Sound Financial Bites 065- Paul Adams

Episode Transcription

> *"It's really easy to think you have 100k on your statement, you have 100k, but you don't, you have a partner."*

Welcome to Sound Financial Bites, where we help you with bite-sized pieces of financial and life knowledge to help you design and build a good life. The knowledge that has been shared from stages at conferences, pages of national business magazines, and clients living across America, our host, Paul Adams, now brings directly to you.

Welcome to Sound Financial Bites. My name is Paul Adams, President, and CEO of Sound Financial Group, but more importantly your host to Sound Financial Bites today. Picking up on our last episode, we talked about those people that are interested in you maximizing your contribution to the 401(k), and were interested in you maximizing the potential in your financial life with your 401(k) not just maximizing your contribution to the 401(k). So, we talked about how the employer has an interest in you maxing out your 401(k). The financial institution also has an interest which we're going to hit next, and then we're going to get to the IRS and how they have an interest in you building your 401(k).

One of the most scathing reviews of financial institutions and the way that they build 401(k) was actually on what I think, although I am not a regular watcher, I only watched this one set of clips and episode is a show. I think it's kind of a comedy late night show called John Oliver. It's called Last Week Tonight with John Oliver. It's on HBO. If you are faint of heart, he has some pretty strong language so I don't necessarily recommend you go listen to it with the kids on the room. You may not want to listen to it on open speakers at your office but it's retirement plan's last week tonight with John Oliver. If you put that in Google you'll find it. In a 20-minute bit where he was trying to set up a 401(k) for his employees and he dug in the fees and he was amazed.

Now this is the reason why many of the new standards are being passed around fees and disclosure for the IRS because for the long time these 401(k) could be laden with fees unnecessarily, because think about this, think about the interest, the financial institution. Number one: They just have one client. When they have a 401(k) even if there's 400 employees they just have that HR director or that business owner who they have to satisfy as a customer. Then they just have to give okay service to everybody else because they just have one customer. As they manage a fairly large amount of money, they have to send out a lot of statements and do some investor education, have a website for the 401(k), but they don't necessarily have to do the kind of work as if they had 300 separate individual accounts.

What happens when we put money to 401(k)? Too often, even though somebody who became a client, say of our firm, we talk about fees, we disclose about fees, people ask about fees when we have a conversation except, how often I have heard that people never had a conversation about fees in their 401(k). And why? Because I'm getting company matched. It's free money. I guess when paying 2% more than I should, it's not that big of a deal because I got a dollar per dollar match of 5% of my contribution. People tend not even to look at the fees. Now the new fiduciary rules are bringing that down because they are having to show the amount of cost and fees that there are because there's fees at the 401(k) level, fees at the mutual fund level, and then transactional fees in the mutual funds themselves. More and more popular business books are coming out and talking about how heavily laden these 401(k) fees can be, but there's one more really big component that has these institutions be in a position that they want to manage your 401(k). Here's why.

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Imagine that you have $10,000 and you are getting ready to put it in. Now you put in your 401(k) contribution every single month throughout the year but for the sake of this conversation, imagine you just had $10,000 and you got two options. You're either going to pay tax on it, we'll just say a 30% tax rate because the math is easy. $10,000. If you don't put it on the 401(k) you have $7,000. If you put $10,000 in the 401(k), all $10,000 goes in there. Now, one thing that should jump out of us is that is not all our money. I'm going to talk about that in a moment when we talk about the IRS wanting you to put a lot of money in the 401(k), though in reality, if I paid taxes on it right now and it landed on my personal balance sheet and then I went and put it on a mutual fund or an investment of some kind, I only have $7,000 to invest. But if I put $10,000 on my 401(k), all $10,000 goes to work. The other part of that money is the IRS's money. It's like a mortgage that's due. In fact, it's a little bit unfortunate that they don't pass a rule that says that they have to put right underneath if I have $100,000 in a 401(k) or you have $100,000 in a 401(k) right underneath they should say approximately $30,000 in taxes due when you take it at retirement, and if you take it now it will be 40% because there will be a 10% penalty. I think that's appropriate disclosure because it's really easy to think that when you see $100,000 on your statement that you have $100,000, but you don't. You have a partner. That's like saying you own 100% of your home when you have a mortgage. No. There is a debt that has to be paid which is the indentured or embedded tax on the 401(k) that has to be paid one day.

"When it's a 401(k), that tax just keeps on growing."

Now, it's not a debt like a mortgage, it's worse and it's worse because if I have $100,000 in there, that $100,000 goes to a million, if that had been a mortgage at least as the property value grew then the actual debt would have stayed the same or been reduced slightly. But when it's a 401(k), that tax bill just keeps on growing so they get to manage their side that you would have put in anyway with an investment company $7,000 and then on top of it they get to manage the IRS's side. You can do some quick math, punch in the calculator. I think also at the top of my head that's like if you're going to put in $7,000 instead you're going to put in $10,000 that's like a 42% increase. No wonder the financial institutions are lobbying every single year to increase 401(k) contribution limits. The reason they continue to lobby to increase them is because it works out really well for them because they get to manage the money and you can't take it out without penalties on top of the taxes until age 59 ½ so they are guaranteed to hold on to the money for an extended period of time.

What are the four rules of financial institutions? They want to get your money. They want to get it on a consistent ongoing basis. They want to hold on to it for as long as possible and they give it back as slowly as possible over time. So, I know you're asking now, Paul why is it that the IRS would want me to put money on the 401(k)? Because it sure seems like it saves me taxes. I put $10,000 on the 401(k) and the 30% tax rate there's $3,000 less in taxes that I paid. But what I want you to consider is even though you paid less than taxes you have less money on your balance sheet that year.

Think of it this way: Yes, the IRS did not collect that $3,000. They didn't collect the tax today or how I'd say is they didn't collect the seed today, instead they get the tax at later when it's harvested. So, think about this a little bit. I have the option to be able to put $10,000 away right now. If I put $10,000 away right now on a 401(k) and it grows now for easy example because you're driving or whatever else you're doing right now I'm going to make this simple. $10,000 becomes like a million and I saved $3,000 of taxes when I put in $10,000. If the same tax rate

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"The 401(k) can be one more vehicle you can use to steward your financial future."

occurs meaning taxes did not rise, it just became $30,000 or sorry $300,000. $300,000 of taxes but we get $300,000 in taxes in return for having saved $3,000. There's a little bit bigger of a problem and the problem is that we did not actually make any money on the IRS's money. If you did the math, and did a side by side if tax rates remain flat we did not get any arbitrary whatsoever because the IRS just own 30% of the partnership the entire time. All we did was feel good because we saved a little bit in taxes. You're not saving any tax. All you're doing is delaying the tax. That tax has to be paid one day and it has to be paid at a future rate and it's a rate that you don't know today. You don't know today and in fact they are in control in terms of congress and its ability to raise funds and raise taxes, they are in control of what percent they take of your 401(k) later. So you might say to yourself "Paul, everybody says I'm going to be in the lower tax bracket when I'm retired." But I want you to reflect. I will contend and agree with you that if you are 64 years old and you have maybe a few million of investable asset and right now you're making a million dollars a year, yeah you might retire in a lower tax rate but that's not many of the people that are maxing out everything in their 401(k) that needs to reflect on this conversation. Let's just say you're 35 years old making $400,000 a year or you're 35 years old and you're making a $150,000 a year your income, if you're already rocking at age 35, your income is likely only going to continue growing overtime. And so at 35, I have $150,000 of income a year, I put $10,000 into my 401(k) now I have other deductions right now like a home mortgage, kids at home, spouse at home maybe, so I've got all these deductions or I'm a business owner and there's all kinds of economic benefit I get from owning the business and producing write offs but I'm maxing out of 401(k). As the result of maxing out 401(k) I am deferring all those taxes until later.

Let me ask. Do you want to have more or less wealth in retirement than you have today? I really want you to answer that for yourself. Like when you one day have financial independence you're 65 years old you want to have more wealth than you have today and if you do have more wealth than you have today and your career is done and the kids have moved out of the house, the business if you're a business owner the business is sold, home is paid off. Essentially you don't have any more deductions and more wealth you might well be in a higher tax bracket in retirement than you were when you were making contributions. Think of it right now. If you're that 40-year-old that's making a good income you and your spouse are both throwing money in your 401(k), go and look back. Now, wait a second I put money in when I was 25 and I'm making a whole heck of a lot more than I was then that's what we call a reverse tax planning where we're positioning our money to give more of it to the IRS. Or positioning more because if we put it in a 30% rate, and now let's go back to my same little example of putting $10,000 in a 401(k) saving $3,000 in taxes and when it grows to a million now you are not paying $300,000 in taxes, you're paying $400,000 in taxes and the real issue there is that diminishes your rate of return meaning you took risk this whole time with your money trying to get a good rate of return and with one change of the tax code it actually effectively diminish your rate of return for the entire lifespan of your investing. So now you're probably saying "Wait a second Paul. But the IRS doesn't get my money this year, they have to get it later. So how are they making money?" Well, very simple little lesson of economics here on how our government funds itself. One interesting I remember somebody said this and I thought it was very very interesting way to think about all our government spending is you think about what our government spends money on right now. I remember somebody saying is it important enough that we should borrow money to pay for it because that's what our government does when it has spending in excess of revenues. So we have spending in excess of revenues then our country borrows. Now, right now we're able to sell

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bonds. As a country we sell bonds to people. People borrow money or lend money to the US government and they get about 2.5% right now or at least the recording of this podcast. When they don't make your $3,000 because you put in your 401(k), now they've got you working as an asset manager for them. You see? They've got you working as an asset manager making sure you grow the money and let's kind of look at the bright side. You get 7.5% rate of return over time on that money. As they don't get your money every year because you're maxing out your 401(k) they are borrowing money at 2.5%. Now, if you could borrow money from somebody at 2.5% and then invest it at 7.5 that's a 300% rate of return on your money. You see you're the one working to grow the money. You're the one that might be staying up late because you're scared about what's happening in the market when the volatility starts hitting. See, you don't pay IRS today and you're doing your best to grow your 401(k) and they still have their piece of the 401(k) one day. Now it's possible that you could retire in a lower tax rate. It's possible that you could retire in a lower tax rate with less income but if that's the case I would have you consider it might mean that your planning didn't work and that is not what we want to be doing. We want to be planning to have more wealth than we have today so that we can live a stronger and more financially independent lifestyle because if we can live a stronger and more financially independent lifestyle then we're in the position to be in a higher tax rate when we retire. In the end, it goes all the way back to that they can increase their interest in the partnership so let's hold just a moment here.

We talked a little bit about financial institutions and how much they want us to put money in the plan. We earlier talked about the employer and how it works out pretty good for them that you max out the plan. Now let's get to the IRS and how much money is really in these. So, the investment company institute as of March 31, 2014, 401(k) plans held an estimated 4.3 trillion in assets representing nearly 19% of all US retirement assets that includes - that's when we count IRAs and there are many IRA that started as a 401(k) and just got rolled over. This is a huge market. There is a lot of money out there that the IRS is waiting to tax. Now, I've heard some people say we think taxes are going to get lowered in this country overall. Well, it's easy to forget that that actually happened at one point in the past. At one point in the past in this country, they lowered taxes and it positively impacted people in retirement like they went from a higher tax rate to a lower tax rate and you know what they added? A lot of people don't know this that they added a success tax and the success tax was actually an extra excise tax on distributions from the 401(k) of 15% so when tax rates dropped from I think it was 40's and dropped to 28% they layered on this excise tax. In fact, CPAs who've been practicing for quite some time might remember that back in the early 90s there was a strategy for some high income earning people to take early distributions. Take the 10% penalty because the 10% penalty was less expensive than this 15% tax. At least the IRS has a history that even if we somehow did away with the income tax altogether and just have one big value added tax that funded our entire system. If that was the case odds are the IRS would still figure out a way to at least get the amount of money that they allowed us to defer initially. They are going to make their money back. They have to. We have a government to run and there are trillions and trillions of dollars sitting inside of these plans that was over four trillion dollars back in 2014. It's only bigger now.

So in our next episode we're going to take time and we're going to talk about how to navigate around these, how to make really solid use of your 401(k) and have it integrated to some other assets so that the 401(k) can be one more vehicle that you use to steward your financial future that you can use to maximize the amount of money that your employer is letting you do and maybe allow you some resources you're going to be able to bring to your employer so that what

you'll have the best ability to do is have the best possible plan where you work enabling you to design and build a good life for you and your family.

So glad you could join us today. If you want some of those 401(k) takeaways we talked about in the last episode, what I want you to do is go to sfgwa.com. That's sfg as in Sound Financial Group, WA like whisky, alpha dot com/401k. Right there, if you're already a subscriber and you get our emails, then what you're going to be able to do is go right into that email and click it will say resources and you're going to be able to download that. If you're not currently getting our emails, just go put your email address and we're going to drop this straight to you in your inbox and you're going to be able to read those things.

If we could ever be of help to you listen to podcast if you're that kind of person that needs to make more sense and kind of realizing that maybe you've collected financial products and you're not yet really designed an entire strategy we're more than happy to help you just reach out to us and we'll just take 10 minutes with you on the phone and see where we could be of help or whether or not we're a fit. If we're not, that's totally fine. I hope you guys had a great rest of your day. Tune in to our podcast next week. We'll talk about navigating around all these concerns in the 401(k) to maximize what's outside of your 401(k).

I want to acknowledge you for taking the time to tune in to Sound Financial Bites. You stopped long enough in your busy day to reflect on your finances and your future to help you design and build a good life. Please take a moment to subscribe to this podcast and follow us on social media. You can find us on Facebook and LinkedIn.

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