February 2020 Tax Tips

Helping you to earn more, and keep more of what you earn.
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Should I Tap into my Retirement Funds?

Often if you are in dire need for money the most tempting area to look is your IRA, 401(k), and other qualified retirement accounts. These funds, set aside for your retirement, may seem to be the answer to your financial woes.

Should I take an early withdrawal?

Is it a good idea to tap into retirement account funds prior to reaching age 59½? Here are some things to consider:

* **The penalty.** Retirement funds taken out for non-qualified use are not only subject to regular income tax, but are also subject to a 10% early withdrawal penalty.

*** Debt collectors love it.** Debt collectors are commonly prohibited from access to your retirement accounts. So if you are using the funds to put off debt collectors, be aware that you may be using funds that might be protected if you became insolvent.

*** There is an opportunity cost.** Currently the funds in your traditional IRA, 401(k), and similar retirement plans grow tax deferred. So a dollar today will compound until you withdraw the funds at retirement. This growth is lost with early withdrawals.

*** Not for your kids.** It is usually not a good idea to use early withdrawals to help pay a child's debt or school costs. There are better ways to help children financially than to pay the stiff penalty on your early withdrawal.

If you still need to make the early withdrawal

*** Withdraw "after-tax" contributions first.** This can be Roth IRA contributions or other after-tax contributions. Why? Since these funds have already been taxed, there is often no additional tax burden or early withdrawal penalty.

*** Certain withdrawals from qualified plans are allowed.** This includes hardship withdrawals for qualified medical expenses, qualified educational expenses, and up to $10,000 to purchase a first time home.

*** Consider taking out a loan from your employer-provided 401(k).** You will then repay this loan to your retirement account with interest. But be careful, you are required to repay any outstanding balance when you leave your job.

While it is never a great idea to tap into funds that are specifically set aside to make your retirement stress-free, if you must do so it is worth being thoughtful about how you go about the withdrawal.

Finding the Balance of Income vs. Spending

Every year the IRS publishes instructions to prepare your Form 1040, individual tax return. The publication for 2019 is a whopping 108 pages! On page 103 of the IRS booklet is a summary of collections (income) and spending (outlays) by the federal government. Given the election year, here is a summary of this recap and some general observations.*

2018 Federal Income and Outlays:

Income:

41% Personal income taxes

28% Social Security, Medicare, unemployment and other retirement taxes

19% Borrowing to cover deficit

7% Excise, customs, estate, gift and misc. taxes

5% Corporate income taxes

Outlays:

41% Social Security, Medicare, other retirement

22% Social programs

20% National defense, veterans and foreign affairs

8% Net interest on the debt

7% Physical, human and community development

2% Law enforcement and general government

Income
$3.330 trillion

Outlays
$4.206 trillion

Deficit
($779 billion)

Observations
23%: The amount of annual spending with no income to cover it.

63%: The amount of spending for social programs, Social Security and Medicare.
20%: National defense (15%), veterans benefits (4%), foreign aid (1%)
8%: Amount of annual budget required to pay interest on prior year deficits.

Why care?

* **Get rid of the noise.** Political rhetoric is often high during election season, and it is nice to have some facts as to how our taxes are actually spent.

* **Ah ha...this is a key reason interest rates are low.** Wondering why your bank savings interest rate is so low? In part it is because they are related to federally set interest rates. Imagine if the federal interest rates doubled. The amount of our government's spending on interest payments would double to 16 percent!

* **Very little is optional.** Debt payments, veteran obligations, Social Security, Medicare. All these payments plus many others are mandatory. These amounts alone, are over 75% of spending.

*** Start the conversation.** Currently, very little of the national conversation is centered around fiscal responsibility (the act of balancing income and outlays). No matter your side of your political leaning, perhaps this should be a starting point for everyone.

***Learning for all of us.** Take a lesson here and see how your household income and spending stack up. Then create a plan to balance your income and outlays. Use tax planning as one of the key tools to do this.

Want to learn more?

The website www.usafacts.org is a great resource for an objective review of the numbers. This nonprofit is committed to providing the figures and letting you decide what they mean to you.

Office Hours

Monday - Thursday 8 am - 7 pm
Friday 8 am - 5 pm
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