THE 401(k) TRAP

PERSONAL · PORTFOLIO
BONUS CHECKLIST
PROGRAM · PROTECTION

By Brian Doe, CFP®
and Kerrie Debbs, CFP®

Contents

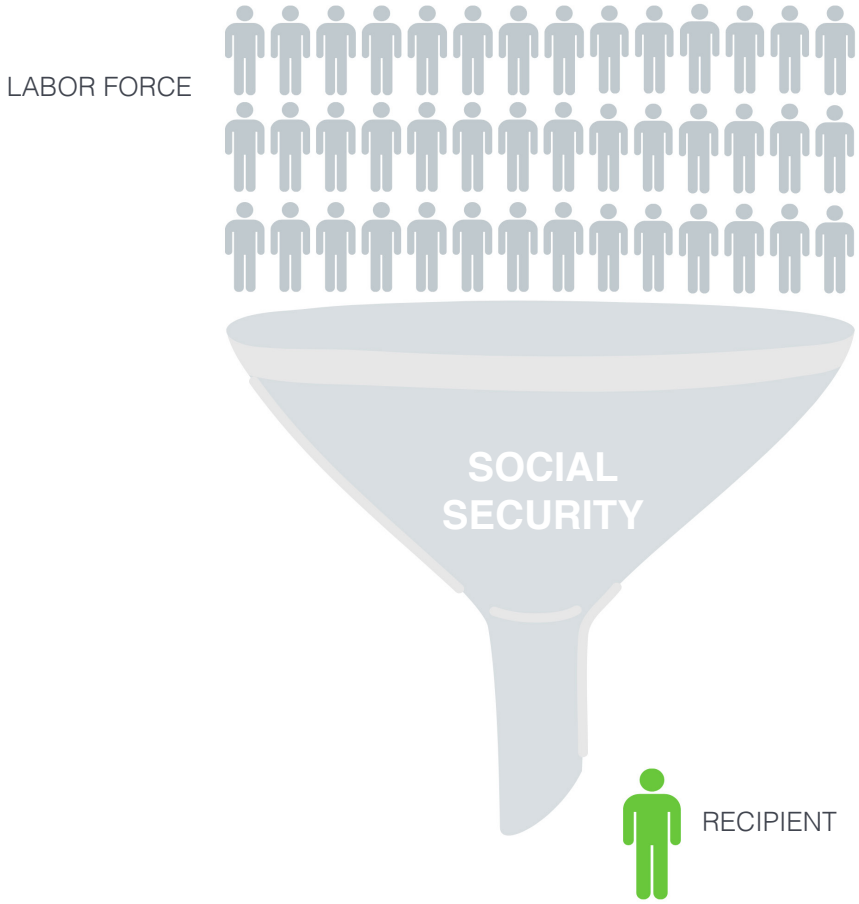
OH HOW TIMES HAVE CHANGED!

Retirement has changed dramatically. Remember the iconic advertisement, *Not Your Father's Oldsmobile*? The Ad ran in 1988 to describe how times change. The spirit of the Ad was used throughout the 1990s and 2000s while still applying today. Today's retirement is *not* your father's retirement. Now the father of 1988 is a grandfather or even great-grandfather and sadly may no longer be alive to tell this story.

In 1988 retirement income was still dominated by corporate pensions. Companies rewarded employee tenure, the longer the better, with savings that guaranteed income in retirement partly based on the worker's compensation and partly on the number of years worked at the company. Does that sound terrific? It was! Pensions have largely been eliminated due to several factors, namely cost and longevity. The 1974 Employee Retirement Income Security Act (ERISA) was the key factor in the gradual disappearance of pension funds as it stepped up enforcement of corporate pension funding. The replacement for pensions became the 401(k) savings plan. One of the biggest "selling points" of the 401(k) savings plan to employees was that control of the retirement savings plan was now in the hands of the employee, not the employer. Three points that were not emphasized nearly enough during this transition were: 1) the investment and savings risks were now assumed by the employee, 2) the cost was now primarily passed on to the employee, and 3) the longevity risk was not even mentioned.

With the introduction of ERISA, the Federal Government's Department of Labor required corporations to fully fund their employee pensions which ultimately led to the exit of companies from the guaranteed corporate pension system.

IN 1945, **42** WORKERS WERE CONTRIBUTING TO SUPPORT **1** SOCIAL SECURITY RECIPIENT.[1]

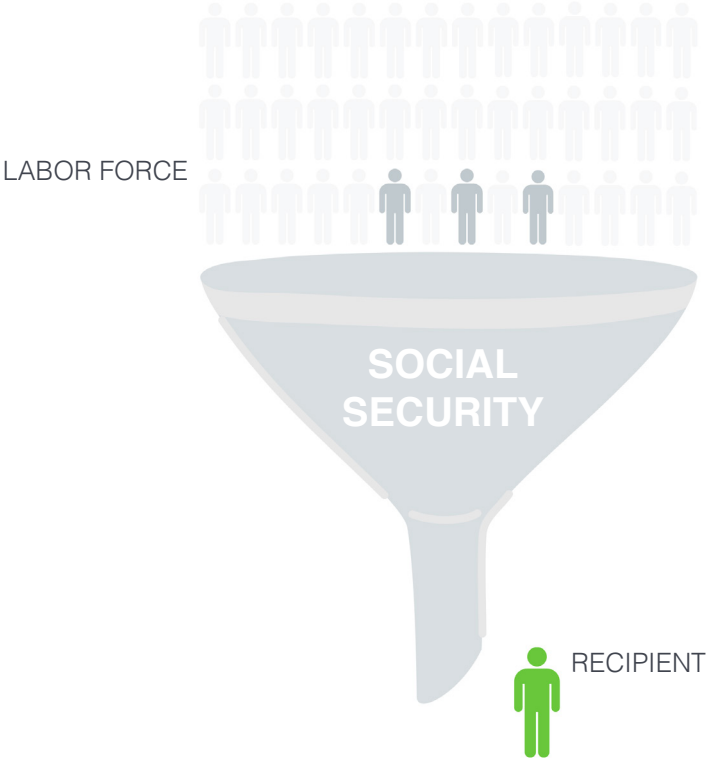


1 Social Security Administration. "Social Security History-Ratio of Covered Workers to Beneficiaries." https://www.ssa.gov/history/ratios.html. Accessed November 4, 2020.

LONGEVITY

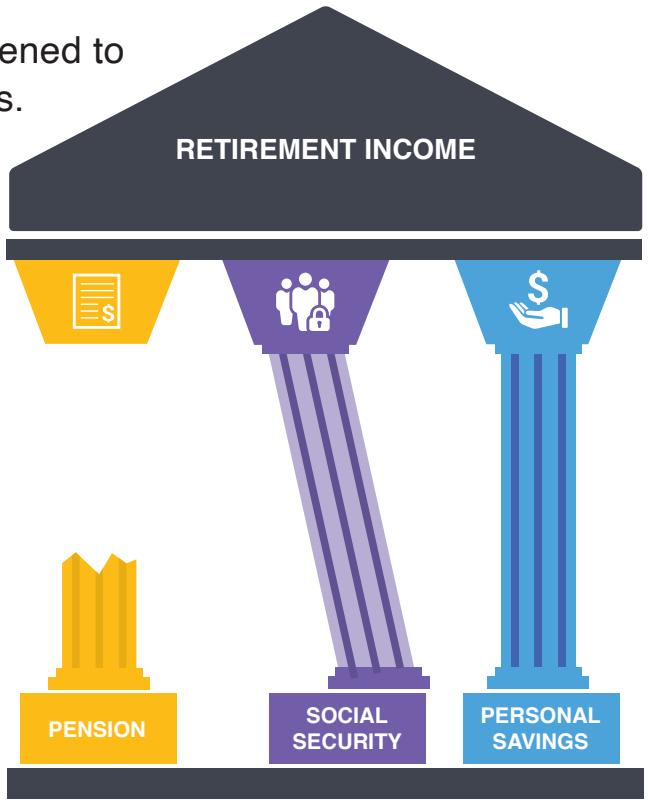
At most basic the 401(k) plan was invented practically by accident in 1978. The name was literally born out of a line in the IRS Code named "Section 401(k)." A 401(k) account would partly or mostly replace a pension but with far less certainty and guarantee. "Partly or mostly" was not and is still not emphasized enough to workers. Recall that with a pension, companies placed aside guaranteed amounts of future retirement income for employees over years and years based on employees' tenure at the company. Companies illustrated the benefits often to employees as an incentive for them to stick around. Employee loyalty was far more commonplace as the majority of workers remained at one company for decades or entire careers. Funds in a company pension could not be tapped prior to retirement or separation from service. Workers' awareness of or ability to manage their future tax situation was not even a concept. Pension and Social Security income were the primary basis for retirement income visibility. Tax implications would come later.

TODAY, FEWER THAN **3** WORKERS ARE CONTRIBUTING TO SUPPORT **1** SOCIAL SECURITY RECIPIENT.[1]



1 Social Security Administration. "Social Security History-Ratio of Covered Workers to Beneficiaries" https://www.ssa.gov/history/ratios.html. Accessed November 4, 2020.

401(k) TODAY



Retirement income today can be likened to a structure consisting of three pillars. One pillar of retirement income, the Pension, is disappearing. The second pillar of Social Security is increasingly strained. The third pillar of Personal Savings now falls almost entirely on the worker or retiree. The conventional wisdom of using the third pillar and maximizing contributions to a 401(k) may seem like the best action a person can take.

Taking responsibility for that final pillar requires a critical element: utilizing multiple available tax structures to allow as much income to flow to the bottom line in retirement. Here is where our **Allocation Optimizer** comes into play *(see page 17).*

With the 401(k) model, responsibility for saving for retirement is all but removed from the employer and placed on the individual employee, or "401(k) plan participant." Discipline and education by the individual employee are key ingredients but not taught or emphasized nearly enough. Even the wealthiest savers have been lulled into a sense of security with 401(k) savings.

AT THE END OF THE DAY, IT DOES NOT MATTER AS MUCH WHAT YOU MAKE AS WHAT YOU KEEP. PROPERLY DESIGNED, THE **ALLOCATION OPTIMIZER** CAN GIVE YOU CONTROL OVER YOUR FUTURE TAX EXPOSURE.

LEARN MORE ON THIS TOPIC?

There are multiple tax traps you can trigger if you're not navigating retirement carefully. Listen to our podcast *Make the Dough Rise* with Brian Doe, CFP® and explore podcasts where we discuss issues important to maintaining or achieving income flows for a self-reliant retirement.

Download recent episodes such as "Social Security Surprise!," "Time for Some Positivity," or "Deadly Dollars and Tax Traps".

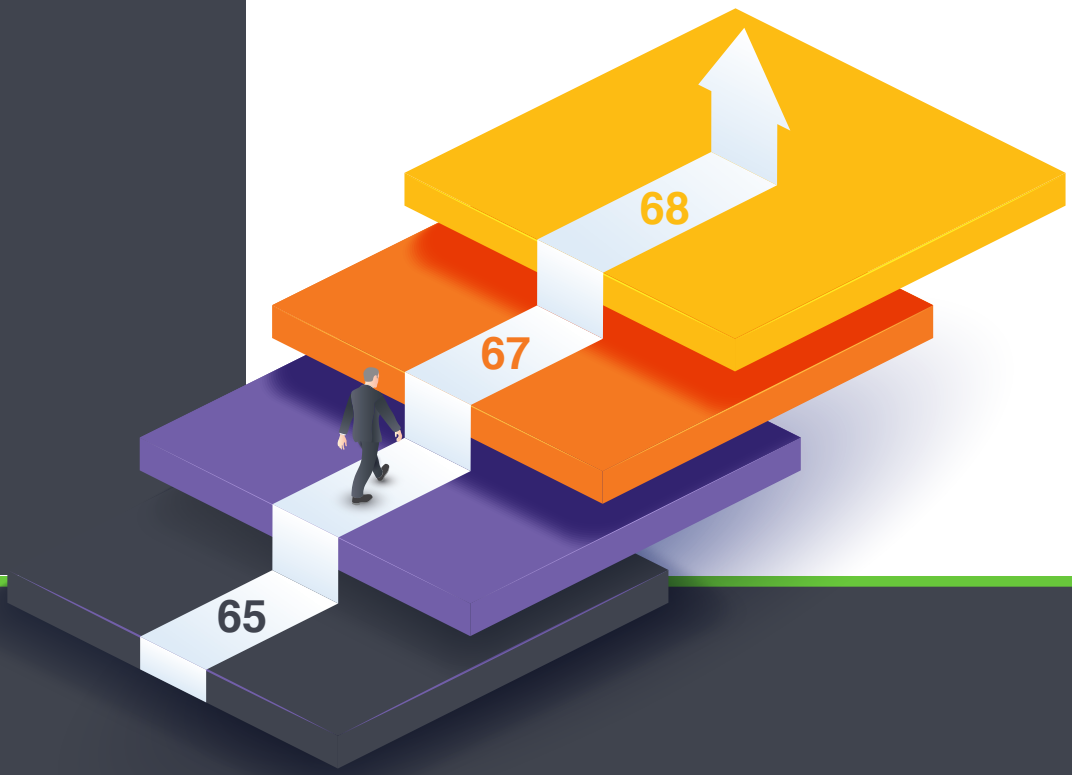
Make the Dough Rise is available on 20+ podcast apps, including Apple iTunes, Amazon Music, Spotify and more. Subscirbe and get notifications for new releases and bonus show materials.

MAKETHE**DOUGH**RISE.COM

401(k) TODAY (CONTINUED)

Most employers who offer a 401(k) plan to their employees either offer or are required by the IRS to make a matching contribution. An employee who takes full advantage of both maximum deferrals from compensation and the employer contribution can create an account that comfortably provides for financial needs in retirement—especially when future Social Security income is factored into the equation.

If the grandfather from the 1988 Oldsmobile commercial were alive today, perhaps he would talk about how ingrained the concept of saving for retirement was in his early years of employment.



RISK OF INCREASED GOVERNMENT SPENDING

Spending by the Federal Government today has become much more in vogue than fiscal discipline. Government has not had the political will to make necessary changes to retirement and entitlement programs. Government debt is staggering and every day becomes more so.

In recent decades the debt has exploded while short-term interest rates are at zero, and the cost of the debt is cheap. When and if interest rates rise to historically normal levels, the amount of government budget dedicated to servicing this debt could easily double or quadruple. As this part of government spending explodes, unpopular choices may need to be made, for example cutting back on programs such as Defense, Social Security, Social Security Disability Insurance, Medicare and Medicaid. Cutting entitlement programs will be nearly impossible as over one-third of the U.S. population may be receiving benefits by then. Rather than cutting benefits the more likely scenario will be raising taxes on both current workers and future retirees.

AN AGING POPULATION

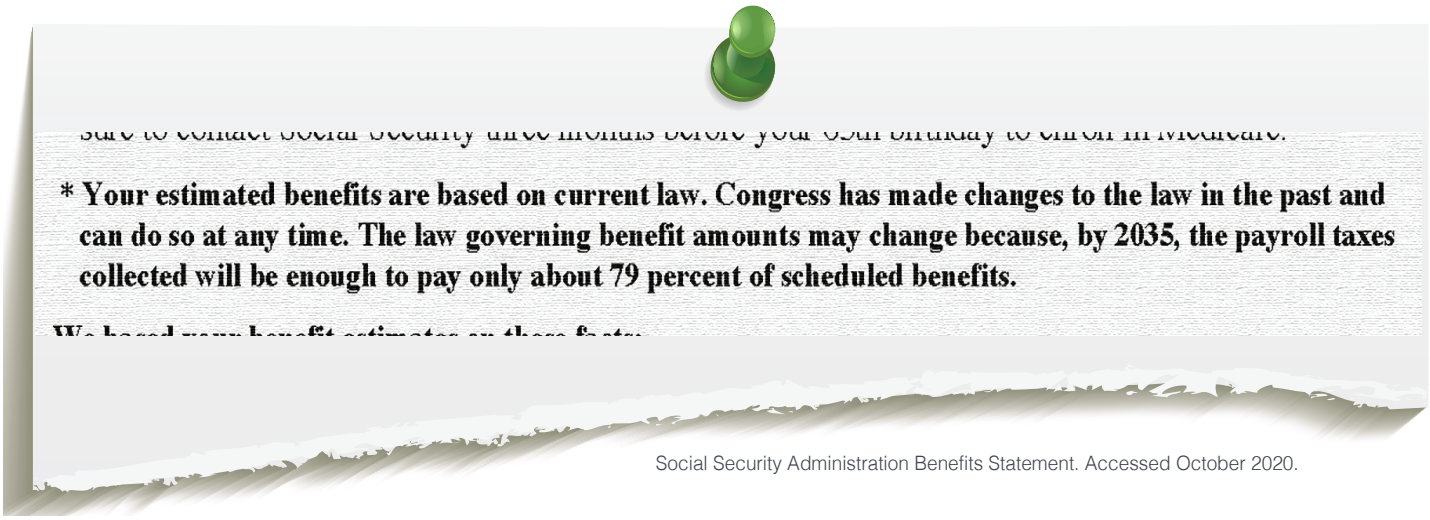
There is trouble in Social Security and Medicare paradise. Several factors have led to increased pressure on the United States Social Security Trust Fund. Longevity, a positive byproduct of medical advances, is a stark example. The average life expectancy at the advent of Social Security was just 62 years. In addition, U.S. birth rates have declined and the massive Baby Boomer generation has reached retirement age. Recipients now often receive Social Security benefits for decades rather than just a few years, which is far from the original parameters of the program. Early on, the ratio of workers paying in was 42 to 1; today that ratio is just fewer than 3 to 1[1]. **This situation is simply not sustainable**.

The U.S. Government has made public the fact that by 2035 Social Security inflows will meet **only about 79% of projected payouts**, and short of major policy funding changes will not be able to pay out full benefits.[2] To make matters worse, Medicare Part B premiums are impacted by overall income in retirement and have risen substantially for high earners.

To summarize, Medicare and Social Security are in trouble. Likely solutions in the immediate future are not palatable, namely cuts to major U.S. Federal Government entitlement and spending programs, and higher taxes.

1 Social Security Administration. "Social Security History-Ratio of Covered Workers to Beneficiaries." https://www.ssa.gov/history/ratios.html. Accessed November 4, 2020.

2 Social Security Administration. April 22, 2020. " The 2020 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds." https://www.ssa.gov/oact/TR/2020/tr2020.pdf 13, 14, and 24, Accessed November 4, 2020.



sure to contact Social Security three months before your 65th birthday to enroll in Medicare.

* Your estimated benefits are based on current law. Congress has made changes to the law in the past and can do so at any time. The law governing benefit amounts may change because, by 2035, the payroll taxes collected will be enough to pay only about 79 percent of scheduled benefits.

We based your benefit estimates on these facts:

Social Security Administration Benefits Statement. Accessed October 2020.

DIRTY LITTLE SECRET

The U.S. Federal Government has a window of time wherein it could make substantial policy changes to lessen strains on the Social Security system. These changes are political dynamite. Recent major government policy changes enacted by the U.S. Congress have been minimal, affecting only the wealthiest. These include eliminating certain Social Security benefits and raising taxes on inherited monies. A quiet change back in 1983 was gradually to push further out to 67 the Full Retirement Age, or FRA, which is the age of eligibility for full Social Security benefits for anyone born after 1960. These most recent changes have been made abruptly as in the overnight elimination in 2016 of the spousal “file and suspend” Social Security strategy for married couples. Additional changes could include reducing delayed credits, and making more of Social Security taxable.

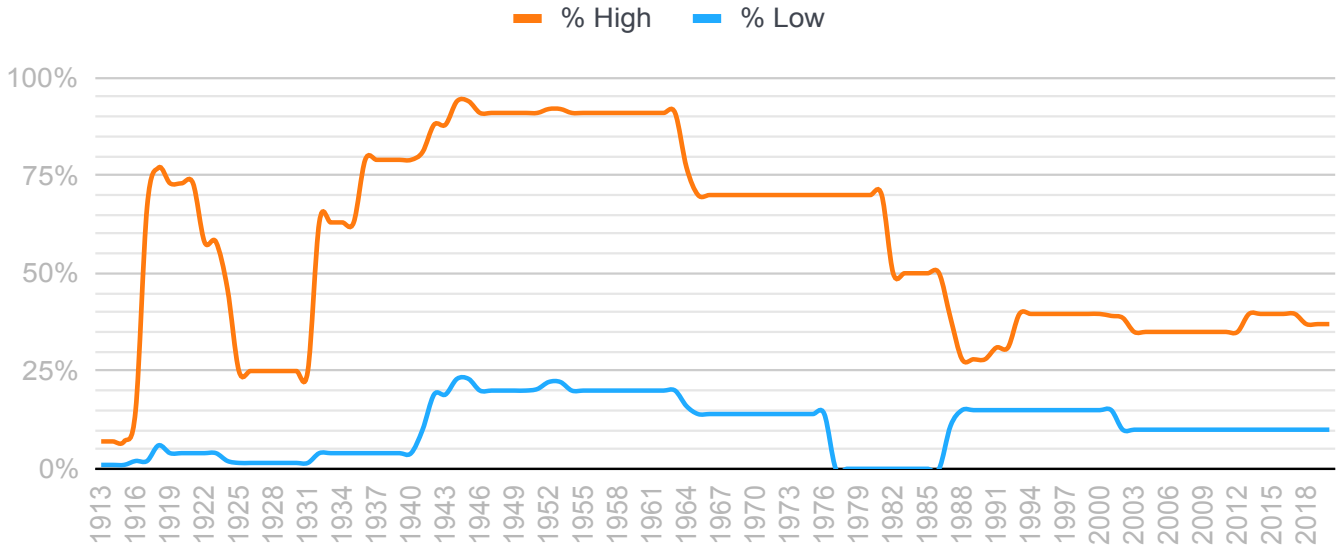
Overall the changes or eliminations were said to hurt only a small segment of the wealthiest savers, although in reality over time savers were universally punished. Each change brought forward current revenue to the Federal Government or pushed further out the timeline for payment

to the Social Security recipient. The negative consequences did not stop there because the future of higher or more invasive taxes will deliver an even bigger, longer-term sting.

Predicting where tax rates will go in the future is not an exact science. The math today indicates that the direction can only be UP. With massive increases in government stimulus programs, Social Security statements openly disclose future benefit shortfalls and Medicare and Medicaid's needs for additional funding are obvious. Quantifying the extent of future tax increases will become clearer over time. Regardless, there is not enough education to the public about how to survive in a much higher tax environment.

Historic Tax Brackets

Married Filling Joint; Lowest and Highest Income Brackets
Years 1913 - 2013; 2014-2020



Source: Tax Foundations. "U.S. Federal Individual Income Tax Rates History, 1862-2013." Washington, DC, 2014., https://taxfoundation.org/us-federal-individual-income-tax-rates-history-1913-2013-nominal-and-inflation-adjusted-brackets. Accesed October 30,2020.

Tax Foundations. "Tax Brackets, 2014-2020". Washington, DC.. https://taxfoundation.org. Accesed October 30,2020.

SURPRISE

With a bigger tax bite potentially cutting into future retirement income, the amount of savings needed for both the average and wealthier retiree will be far greater than currently estimated. Key point: the types of retirement account vehicles used today and the tax strategy around them need to change drastically. In 2001, academics researchers Jagadeesh Gokhale, Laurence J. Kotlikoff and Todd Neumann for the National Bureau of Economic Research warned of the dangers of higher taxes in their paper, *Does Participating in a 401(k) Raise Your Lifetime Taxes?*. Paying higher taxes on income today may need to be tolerated in order to avoid paying crippling taxes on retirement income in the future. In order for savers to preserve the lifestyle in retirement that they envision and map out today, major steps need to be taken with a researched approach. And we have done the research.

The research leads to a counterintuitive conclusion: NOT accumulating an outsize amount of savings in a traditional pre-tax 401(k). Saving over multiple decades is still one of the only ways to achieve the goal of retirement but not without eyes wide open to future tax consequences. One major limiting factor is being able to estimate future tax rates and if they will be higher, lower or the same in retirement as today. The following suggestions apply to a retiree expecting a similar or higher tax rate in retirement.

For the worker who expects to be in a similar or higher tax bracket in retirement, the ideal savings vehicle is the Roth 401(k)–while it is still available. The Roth 401(k) was introduced in 2001 but not widely adapted and offered by employers until more recently. Moreover, the Roth 401(k) is still somewhat misunderstood as to who benefits most. The wealthy

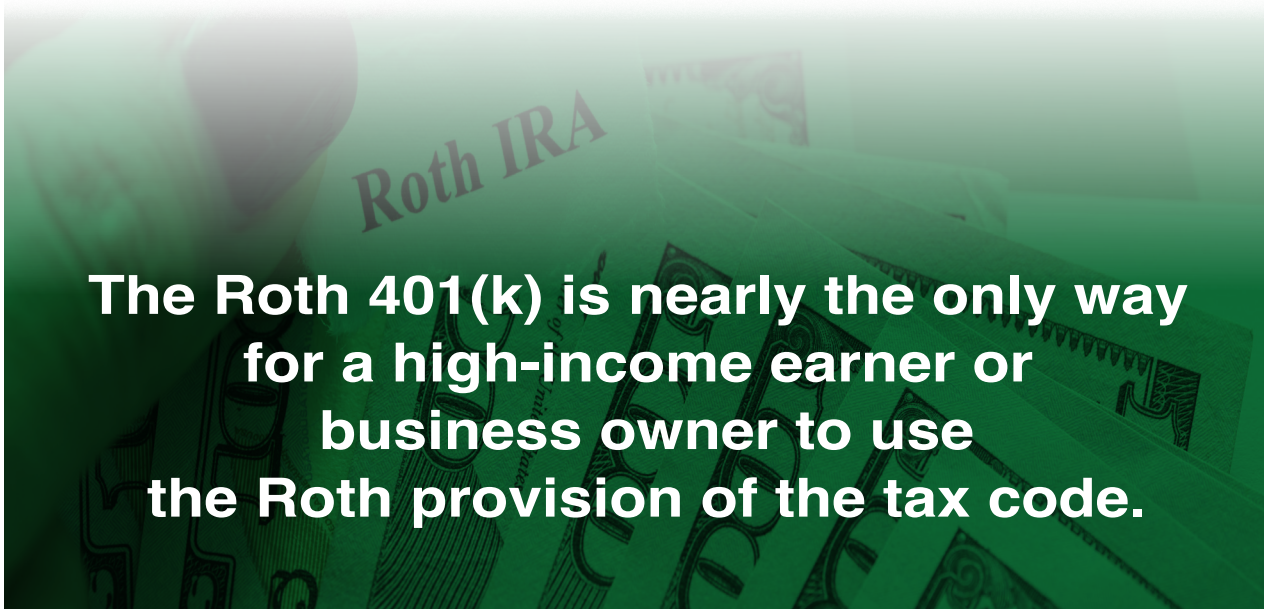
benefit greatly in the longer-term which is the focus of this paper. The Roth 401(k) is nearly the only way for a high income earner or business owner to use the Roth provision of the tax code. Unlike the Roth IRA, the Roth 401(k) can be used no matter how high the worker's compensation. Roth 401(k) contributions are made after tax today, grow tax-free and in the future can be withdrawn tax-free with no required minimum distributions. The Roth 401(k) is an exercise in delayed gratification.

Furthermore, even for those no longer working and without access to a Roth 401(k), existing traditional IRA and rollover IRA accounts can be converted to Roth IRA accounts. In this scenario the owner of a traditional pre-tax IRA converts the money either gradually over a number of years or as a lump sum, by removing them from the traditional IRA or rollover account, paying taxes on the removed monies at today's ordinary income tax rates and then reclassifying the monies by "conversion" to Roth IRA status. This person expects that taxes in the future will be higher than today. This is an especially timely opportunity for an early retiree or person who has not started drawing Social Security yet. In this case, there may still be a number of lower-tax years in which to make a series of partial Roth conversions, keeping the overall tax bite low.

In addition to the Roth 401(k) and Roth conversion, workers age 50 and over can use the catch-up provision to increase their Roth 401(k) contributions. The "catch-up" was designed for just that: a worker to catch up and maximize savings nearer to retirement. A worker may have started saving later in life, thus needing to accelerate saving in order to be able to retire without relying solely on Social Security for retirement income. The catch-up can also be used by a worker who has already maxed out retirement savings and simply wants to further take advantage of the tax-free benefits of the Roth.

Even if a person has enough clarity to predict future tax rates, consider that there may be an unforeseen scenario that bumps the taxpayer into a higher bracket because of a single expense. Common scenarios include funding the purchase of a second home, paying college tuition for a grandchild, funding future long-term care, or simply an unexpected emergency. Steps taken earlier can prevent being suddenly thrust into a high tax bracket by having to take a large withdrawal from tax-deferred monies.

A couple in their 50s or early 60s today with a lack of awareness or perhaps a mistaken belief that tax rates will be similar in retirement, but who has a sudden large expense later in life, may consequently create a cash flow squeeze. In this scenario, the result is not only a hefty tax bill for the lump sum IRA withdrawal but also a surcharge on Medicare Part B premiums of potentially thousands of dollars.



THE EARLIER THE BETTER

There was talk within the past 5 years of lowering the maximum allowed 401(k) contribution overall, so while the current amounts still exist use them!

The phrase “the earlier the better” applies for multiple reasons with regard to Roth IRA, Roth IRA conversion and Roth 401(k). For the simple reason of compounding returns for younger savers, using these vehicles early in life can pay off big down the line. Even for the not-so-young when overall compensation temporarily shifts lower for a year, say in transition to a new job, the Roth IRA is an option due to income limitations on contributions. Roth IRA and Roth 401(k) accounts feature tax-free treatment of withdrawals and no required minimum distributions, multiplying the power of these monies. Teaching and passing on the this savings strategy to young people can help them create a strong foundation.

In the case of Roth IRA conversions that create a large upfront tax bill, the argument for “the earlier the better” still stands strong. The reasoning is based simply on time for the converted monies to compound tax-free. The investor’s portfolio grows at Uncle Sam’s expense.

An ideal solution over time is to create diverse and alternative tax structures for future retirement income. When these structures are funded on a gradual basis the tax bite is spread out over years and possibly decades. There is no better time than the present to get started. Although 401(k) accounts are not always the ideal solution, they present a window of opportunity as one source of retirement security beyond the struggling Social Security system.

ALLOCATION OPTIMIZER

40% **TAXABLE ACCOUNT**

BROKERAGE I SAVINGS
CHECKING I ETFS I CDS
TAX FREE BONDS I MUTUAL FUNDS
STOCK

40% **TAX DEFERRED ACCOUNT**

IRA I 401(k)
DEFERRED COMPOSITION
DEFERRED ANNUITIES
PROFIT SHARING PLANS
DEFINED BENEFIT

20% **TAX FREE ACCOUNT**

ROTH IRA
LONG TERM CARE BENEFITS
HEALTH SAVINGS ACCOUNTS

Just as you would diversify your portfolio holdings you should also diversify your tax-exposure.

THE DEBT CLOCK

Peering into the future we predict rising or dramatically increasing taxes. The sobering truth is that for the US Federal Government, trillion is the new billion. Current U.S. Federal Government unfunded obligations total an estimated $155 trillion (with a "T"). That adds up to an average of $467,000 of obligation per US citizen. It is difficult to illustrate the size of these numbers but one way to make it real is writing out $155,000,000,000,000. Those who earn a hefty $1 million are simply at: $1,000,000.

One result of the continued growth in unfunded U.S. Government obligations could be hyperinflation. Hyperinflation is a term that describes rapid, excessive, and out of control general price increases in an economy. The Federal Reserve's strategy of printing money for over a decade and setting benchmark interest rates at near-zero could end badly. The timing of this bad ending could occur just as responsible, wealthy savers decide to enter retirement.

One Trillion—What's that look like?

If you wanted to count to one trillion, at a rate of one number per second, it would take you **over 32,000 YEARS** to finish.

1,000,000,000,000

For high earners currently in their 50s and early 60s, the retirement lifestyle they thought they correctly predicted could cost far more than estimated. Imagine what a 10-20% increase in tax rates mean, and what items such as vacations or second homes would require cutting back. All of these forces converge to mean higher costs of living and higher taxes across the board. Not to mention higher healthcare costs.

At the time of publication of this report, it was estimated that there was over $27 trillion dollars of National Debt.[3] *(See the Debt Clock snippet below.)*

3 Debt to the Penny. U.S. Treasury, Washington, D.C., 2020. https://mobile.treasurydirect.gov/#/publicdebt/alltotals. Accessed November 3, 2020.

The U.S. National Debt

The debt clock tracks the national debt, which hit $27 trillion in 2020. Seymour Durst created the clock in 1989, when the debt was just $3 trillion.

U.S. NATIONAL DEBT
$27,206,869,321,111

SOCIAL SECURITY LIABILITY
$20,822,493,569,026

MEDICARE LIABILITY
$32,243,547,322,796

U.S. UNFUNDED LIABILITIES
$155,338,074,475,294

LIABILITY PER CITIZEN
$469,889

Source: U.S. National Debt Clock. usdebtclock.org. Accessed November 3, 2020.

The Stroke of the Pen

The writing is on the wall. Additional changes could be needed to keep programs solvent. Here is a list of actions and changes that have been implemented in recent years.

- Elimination of some claiming strategies
- FICA taxes increasing faster than COLAs (Cost of Living Adjustments)
- Medicare Part B increasing faster than COLA
- Social Security outflows exceeding inflows (2019)
- Projected Depletion of the “Trust Fund” accelerated
- By 2035, projected Social Security inflows to cover only 79% of outflows
- Steadily increasing number of recipients vs. contributors

THE WAKE UP CALL

The unpleasant wake-up call to dramatically higher taxes has not fully yet occurred and is not loud enough. There are not nearly enough investors who want to acknowledge this reality because the issue has become overly politicized and seemingly impossible to manage. The complexities of the tax code almost deliberately obscure the very traps we are attempting to expose. Ultimately, retirees will need to access the flexibility of alternative tax strategies in the near future.

Incremental changes have occurred since the Oldsmobile commercial of 1988 and even prior with the U.S. government's ERISA Act in 1974. Every gradual change, especially recently, has been in the name of much needed revenue to support the sustainability of Social Security, Medicare and overall government spending programs. The knicks and dings in these programs will become so deep that the future may be more stark than our worst predictions. The creep in taxation on overall income, capital gains, dividends and Social Security, will continue and may hit hardest when savings are desired most.

The highest earners are at the most risk. This state of affairs requires informed action now. **A key next step is a "401(k) Audit." This process includes exploring your current 401(k) contribution strategy and understanding the tax implications of the future withdrawals. Based on your current contributions we will project the future value of your retirement savings and the potential taxation of future distributions.**

IS YOUR TAX STRATEGY READY?

Do you have or feel comfortable with the following?:

- ☐ I have calculated the tax impact of Required Minimum Distributions.
- ☐ I have a backup plan for rising taxes in retirement.
- ☐ I have a tax-efficient distribution strategy by account type.
- ☐ I have an intelligent amount of cash in a tax-efficient account.
- ☐ I have evaluated the use of Roth IRAs for tax-free income.
- ☐ I have tax-free Long-term care benefits in place.
- ☐ I have a plan to maximize my Social Security Benefits.

MY CURRENT ADVISOR HAS DONE THE FOLLOWING:

- Provided a comprehensive financial plan document.
- Looked at my tax return (and reviews it annually).
- Knows my current and potential future tax situation.

Book a Complimentary 401(k) Audit

WEBSITE

LIVINGWORTH.COM

CALL

706-451-9800

Next Steps

To request a **complimentary 401(k) Audit** simply contact us by phone or on the website. With convenient meeting methods and a customized approach to your financial planning you can be confident in embarking on a new path to building your self-reliant retirement.

If you would like to know if your 401(k) contributions are optimized for a tax-efficient retirement, take advantage of this complimentary analysis.

MEET THE AUTHORS

Brian Doe, CFP®

No two days are the same for Wealth Advisor Brian Doe, and that's the way he likes it. Between advising clients, calling on his resourcefulness, and following daily movements in the market, the financial world keeps him on his toes. After working in the industry for 20 years, he still finds it fascinating and enjoys helping people reap the rewards of an entire lifetime of hard work.

Kerrie Debbs, CFP®

Kerrie Debbs is no stranger to the financial world. For over 20 years she worked with clients to determine their lifetime needs, goals, hopes and dreams. With special focus on cash flows (i.e. personal income and spending), Kerrie and her clients work together to implement solutions to enable clients to make smarter decisions with their money.

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1031 PARKSIDE COMMON SUITE 101
GREENSBORO, GA 30642

706-451-9800