Tax Deferrals

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Many taxpayers walk into our offices at WCG and tell us they want to pay fewer taxes. Who doesn't? We usually chuckle, and tell the client that he or she is the only one. Reminds us of Top Gun, "So, you're the one." It is sooooo refreshing to hear someone want to pay fewer taxes. Sorry for being snarky, but taxes are a way of life. And Yes, our job is to have you pay your fair share of taxes and not a dollar more.

Tax Savings

Tax savings comes in four variants- you can lie, cheat and steal, or you can understand the allowances and wiggle room afforded by the IRS code. We prefer the latter of course although the audit rate risk of 0.4% for S Corps makes it all too tempting. We hate when laws and ethics get in the way of a good tax scam (kidding).

However, notice how 401k plans, IRAs, and other tax-deferred vehicles are **not** listed as one of the four ways to save taxes. A tax deferral is not automatically a tax-savings technique- it might be. It might not be. In true accountant fashion, it depends.

This is a real life case- we have two Boeing engineers who saved about $1 million in the company 401k plan. The employee deferrals were all pre-tax, so they avoided about $250,000 in taxes since they were in the 25% marginal tax rate. Not bad.

However, they currently have four children, a house mortgage, and the usual tax deductions of a household of this size and age. When this couple retires in 2025, their marginal tax rate will increase to 28% due to their pension income and other income sources, and the dramatic reduction in tax deductions and credits.

So, they save at 25% and they will pay it back at 28%. Bummer. But wait! There is more to the story. Just like Paul Harvey, there is a page 2, or in the case of this page there is a scroll bar.

Turn Tax Deferrals Into Savings

What about all tax deferrals? Where does that money go? Usually to buy stuff like cars, vacations, food, and other consumables which don't offer a return on investment. But what if this same couple invested the current tax deferrals into a conservative portfolio which yields a nice 5% rate of return (after tax consequence)? Things tilt in their favor- so we are back to having a tax benefit from tax deferrals. Huh?

The following is a ridiculously overly simplified table to demonstrate what we are talking about. Here are the assumptions-

- Defer $18,000 per year for 10 years
- Marginal tax rate is 25% during wage earning years
- Rate of return on investing tax deferral savings is 5% net of taxes

Year	Defer	Tax Savings	Growth
1	18,000	4,500	4,725
2	18,000	4,500	9,686
3	18,000	4,500	14,896
4	18,000	4,500	20,365
5	18,000	4,500	26,109
6	18,000	4,500	32,139
7	18,000	4,500	38,471
8	18,000	4,500	45,120
9	18,000	4,500	52,101

10	18,000	4,500	59,431
Totals	**180,000**	**45,000**	**59,431**

A quick recap- you deferred $180,000 and deferred $45,000 in taxes. That deferral grew to $59,431 because you invested it in a safe 5% investment portfolio. Great. What does this do?

28% Tax on Withdrawals	50,400
Growth on Tax Savings	59,431
Realized Savings	**9,031**

If your marginal tax rate increases from 25% to 28%, you still see a savings of $9,031 as shown above. Again, this is predicated on you taking the tax you normally would have paid, and investing it wisely. Not all of us are this disciplined.

But if your marginal tax rate increases from 25% to 33%, your savings is zero. Granted, to jump 8% in marginal tax rate between wage earning years and retirement years seems rare, but you get the point.

33% Tax on Withdrawals	59,400
Growth on Tax Savings	59,431
Realized Savings	**31**

Tax Deferral Moral

The moral of the story is this. Yes, tax deferrals can lead to tax savings but you have to work the system and be disciplined. Not just today, but for several years. And you need a jump in marginal tax rate that is 8% or less (in general)- assuming you have an increase at all.

What should you do? Probably hedge your bet between pre-tax and post-tax retirement savings. At the end of the day, financial planning and tax projections can help in determining which way to go. WCG (formerly Watson CPA Group) can help.

There is also the **RMD angle.** RMD is a common TLA (three letter acronym) tossed around at bingo parlors and country clubs, and stands for required minimum distributions. In a nutshell, the IRS forces you to take out a portion of your pre-tax retirement savings every year so they can collect on the IOU you gave them several years ago.

So, for you there is tax savings built into the RMD system since not all the money is taken out and taxed. If you add in your heirs' marginal tax rates, perhaps this changes from a “family unit” perspective. Heck, you're the dead person- let your kids worry about your taxes by assuming them as their own. It takes a while to payback for all those sleepless nights and stinky diapers, but eventually it happens.

All kidding aside, here is something to consider- with life expectancy well into the 90s, your children might be retired too when you pass. Crazy but realistic, especially if you had kids before you had a career.