in significantly higher taxes.

5. Ensure that you can still access a significant amount of your wealth if the financial markets close, the government declares a "bank holiday," or the grid goes down.

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I would love to hear from you! I thrive on feedback from readers. If you have any comments, suggestions, insight/wisdom, or you'd like to share a link to a great article, please email me.

Generally, I don't have time to answer questions about your specific situation, but if you have a general question that I think other readers also have, let me know and I will provide an answer in a future issue.

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