How Taxable is your Retirement?

With just over 60 days before the 2011 income tax filing deadline, many people are now evaluating their retirement plans and how much to contribute. There are many considerations one should evaluate with respect to a retirement plan. First of all, the immediate tax impact weighs heavily on the decision how to save for your retirement. Contributions to a traditional Individual Retirement Account are generally tax deductible, while contributions to a company retirement plan such as a 401 (k) will reduce the employee's taxable income by the amount of contribution. These tax advantages provide an incentive towards making such contributions.

There is, however, one additional consideration that many people overlook. Traditional retirement products, like the traditional IRA and 401(k) will be taxable at the time of withdrawal at whatever the tax rate is for the individual at that time. For example, a retiree in the 25% federal marginal tax rate would need to withdraw about $1,333 from their retirement account in order to have a net-after-tax income of $1,000, assuming no other offsetting deductions. This "tax erosion" could be more significant if Congress were to increase tax rates as many experts believe will happen in the future, especially in light of the monumental Federal Debt.

What can a person do if they are concerned about their retirement tax future? The first and simplest answer is a Roth IRA or Roth account in a 401(k). A Roth contribution does not provide any immediate tax benefits, such as a tax deduction or taxable salary reduction but if held for five years and to age 59 ½, the withdrawals from a Roth are tax free. In addition to a Roth IRA or Roth 401(k) account, a number of other investments like a well-designed life insurance program offer similar "Roth-like" benefits that allow a person to save and to obtain tax-advantaged retirement income.

Universal Life insurance, both interest-based and variable universal life, can be structured so that a premium purchases minimal amounts of death benefit, to a certain threshold established by the IRS in order for the policy to be considered life insurance. Withdrawals are made in the future by means of policy loans and withdrawal of original premium, which are exempt from income tax under current laws in most cases. This can be a valuable alternate use for a product most everyone has a need for, and it self-completes in the event of death by paying a tax free benefit to the owner's beneficiary. Consult an expert before beginning this kind of plan to make sure of the costs and provisions of the policy you wish to use.

Planning is the key to a successful retirement strategy. A person should not only plan for the amount they will need at retirement, but should also plan for the effect taxes will have on their retirement income. A qualified planner can help, and there are many resources on the internet.

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