

### Qualified Plans: The Hidden Truth

For many people, the term 401k is synonymous with retirement preparation, and sometimes represents the full extent of their preparedness. Such accounts are often included as part of a benefits package provided by employers, and chances are if you have one, most of your retirement savings are being deposited into this account. Given that it can play such a prominent role in our financial picture, it is imperative that you fully understand exactly how these plans work.

So what do Qualified Plans do exactly?

Most people will be familiar with the fact that they defer taxes, which is true. But this term “defer” can often lead to a misunderstanding about what is actually happening. Some people fall victim to the misconception that “deferred” taxes are taxes they are “saving” because the taxes do not have to be paid; which is not true. These are not tax savings plans but rather tax deferred savings plans. The government did not say that you don’t have to pay taxes on the dollars in your Qualified Plan; they said that you don’t have to pay the taxes *now*.

If not now, then when? Well, later obviously. The key difference between now and later though is relative to your tax bracket. What bracket you are in now, and what bracket you will be in when you decide to take the money out of the account. If you defer the tax and you are in a higher bracket later than you are in today your share of the account will be less. If you are in a lower bracket when you take the money than when you put it in you will get more. The IRS is not going to ask you what tax bracket you were in the day you made the contribution to your account. Their only concern is going to be what tax bracket are you in at the time of withdrawal. Because this is true you will need to make an informed decision about which option is best for you.

The Check Story

*“Let’s assume that you call me one day and want to borrow \$10,000. I hand you the check, but before you take it you are going to ask me two questions. The first is how much interest am I going to charge you, and the second is when do you have to pay it back?”*

*Suppose I said to you, I am doing fine right now and do not need the money, but there will come a day when I need it, and when I know how much I need we can figure out how much interest I need to charge you to get how much I need.”*

Would you cash that check? Probably not, but you are standing in line to do exactly that with the federal government in your qualified plan. They did not say that you don’t owe the tax; they said you can pay us later. At what rate? Now that is a good question.

Understand that Qualified Plans do two things:

1. They defer the tax, AND
2. They defer the tax calculation

Ultimately, the impact these plans can have on your finances either positively or negatively, depends on a number of factors. The first and most fundamental of these is your understanding of the rules of the game, and secondarily the strategy you use to play the game.

Tic-Tac-Toe

You may not remember the first time you played tic-tac-toe, but you can probably guess who won. It was likely the person who showed you how to play the game. The game has only a few simple rules, one is the X, the other O, three in a row wins. As we first learned this game as children, we lost routinely until we learned the strategy of the game. If you have dollars in a Qualified Plan, you are already playing the game. As an advisor, my job is helping clients employ a winning strategy by better understanding the rules of the game.