

## Who Should Read Chapter 2



Everyone should read this chapter. It describes the basic tax rules that apply to your retirement plan when you leave your job. (Chapters 3-6 contain more specific rules.) If the only retirement plan you have is an IRA, you can skip Sections C and D of this chapter.

Our tax laws provide both incentive and opportunity to sock away significant sums for retirement. The combination of an up-front tax deduction for contributions to retirement plans, years of tax-deferred growth, and eventual taxation at relatively low rates (such as during retirement) can produce dramatic returns on retirement savings.

### A. Taxation Fundamentals

To reap maximum benefit from your retirement plan, you must contribute as much as you can through the years, and you must adhere to certain guidelines when you draw money out. Keep in mind that your financial goal should be to maximize your after-tax wealth. It won't do you much good to accumulate a comfortable nest egg if you lose the bulk of it to taxes. As you pursue this goal, the following fundamentals will serve you well when you are not sure how to proceed.

### 1. Defer the Payment of Tax

When you have a choice, it is usually best to delay or defer the payment of income tax for as long as possible. During the deferral period, you will have the use of money that would otherwise have gone to taxes; if you invest it, that money will help generate more tax-deferred income. The easiest way to defer the payment of tax is by deferring the receipt of income. For example, if you have the option of taking a distribution from your retirement plan this year or next, it is often better to wait. As the tables below show, even a one-year delay can be beneficial. Your money grows while the tax man waits.

Many people vastly underestimate the benefits of tax-deferred compounding of investment returns inside a retirement plan account. Take a look at Tables I and II below. Both cases assume a simple 8% return on your investment and a flat 28% tax rate. Table I shows what happens if you take \$10,000 out of your IRA, pay tax on it and invest the remainder for 15 years. Because the investment is outside your IRA, each year you will pay tax on your interest, dividends, and capital gains.

Now look at Table II, which shows what happens if you leave the \$10,000 inside the IRA. The table projects the value of your investment after one year, two years, or more. After 15 years, the total value of your IRA will be \$31,722, almost twice as much as the balance shown in Table I after 15 years. If you take the money out and pay