Designing a New Paradigm for Financial Planning

By Marc Cram, CFP

We have planned our retirements pretty much the same way for the last 30 years but maybe it is time to design a new paradigm for the future.

What do we mean by the word paradigm? The dictionary defines a paradigm as *a set of assumptions, concepts, values, and practices that constitutes a way of viewing reality for the community that shares them, especially in an intellectual discipline.* In other words, a paradigm becomes our TRUTH. We accept it as fact until we believe it otherwise. It is our way of viewing reality and everything that agrees with it we take as true and everything that contradicts it, in our mind, is rejected as false. Sometimes we learn that our paradigms themselves are false (think of the discovery that the world was round) and we then have to create new paradigms and fit the new facts within them. It is lucky for us that we can do this, because if we were unable to make these adjustments we would have a hard time with change. Because we are reasonable beings, we can take new information and adapt it to new circumstances allowing us to create, evolve and progress.

So, what is the set of assumptions we have been planning with up to now? There are two basic assumptions that I see are in need of immediate evaluation:

1. Saving money in a tax-deferred environment is prudent planning.
2. You will be in a lower tax bracket when you retire.

Let's deal with the second assumption first as I feel it is what has been driving the first assumption for a long time. In every seminar I give I ask the participants if they think taxes will be lower, the same or higher in the future. Without fail 100% of those responding agree that taxes will be higher in the future. Now there are many reasons why we believe this is so but let me enumerate just a few:

1. People over age 65 will nearly double in the next 30 years (from 12% today to 19.4% in 2030)
2. Our governmental debt ($7 Trillion) and trade balance of payments ($617 Billion) do not favor lower taxes
3. Social Security, Medicare and Medicaid are headed for huge deficits (up to $70 trillion by some estimates)
4. We have fewer deductions once we retire (no children and low or no mortgage interest write off)

Laurence J. Kautlikoff, Professor of Economics at Boston University and author of the book "*The Coming Generational Storm*", has done the accounting, looking out several generations, and he concludes that "*After calculating the immediate and permanent federal personal and corporate income tax hike needed to achieve generational balance… the requisite tax hike is a whopping 69 percent!*" There are plenty of other authors out there saying the same thing which leads me to agree with my seminar attendees, that income taxes are going to be higher in the future.

Assuming you are still with me and that you agree with the forgoing assumption, we need to examine the thinking behind assumption number one, that saving money in a tax-deferred environment is prudent. First, we need to look at what deferred growth provides us. One of the reasons financial planners have been preaching deferred growth for so long is that you can accumulate more real dollars

in a tax deferred environment than you can in a taxable environment. If your money isn't being chipped away at with taxes every year, you can indeed end up with more dollars in your retirement account. However, what you have done is to defer those taxes to a day when you thought you were going to be in a lower tax bracket, thereby allowing you a larger income in retirement.
Are you starting to see where I am going here? What we have unwittingly done is create a retirement plan for Uncle Sam, not for us. If we are in fact going to be in a higher tax bracket in retirement, we will end up with less real dollars in our pockets and Uncle Sam will end up with more in his. Let me give you an example that makes this real:

> Assume you are in a 33% tax bracket and that you have saved $4,000 per year for 30 years in a tax-deductible account (a total of $120,000). If your account grew at 8% per year your account would be worth about $500,000 at the end of the 30th year. Over those 30 years you would have saved $1,320 per year in taxes or a total savings of $39,600. Now assuming you stay in the same tax bracket in retirement (although it could be a higher one) and you take out 6% of you retirement account each year, you will have an income of $30,000 on which you pay 33% in taxes ($9,900) to net $20,100 in spendable income. If you look, you can you see that it would take only 4 years in retirement for you to exhaust 30 years of tax savings ($39,600 ÷ $9,900 = 4).
> Every year after year four in retirement you are creating Uncle Sam's retirement plan. On top of that, if you need $30,000 to live comfortably in retirement you will need to take out $45,000 each year in order to net the $30,000 you need to live on. You had better be earning at least 9% in your portfolio or you will run out of money before you run out of life.

Have we been duped? We were convinced that deferring the taxes was a smart move. What if we were farmers and the government came to us and said, "You have a choice. You can choose to pay tax on your seed or your harvest, which do you want?" We would most certainly say, "We will pay tax on the seed". We understand that tax-free beats tax deferred all day long. In the example above, we will have increased our retirement income by 50% if we are able to access and spend the full 6% of our saved dollars without being taxed on it.

Wouldn't it make more sense to create a tax-free retirement plan, or at least try to cut some of Uncle Sam's take? We can do that, although the number of instruments is narrow, if we start adopting the new paradigm. Here are some of the things you can do right now:

1. Change your 401k contributions so that you are only capturing the company match. No reason to create a larger taxable harvest than necessary.
2. Fully fund a Roth IRA if you are eligible.
3. Fund an investment grade life insurance policy that can be accessed tax-free in retirement.
4. Optimize idle assets, like home equity, to fund your tax-free vehicles.

If we start educating ourselves in this new way of thinking we can create a successful, long retirement and remove some of the burden on our children and grandchildren.

If you want to learn more about these concepts I recommend you read the book "*Missed Fortune*" or "*Missed Fortune 101*" by Douglas R. Andrew. You can also get an overview of these concepts by attending one of my live or web-based seminars.

Marc Cram is a certified financial planner in Durham NC
He teaches these concepts through both live and web-based seminars
He can be contacted through his website
www.cramgroup.com
919-383-8194
marc@cramgroup.com