Talking Out of Both Sides of Their Mouth

Have you been told that you will retire in a lower tax bracket? Have you also been told to "max out" your 401(k) and/or IRA because it's a "tax savings"? 401(k)s and IRAs are tax qualified accounts and/or deferred compensation vehicles. Contributions are free from income tax today but withdrawals in the future will be taxed at ordinary income tax rates. What makes you think that those income tax rates will be lower in the future? "Max out" qualified retirement accounts, you'll save on taxes now and you will be in a lower tax bracket in the future. That is Wall Street talking out of the left side of their mouth.

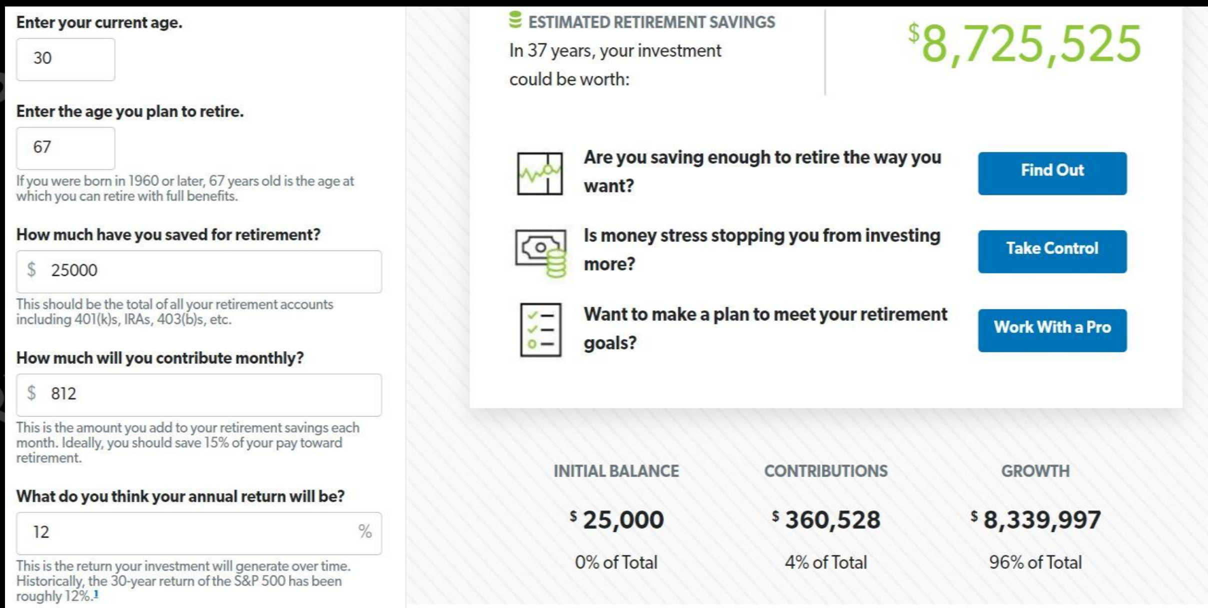
Here is the right side of their mouth...
https://www.daveramsey.com/smartvestor/investment-calculator?snid=free-tools.retirement-and-investing.investment-calculator

https://www.fisherinvestments.com/en-us/retirement/retirement-calculator/401k-calculator

The first link is to an investment calculator on Dave Ramsey's webpage. The second link is to a 401(k) calculator on Fisher Investments' website. While these two calculators are oversimplified and, in my opinion, terrible, they are not the only two. You will see calculators like this all over the Financial Services Industry. I will use Dave Ramsey's calculator and website to point out a serious problem. If you follow his inputs and suggestions, you will find yourself on a path to a mythical place that does not exist. Dave's inputs ask for and suggest the following.

Box 1, *age* (they left this blank); Box 2, *age you plan to retire* (here, the site suggests age 67 and it pre-fills this box for you); Box 3, *how much have you saved for retirement* (here, the site asks for the total of all of your retirement accounts); Box 4, *how much will you contribute monthly* (here, the fine print suggests 15% of your income); Box 5, *what do you think your annual return will be* (here the site suggests that the S&P historically generates 12%). I am just going to say it, all the little hints on the webpage are designed to mislead you. By backing up your retirement age to 67, the calculator will project a bigger balance. More time equals more growth. By suggesting you total all your retirement accounts for box 3, even though each account should be treated separately, the calculator will project a bigger balance. By suggesting 15% of your income is ideal in box 4, the calculator will project a bigger balance. If the site is calculating interest monthly as it suggests, this will also calculate a bigger balance.

Finally, even hinting that you should put 12% into box 5 should be criminal, but this will certainly project a MASSIVE balance.



So here we go, I'm going to put age 30, retirement age 67 (as suggested), total amount saved $25,000. I am going to put $812 as the monthly savings number. (This is a hypothetical 15% of $65,000 of annual income, divided by 12 months, as the site suggested). I will use the websites suggestion and put 12% in the last box…wait for it… Holy Shit!! **$8,725,525**. I better call, email, smoke signal whoever's website this is and give them my money.

I have yet to write a paper that discusses financial irresponsibility, but with these types of calculators out there, I better get on it. This paper is about financial institutions ***Talking Out of Both Sides of Their Mouth***. Do you remember what you may have been told about retiring in a lower tax bracket?

How can I expect to be in a lower tax bracket if your financial calculator suggests I will have this much money? On one side you are telling me that I will retire in a lower tax bracket. On the other side, you are telling me I will have $8,700,000. I have news for everyone, you cannot have both scenarios, an obscene balance and a low tax rate. Not in your qualified retirement accounts as the site suggests in box 3.

What if I do get all that money and just do not want to use it all? What if I want to take out as little as possible at age 67 to control my tax liability? Well the IRS has this little thing called RMDs or required minimum distributions. This means that at the age they tell you, currently age 72.5 but previously 70.5, the IRS will tell you how much money you are REQUIRED to take out each year. You read that right. They will take your total balance, factor in the age they expect you to die, and then mandate that you take the required minimum distribution to satisfy their tax needs. The formula is listed on the IRS's website but let's just keep this simple. $8,700,000 divided by 20 years (your age 70-90) means you could be required to take $435,000 in RMDs annually. It is not that simple, there is a "life expectancy calculator" but I'll tell you, it's pretty close. You know what is simple, if you miss an RMD, or forget, or don't cooperate, the penalty is 50%!

The point is this, the financial services industry must stop ***Talking Out of Both Sides of Their Mouth***. The industry must stop telling people that if you invest in these mutual funds, these target date funds, this average rate of return, you will have this ginormous balance. The industry must stop telling people they will be in a lower tax bracket in the future. Remember, the financial services industry generates revenue based on the balance of your account. Telling you to "defer" more money today because it is a tax savings, means more revenue for the financial industry today. Projecting large unrealistic future balances encourages you to invest more today which generates more revenue for them today. When I see websites like these telling you that you can have both, lower taxes in the future and massive unrealistic balances, I want to scream.

The fact of the matter is, that you will likely be in a lower tax bracket in the future if you do follow their advice. Not because of their sound strategy but more likely based on their failure. Less than 1% of all 401(k)s have a balance over $1,000,000. If your 401(k) fails, if your retirement strategy fails, if you do not get what their calculator projects, then yes, you could be at poverty levels in retirement. If that is the case, then perhaps yes, you could be in a lower tax bracket…

Even that assumes the government is fiscally responsible and able to keep those future tax brackets low. America, watch out for… "invest with me and look how much money you could have" followed by, "don't worry, you will be in a lower tax bracket in retirement…"

Best of luck out there…

Is there a better way? YES.