What Most Retirement Gurus Get Wrong

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SEPTEMBER 27, 2013 - REPRINTS

There is a grim mathematical reality facing Americans who save for retirement in tax-deferred vehicles, such as 401(k)s or IRAs: it is impossible for our government to liquidate $17 trillion of debt (and growing) without dramatically raising tax rates.[1] Former U.S. Comptroller General David Walker has even suggested that tax rates have to double in order to keep our country solvent.[2]

Given the threat of higher taxes, many mainstream financial gurus have begun to adopt "tax-free paradigms" in an effort to insulate their adherents' retirement accounts from the impact of rising taxes. But what strategies are these gurus advocating, and are all tax-free paradigms created equal?

The best way to insulate your clients from the impact of higher taxes is to put them in the zero percent tax bracket. After all, if tax rates double, isn't two times zero still zero?

Getting to the zero percent tax bracket involves accumulating precisely the right amounts of dollars in each of the three basic types of accounts or buckets: taxable, tax-deferred and tax-free. When our clients contribute dollars to the first two buckets in a willy-nilly or haphazard way, they unwittingly prevent themselves from ever getting to the zero percent tax bracket. The tax-free paradigm, by definition, advocates strategies that remove the IRS from the retirement equation.

3 ways to reduce your clients' lifetime tax burden

Now that I've defined the tax-free paradigm, let's see how some of the mainstream financial gurus measure up. For starters, there are three basic strategies upon which these "experts" tend to agree:

> Strategy #1: Have about six months' worth of income in an emergency fund (taxable account) to safeguard against unexpected emergencies.
>
> Strategy #2: Contribute to the 401(k) (tax-deferred account) up to the match, but not a penny above and beyond. Do enough to get the free money, then move on!
>
> Strategy #3: Finally, direct any dollars above the 401(k) match to the tax-free Roth IRA.

Pretty standard stuff. There isn't a mainstream guru out there (Dave Ramsey, Suze Orman, Clark Howard, etc.) who doesn't advocate these strategies.

But are these three recommendations alone enough to get our clients to the zero percent tax bracket? In some cases yes, but in many cases no.

If you want to understand the make-up of any guru's (or financial advisor's) tax-free paradigm, you can apply a fairly easy litmus test. Simply find out what they recommend be done with any surplus savings once Strategy #3 has been satisfied.

Why the "experts" are wrong

To test my hypothesis, I ventured onto the website of leading financial guru Dave Ramsey. Under Ramsey's general investment philosophy link, I found advice on how to invest any extra savings once the 401(k) match and Roth IRA have been maxed out:

"If your employer matches your contributions to your 401(k), 403(b), TSP, then invest up to the match. Next, fully fund a Roth IRA for you (and your spouse, if married). If that still doesn't total 15 percent of your income, come back to the 401(k), 403(b) or TSP."[3]

So, what should we make of Ramsey's "tax-free paradigm"? Well, he starts off by adhering to the traditional recommendations, but once the 401(k) match is met and the Roth IRA fully funded, he reverts right back to the 401(k). By doing so, he unleashes a litany of unintended consequences for his unsuspecting adherents.

When our clients contribute to the 401(k) above the match, they run the risk of having too much money in their tax-deferred bucket. It's OK to have some money in this bucket because they'll be able to utilize standard deductions and personal exemptions in retirement to offset the taxes. But if this bucket gets too big, RMDs alone could overwhelm these deductions, pushing the zero percent tax bracket beyond our clients' reach.

Further, any dollars coming out of their 401(k)'s qualify as provisional income. This is the type of income the government keeps track of to determine if Social Security is taxable. When our clients pay tax on their Social Security, they must spend down their other assets to compensate. This act alone can cause them to run out of money five to seven years faster than when they receive their Social Security tax-free.

Ramsey's investment philosophy betrays a pseudo tax-free paradigm that, if adhered to, could effectively prevent our clients from ever getting to the zero percent tax bracket. Remember, the only way to insulate our clients from the impact of rising tax rates is to get them to the zero percent tax bracket and keep them there!

But Ed Slott has it right

The next financial guru I decided to investigate was Ed Slott. Slott is a nationally renowned CPA and author who has made it to the New York Times best-seller list multiple times. You may even have seen his financial workshops on PBS in any of a hundred metropolitan areas across the country.

Like other gurus, Ed Slott agrees that the 401(k) match is "free money, so you don't want to give that up."[4] He likewise agrees that the Roth IRA is indispensable in warding off the impact of higher taxes. But what about those surplus dollars once the 401(k) match is met and the Roth IRA maxed out? Instead of directing these dollars back to the 401(k), he makes the case for contributing them to a properly designed life insurance policy. "You need to realize that life insurance is an investment," he says.
"But it's better than your typical investment accounts because it's tax free."[5]

Hold the phone, you may be thinking. There are tax-free alternatives other than the Roth IRA? Yes, in fact there is great power in combining the tax benefits of both Roth IRAs and properly designed life insurance policies. Slott explains: "Roth IRAs and life insurance can single-handedly remove most of the taxes you or your beneficiaries will ever have to pay."[5]

So, the man who the Wall Street Journal calls “The Best Source for IRA Advice” is recommending life insurance over a fully funded 401(k)?[6] After assuring us that he’s not a shill for life insurance companies (he isn’t even licensed to sell it), he goes on to say that “the tax exemption for life insurance is the single biggest benefit in the tax code. Make it a part of your retirement savings plan.”[5]

Allow me to expound upon the tax benefits of life insurance before pronouncing a verdict on Slott’s tax-free paradigm.

1. When structured properly, a life insurance policy can mimic the tax-free attributes of the Roth IRA but without the traditional limitations (income limits, contribution limits, etc.). This is done by buying as little life insurance as the IRS requires while contributing as much as the IRS allows.
2. Distributions from life insurance policies are tax free, are not counted as provisional income and therefore do not contribute to the thresholds that cause Social Security to be taxed.

When our clients contribute their surplus savings (beyond the 401(k) match and the Roth IRA) to a properly structured life insurance program in lieu of the 401(k), they increase the likelihood that they’ll reach the zero percent tax bracket in retirement and receive their Social Security tax free.

By advocating this strategy Mr. Slott passes the litmus test I spoke of earlier and demonstrates his understanding and mastery of the tax-free paradigm.

Just because a financial “expert” (or financial advisor for that matter) professes a tax-free paradigm, that doesn’t mean their recommendations are sufficient to get your clients to the zero percent tax bracket in retirement. By using the simple litmus test discussed in this article, you can identify the financial gurus that advocate tax-free planning principles and leverage their advice and expertise to keep your clients on the path to a tax-free retirement.

Footnotes

1. http://money.cnn.com/2011/03/25/news/economy/tax_increase/index.htm
2. http://www.cnn.com/2009/POLITICS/04/15/walker.tax.debt/
3. http://www.daveramsey.com/articles/article/articleID/daves-investing-philosophy/category/lifeandmoney_investing/
4. https://www.irahelp.com/aboutEdSlott.phpttp://www.foxbusiness.com/personal-finance/2011/04/15/fund-401k-ira/
5. “Ed Slott’s Retirement Rescue”, DVD 2013
6. https://www.irahelp.com/aboutEdSlott.php