The Hidden Cost of Avoiding Taxes

By: Exchange Capital Management
September 28th, 2023

In life, two things are certain: the inevitability of death and the unyielding grip of taxes. While you may find humor in this age-old saying, it’s undeniably true. Unfortunately, there's no magic trick to outwit the IRS and evade taxes. Trust us, we’ve looked. In fact, even attempting to do so through legitimate means, such as tax-deferred accounts, can lead to unintended consequences.

The Downside of Tax-Deferred Accounts

Embedded tax liability

If you're like most individuals, you've been diligently saving for retirement through your Traditional 401(k). You’ve worked hard, watched your savings grow, and feel a well-deserved sense of pride when you finally crest $1 million. You’re finally a millionaire, you should celebrate, right? While this is an impressive milestone that you should be proud of, the hard truth is that you won't actually get to enjoy the full balance. Instead, you'll take home the after-tax portion, which we typically estimate to be two-thirds of the total, leaving you with roughly $700,000. It's easy to focus on the impressive value on paper and forget about the embedded tax liability that comes with the assets in these accounts.

You may have more income in retirement

People often save in tax-deferred accounts to avoid paying taxes for as long as possible. The general expectation is that you will be in a lower tax bracket in retirement when you

need the money. However, trying to avoid taxes by placing all your money in these accounts can result in the same or an even higher tax bill in your golden years.

To gauge your tax liability in retirement, you must consider all sources of taxable income, including items such as Social Security, pensions, rental properties, and even future inheritances. Also, tax-deferred accounts may come with Required Minimum Distributions (RMDs). With all these additional income streams, you might find yourself in a higher tax bracket, ultimately paying more in taxes than if you had opted to pay them earlier.

To illustrate this point, let's examine just two of these income sources: Social Security and your RMDs. Social Security payments alone could reach above $60,000 annually for a married couple. Furthermore, if you've both diligently saved into your 401(k)s, your RMDs could be substantial. These factors limit the options retirees have for implementing tax strategies during their retirement because it becomes significantly harder to reduce their taxable income. The Internal Revenue Service (IRS) mandates that you take your RMD, and naturally, you would want to receive your Social Security income as well. As a result, the minimum amount of income you receive is not adjustable.

Future tax rates aren't guaranteed

Another downside of relying heavily on tax-deferred accounts is the unpredictability of future tax rates. By deferring taxes now, you're essentially tethering your retirement lifestyle to the whims of the government. Tax rates are subject to change and can become more aggressive (or less so) with little to no notice. Placing all your chips on legislator's decisions can add a lot of risk to your portfolio.

Try To Find the Perfect Mix of Tax-Deferred and Tax-Exempt Withdrawals

You shouldn't try to avoid all taxes during your working years, as this often merely postpones the inevitable. Instead, you should try to stay within favorable tax brackets. Diversifying your tax exposure with a mix of taxable, tax-deferred, and Roth accounts can help you achieve this goal.

Let's break it down with an example: Suppose you and your partner need $85,000 annually to maintain your retirement lifestyle, which places you in the 12% tax bracket. However, if you have significant expenses that year and need to withdraw more money, you might inadvertently push yourselves into the higher 22% tax bracket. This is where tax diversification comes to the

rescue. If you have retirement savings in a Roth or other taxable accounts, you can sidestep this issue by coordinating tax-efficient withdrawals.

By diversifying your tax exposure and keeping an eye on your taxable income and withdrawals, you can avoid paying more in taxes than necessary. The goal is to seek out the most advantageous tax rates, ensuring that you get the best value for your hard-earned money.

The Bottom Line

Understanding the hidden costs of tax deferral is essential for sound retirement planning. Striking the right balance between where your dollars are being saved and invested is key to minimizing your total tax burden. Try to aim for the most tax-efficient approach to secure your retirement.

Remember, it's not about doing everything to benefit yourself today, as overloading on tax deferral strategies may end up impacting your future retirement. Find that critical balance to optimize both your present and future financial well-being.