KELLY O'CONNOR
financial

Why IRAs Should Be Avoided

Traditional IRAs and Roth IRAs are Identical

Both Should Be Avoided!

I'd like to begin with a quote by Dave Ramsey and his Financial Peace Revisited book (full reference below). This quote is so unbelievably wrong it needs to be ripped out. But it's very relevant to the topic at hand because it perfectly points out a common misconception about pre-tax investments (like the IRA) and post-tax investments (like the Roth IRA).

A Quote from Dave Ramsey

"Billionaire J. Paul Getty says that one of the keys to building wealth is not to pay taxes on money until you use it. So you shouldn't pay taxes on retirement dollars until you use them. You should always invest long term with pretax dollars. What if I gave you $2,000 each year and these were the conditions: You can earn all the interest you want on that $2,000 – and keep it – but you have to give the $2,000 for each year back to me when you are seventy years old. If you were thirty-five years old and we did that for thirty-five years at 12 percent, you would have $863,326. You do have to give me back $2,000 x 35 years or $70,000, but you still net $793,326. If you save $6,700 per year in a pretax investment like a 401(k) or SEPP (Simplified Employee Pension Plan), the above scenario would have occurred. If you bring that $6,700 per year home, it turns into $4,700 by the time Uncle Congress gets his greedy cut, so $2,000 of that money is Uncle Congress's – which, if we invest pretax, we get to keep for free all those years. What a deal!
I have heard the ridiculous pitch that it is better to pay your taxes today because tax rates may be higher by the time you get to retirement. The only people who believe that argument do not understand the power of the present value of dollars or are life insurance salesmen."

(*Dave Ramsey, Financial Peace Revisited, Penguin Group, page 154-155)*

"Financial Idiots" – Remember, That's You

What a……joke!

If you've read any of my previous blogs or my other eBooks, you'll remember the conversation I had with Dave's right-hand-man (who I can't name since he's a friend so I fully understand that it's "hearsay"). I addressed this particular quote from Dave's book, and several other topics of equal concern, and he admitted that this commentary quoted above was in fact inaccurate. I guess we'll see if it's printed correctly next time around…I highly doubt it. Remember what that friend said at the end of our conversation concerning Dave's followers? No? Well let me refresh your memory. He said this, "Kelly, you have to understand, 80% of our clients are financial idiots."

Unfortunately, it appears he's right in this situation because you'd have to be a financial idiot to believe the above paragraph is accurate…or maybe you're just way too trusting. Honestly, I don't understand why the SEC doesn't require this to be corrected because it's TOTALLY false.

Seriously, Are You That Gullible?

First, do you really believe the government only takes that which you put in? Are you so gullible to believe that the government will allow you to contribute $2,000 each year, pay no tax on that $2,000, let it grow, and then only pay them back the $2,000 when it's time to take it out? Unbelievable. You see, in reality, the government gets to take as much as it wants of the full account balance. How?

They, Uncle Sam, get to decide what tax bracket you'll be in at the time of withdrawal. The entire balance of $863,326 is at their mercy when it's time for you to take it out. You don't get to decide! You have no idea how much of your Qualified Plan (401k, SEP, Traditional IRA, etc) is actually yours until that day comes.

Let's say you happen to fall into a 30% tax bracket when you're 70 years old. Okay, so how much of your 401(k) is the government's in Dave's example above? What's 30% of $863,326? It's $258,997.80! Not $70,000. You see, you haven't paid taxes on any of it yet. You didn't pay on the $2,000. You didn't pay on the growth along the way. But now you're withdrawing and the government gets their share. The very fact that he, Dave Ramsey, claims you only have to pay back what you put in is utter stupidity and complete ignorance of how these financial instruments work but more importantly how the tax code works.

No Dave, There Is No Difference

Second, let's address the pre-tax and post-tax issue and why they are identical. Read this one slow: there is no difference mathematically between pre-tax and post-tax dollars when invested. Dave would yell foul (he said abov
e that "you should always use pre-tax dollars to invest long-term"). When I say, and I've said it over and over, that Dave can be proven wrong with math not opinion…well, this is another perfect example. Don't believe me? Let's allow the math to decide for us. I'll even use his numbers from above.

.

If you invested $2,000 for 35 years and earned a 12% actual rate of return (remember, there's a difference between average and actual rate of return) then your money would grow to $863,326. If you were in a 30% tax bracket at that time, and took a lump sum, you would have to pay the government $258,997.80 leaving you a balance of $604,328.20.

Now the "post-tax": If you took that same $2,000 but were taxed 30% on it when you brought it home then you'd have $1,400 to invest. If you invested $1,400 each year for 35 years at an actual rate of return of 12%, guess how much you have at the end? $604,328.20. What? How can that be Dave? It's math people

A No-Calculator-Needed Example

How about an easy example so you don't have to pull out your calculator to determine if my math is right or not. Let's say that Brother A had $10,000 before tax to invest. He put it in an investment product that doubled his money after 10 years...so he now had a balance of $20,000. At the end of the 10 years if his taxes were 30% then $6,000 (20,000 x .30) would go to the IRS and he'd have a balance of $14,000. Congratulations, you followed Dave Ramsey's advice and you apparently made the wise decision.

Let's then say that Brother B also had $10,000 to invest but he decided to take the 30% tax hit at the beginning. He'd have $7,000 left over after paying the IRS $3,000 (10,000 x .30). Now, if he used the same investment account as Brother A and doubled his money then what would his balance be at the end? Pretty easy, $7,000 x 2 = $14,000.

Pre-tax and Post-tax are the EXACT SAME if the variables are the same (i.e. investment return and taxation). They are identical. So what then becomes the primary consideration when choosing these types of accounts? TAXATION! It is the number one issue. Dave, you said above that others who disagree with you "do not understand the power of the present value of dollars." Uh, right. Pure stupidity. It has nothing do with that Mr. Ramsey. It has everything to do with MATH! My 5th grade son could prove this point.

If you are not educating yourself about the economic and social conditions of our country and the impact they will have on your dollar then you better start. These issues will be crucial when determining future taxation and it's the taxation issue that has the biggest impact on your future dollars. Please, please start reading. The information exists. I'll be addressing some of it a little later in this book.

You Never Avoid the Taxes

Again, what were the conditions in the above examples? The conditions simply assumed a 30% tax bracket for both and the same actual rate of return. Guess which option, pre-tax or post-tax, gets worse in an increasing tax environment? Come on, guess. Pre-tax loses every time. Dave's example, and advice, gets worse in an increasing tax environment. His quote at the end about those who believe taxes will be higher are giving a "ridiculous pitch", I wonder if he still feels that way. I will say his book was published in 2003. Are any of you really under the impression economically that we are in a decreasing or flattening tax environment?

Outside of all the various conditions that are pointing to higher taxes, what is it that determines your tax bracket anyway? Your income. How many of you have incorporated into your financial plan to be at the lowest income bracket once you retire? I assume none of you. Yet Dave continues to sound off that you will be in a lower tax bracket which completely counters the economic conditions and your own lifestyle desires.

The government virtually ensures they'll get more money from you than you defer. The 10% penalty they enforce on withdrawals made prior to age 59 ½ is evidence of this fact. If you don't allow your money to extend into the future and you decide you need to take it out "early", they tack on another 10%. Interesting. They ALWAYS get more.

Now I understand why the company of Dave Ramsey refers to their followers as idiots because you'd have to live in a hole to think your taxes aren't going up.

Anyone Think Taxes Are Going Down?

What if, when the person in Dave's example turns 70, the tax rate goes up to 35%? Not a huge hit or is it? Well, 35% going to the government would leave this follower of Dave a balance of $561,161.90. So he deferred at a 30% tax in order to pay at a 35% on the whole balance...genius planning. If he simply contributed along the way with his post-tax dollars of $1,400 then he'd still have the $604,328.20...because he already paid his taxes on this money. That's a difference of $43,166.30. Now Dave, that simple decision could buy this retiree a new car. But if you would rather pay that to the government then go ahead.

Dave’s advice is not only wrong in regards to the rules established by the IRS but also from a mathematical position.

Am I saying that Qualified Plans are foolish? Not necessarily. If two financial realities existed then they’d be a good thing:

1. If we were in a decreasing tax environment and you could defer taxes today at a higher rate and pay them later at a lower rate then dump money into them (you would still have to understand that the government is in charge of this money along the way even in a decreasing tax environment). But that’s not the condition nor the situation our country is facing. We are NOT in a decreasing tax environment and the less money that you have at the control of the government (keep in mind they can change the rules on these accounts with a stroke of a pen) the better. YOU need to be in control and Qualified Plans like these give you ZERO control of your money. If you don‘t believe that then please tell me how you are getting around the rules...millions of people would love to know.
2. If your Qualified Plan retirement income distributions weren’t means tested against your Social Security benefits. That would be great. But that’s not the case. The government currently determines the income levels that are then disqualified from receiving a full Social Security benefit. Think about that for a moment. You fund Social Security with after-tax dollars, you’re promised it back, but because you distribute money from a Qualified Plan that is fully taxable and your distribution exceeds their limit then your benefits get taxed at Ordinary Income rates for A SECOND TIME! That’s double taxation with representation and we do nothing about it. If you withdraw $80,000, 85% of your benefits are added on top of your gross income and taxed again. $40,000 and 50% of your benefits are taxable. Absurd!

It’s the Postponement of Taxes!

You must remember that Qualified Plans defer two things (we like to say “postpone” since that’s what they do): they postpone the tax AND postpone the tax calculation. It’s the second one that’s the killer. It’s the second one that makes the difference that determines how much is yours, that determines if it’s a wise decision or not. Are you educating yourself about the second one or are you only falling for the whole “pre-tax is the best place to be” sales pitch?

Why is the Gov’t More Interested in Our Pre-Tax Dollars

So, if the post-tax (Roth) and the pre-tax (IRA) get to the same place mathematically, then why is the government more interested in the pre-tax than our post-tax dollars? Let’s prove that first.

The Roth has income limitations. What? Why? Why do they tell you that you are unable to contribute post-tax money into an account that will grow tax-deferred and can be used tax free later? Why are they punishing your success? As of the time of this writing, as soon as you make around $117,000 per year then you begin to be phased out of the Roth IRA. But I want the Roth IRA...too bad.

So there are income limitations on the post-tax Roth. Are there income limitations on the pre-tax IRA? Nope. Nothing. Zero limits. You could make $10,000,000 a year and still contribute to an IRA. So they’ll gladly accept my $54,000 into my SEP IRA but they won’t let me do one dollar into a Roth. Obviously there’s a reason.

What if you do qualify for a Roth IRA? You're only allowed to contribute $5,500 per year. That's it. But you can do $18,000 into your 401k or IRA and $54,000 into a SEP. Those people whose income is low enough to do a Roth still face a sizable limitation on how much they can contribute. So interesting to me.

Why? Why the push by the government into the pre-tax investments if pre-tax and post-tax get to the same place mathematically? Again, if they are mathematically the same then why is the government more interested in one over the other?

It has everything to do with the future tax rate. The future tax rate is the only mathematical factor that determines the winner every time. Let's get back to my Brother A and Brother B example. Brother A invested his pre-tax $10,000 and doubled his account to $20,000. Brother B took the 30% tax hit and invested his $10,000 after he first paid $3,000 in tax, so he had $7,000 and then doubled it to $14,000. If Brother A is facing a 30% tax rate then they both get to the same place; however, if taxes have gone up then Brother A loses. If taxes are at 40% then he has to pay $8,000 and now has a balance of $12,000. Brother B won. But, if taxes go down to 20% then Brother A only has to pay $4,000 and his ending balance is $16,000 so he wins.

You see, the ONLY factor that determines the winner is the future tax rate. It's math. It works this way every single time.

Here's what you have to ask yourself: do you really believe that the government is excluding you from post-tax investments (or drastically limiting what you can contribute to them) and allowing you to put a sizable amount into a pre-tax account in order for you to owe them less sometime in the future? Seriously?

If you believe they are operating in such a way to make sure you win and they lose then I am NOT a writer, advisor or friend that you'll enjoy having conversations with on a regular basis.

There are two systems of taxation in our county, one for the informed and one for the uninformed.

Let's Look at the SEP IRA

I've had so many conversations with successful entrepreneurs who are instructed by their financial team to put money into a SEP IRA. The number one reason people are told to put their money into these accounts is because of the apparent tax savings. Since we know these accounts postpone the tax and the tax calculation, we have to ask a couple questions first:

1. What tax bracket will you be in at retirement?
2. What deductions will you have when you take the money?

The government can certainly raise taxes or you may simply earn yourself into a higher bracket. Later on in life when you have no mortgage, the kids are gone and you've sold your business you very well may be out of tax deductions.

I want to use an actual example of a friend of mine. He owns an HVAC business, has about 50 employees, a fleet of 25 vehicles and they've spent the last 25 years building this business. They have something I call, concentrated risk. Meaning all the money is in the business. They went to their CPA who's doing a fine job saving them some taxes, helping them pay the least possible, maximizing their deductions, etc. They told their CPA that they wanted to start putting money aside on their own outside of the anticipated sale of their business down the road. They had a few issues since they were personally grossing over a $1,000,000 annually, they were in the highest tax bracket and they lived a rather wealthy lifestyle...two vacation homes, a huge primary residence, vehicles, toys, all the good things that money can buy. This makes it very unlikely that they'll be in a lower tax bracket when they retire plus they'll have virtually no deductions since they won't own the business anymore.

Now the CPA gave them some interesting advice. Remember, a CPA's job is to reduce their tax for this year. So he said, "We can put the wife on the payroll and you can max out the catch-up provisions and put $42,000 into a SEP IRA (this was a few years ago) because it will save you taxes." Both the husband and wife were 50 years old and they wanted to be done in 10 years.

The CPA felt that they could actually get an annual rate of return over the next 10 years of about 10%. Crazy but we'll use that number. When we calculate this out you'll see that if this were to come to fruition then they'd have an account balance of $736,309.

Annual Contribution	$42,000
Current Tax Bracket	33.00%
Withdrawal Tax Bracket	33.00%
Years Until Withdrawal	10
Investment Return	10.00%

Account Balance	$ 736,309
Your Share	$493,327
Amount Due IRS	$242,982
Apparent Taxes Deferred	$138,600
Apparent Taxes at Interest	$242,982

When this statement arrives in 10 years, they'll think that they have how much money? I'm sure you guessed correctly: all $736k. Unfortunately, that's not really the case because they haven't paid the tax on that balance yet. In this example, if they took all the funds out in one lump sum (yes people do that for good reasons), then they owe the government 33% of that balance...in this case the amount due to the IRS is $242,982. Which leaves them an after-tax balance of $493,327.

Where did the $242,982 come from? Well, over the years this couple did not pay the government the 33% tax due on the $42,000 contribution. Annually that calculates to $13,860. Over a 10 year period that's a total of $138,600 that they deferred. Here's the kicker: they deferred it at interest and in this example their account grew at a rate of 10% each year. So, the IRS' share grew from $138,600 to $242,982. How awesome. I've actually heard financial professionals tell clients that if they contribute to a SEP (or a traditional IRA for that matter) then they are "using the government's money" to grow an account; however, if that were the whole truth then this couple would only owe the IRS the $138,600 that they deferred. But that's not the case because they never had $42,000 a year in the plan originally, they only had $28,140 (42,000 minus 13,860). You see, while their $28,140 is growing at 10% so is the government's share of $13,860.

A fundamental mistake people make is when they put $42,000 into the plan, they act like all $42,000 belongs to them. It doesn't.

Now, if after 10 years, the government came to them and said, "Look, you've been putting aside the funds but we'd like our share now and we just want you to write us a check for the $138,600 to call it even" then these business owners would certainly sign up for that type of an account because that would truly be using the government's money. Remember, that's what Dave Ramsey said actually happens...unbelievable.

If the future tax rates are lower, the government's share is simply less and the business owner's share is greater. But, if tax rates go up, then the government's share is greater and the investor's share is less. For example: if this individual somehow magically falls into a 10% tax bracket after the 10 years then he'd only owe 10% of the $736,309 balance. But, if his taxes are at 50% then he'd get half and the government would get half. Who controls the future rate? You or the government? So this actually begs a very important question:

If you know that our government is fiscally irresponsible and constantly mismanaging money, then why in the HELL would you invest in an investment account where they own and control the rules and the calculations to ensure they win more than you?

Makes ZERO sense to me. Literally, why would you give them control of one single dime if you had a choice to do so or not? Don't forget, our very own politicians exempt themselves from these types of retirement plan accounts...that's key! They themselves will not use them.

So that leads me to our final topic, what the government is telling us they're going to do in the future.

Government Outlays and Receipts

There is a document that I suggest you monitor on an annual basis: the Government Budget Summary Tables. Specifically, the Table S5 Proposed Budget by Category. It looks like this:

Table S–5. Proposed Budget by Category

(In billions of dollars)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Totals 2013–2017	Totals 2013–2022
Outlays:														
Appropriated ("discretionary") programs:[1]														
Security	838	868	851	768	749	757	771	786	803	820	837	856	3,897	8,001
Nonsecurity	462	450	410	393	385	386	390	397	405	415	420	430	1,964	4,032
Subtotal, appropriated programs	1,300	1,319	1,261	1,160	1,135	1,143	1,162	1,183	1,208	1,236	1,258	1,287	5,861	12,033
Mandatory programs:														
Social Security	725	773	820	867	918	970	1,026	1,085	1,149	1,216	1,287	1,361	4,601	10,699
Medicare	480	478	523	551	569	619	633	654	716	767	822	908	2,895	6,762
Medicaid	275	255	283	328	370	399	423	450	479	510	542	578	1,813	4,372
Troubled Asset Relief Program (TARP)[2]	–38	35	12	8	5	2	1	*	*	*	......	......	29	30
Other mandatory programs	631	711	654	644	665	705	712	716	750	775	821	826	3,381	7,269
Subtotal, mandatory programs	2,073	2,252	2,293	2,409	2,527	2,696	2,796	2,906	3,094	3,269	3,472	3,673	12,719	29,131
Net interest	230	225	248	309	390	483	565	631	692	748	798	850	1,996	5,715
Adjustments for disaster costs[3]	*	*	2	5	7	8	9	9	10	10	10	10	31	80
Total outlays	3,603	3,796	3,803	3,883	4,060	4,329	4,532	4,729	5,004	5,262	5,537	5,820	20,607	46,959
Receipts:														
Individual income taxes	1,091	1,165	1,359	1,476	1,617	1,763	1,912	2,052	2,184	2,319	2,459	2,605	8,128	19,747
Corporation income taxes	181	237	348	430	445	455	473	480	485	494	507	520	2,151	4,637
Social insurance and retirement receipts:														
Social Security payroll taxes	566	572	677	742	781	833	881	936	987	1,034	1,093	1,150	3,915	9,112
Medicare payroll taxes	188	203	214	226	240	257	273	290	306	321	339	357	1,210	2,823
Unemployment insurance	56	57	58	59	75	79	75	73	65	64	66	67	347	681
Other retirement	8	9	10	11	12	12	13	13	14	14	16	17	57	130
Excise taxes	72	79	88	99	104	106	112	120	136	142	150	159	509	1,216
Estate and gift taxes	7	11	13	23	25	27	29	32	34	37	39	42	117	301
Customs duties	30	31	33	36	38	39	41	44	46	48	50	52	188	428
Deposits of earnings, Federal Reserve System	83	81	80	61	46	36	36	38	40	42	43	45	260	468
Other miscellaneous receipts	20	24	21	52	68	71	74	77	83	89	95	101	286	729
Total receipts	2,303	2,469	2,902	3,215	3,450	3,680	3,919	4,153	4,379	4,604	4,857	5,115	17,167	40,274
Deficit	**1,300**	**1,327**	**901**	**668**	**610**	**649**	**612**	**575**	**626**	**658**	**681**	**704**	**3,440**	**6,684**
Net interest	230	225	248	309	390	483	565	631	692	748	798	850	1,996	5,715
Primary deficit / surplus (–)	**1,070**	**1,102**	**654**	**359**	**219**	**166**	**47**	**–56**	**–67**	**–90**	**–117**	**–146**	**1,445**	**969**
On-budget deficit	1,367	1,394	945	695	629	673	634	601	647	667	686	701	3,576	6,877
Off-budget deficit / surplus (–)	–67	–67	–43	–27	–19	–24	–22	–25	–21	–10	–5	4	–136	–193

I'd direct you first to the Outlays, which is what the government pays out, and the Receipts, which is what they bring in through taxation. The Outlays is broken down into three categories:

1. The Appropriated Programs: which is all military spending (Security) and everything Federal government (Nonsecurity).
2. The Mandatory Programs: basically all the entitlements.
3. The Net Interest Expense.

So let's look at 2017. The total Appropriated budget is $1,162,000,000,000 of which $771,000,000,000 is military. Crazy numbers. The Mandatory is far worse: it's $2,796,000,000,000 and the Net Interest is $565,000,000,000. For a grand total outlay of $4,532,000,000,000.

Now, let's look at the expected Receipts. They show a total of $3,919,000,000,000. They will spend $613,000,000,000 more than they bring in.

Now, let's look just a few years down the road to year 2022. Specifically the total Receipts. They show an estimated $5,115,000,000,000 in total tax "revenue". That's a lot higher than the 2017 total. As a matter of fact, that's a 30.5% increase in tax revenue. 30.5%! Do you really believe that they will have your best interest at heart and make sure they take less from your untaxed investment accounts in the future just so you can be the winner and not them? That is truly what any professional who recommends these types of pre-tax accounts needs you to believe...naively so most likely.

A pre-tax investment and a post-tax investment both get to the same place mathematically. The only factor that determines the winner is the future tax rate. The government is far more interested in the pre-tax accounts because they know they control the future rates. You won't win with these accounts and you most definitely shouldn't trust them with your investment dollars. You worked way too hard to give them that privilege.

I believe the government tries really hard to take the fun out of being successful and they do this by creating obstacles to get in our way. These accounts are one of those obstacles. Because of this, I believe successful individuals deserve the opportunity to learn how the tax code permits them to get their money positioned in a such a way so that when it's time to finally use their money, they are completely exempt from both federal and state income taxes... regardless of their income level and regardless of the state they reside in. How I do this is by understanding and demonstrating that tax code. What I do is make this possible for people.

We have to two systems of taxation in our country, one for the informed and one for the uninformed. You see, our tax code only requires that your money be taxed one time. If you experience a second tax of any type, it's completely voluntary. Do your part to be informed.

Thanks for reading,
Kelly D. O'Connor

the green button