TALES FROM THE CRYPT
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People need to be aware that there is steep tax liabilities associated with taking money out of your retirement accounts. The majority of the people that take distributions from their retirement accounts could have avoided these additional liabilities if they only asked before acting. We all know that there are circumstances that are beyond our control, but if it can be avoided we should try to avoid.

The IRS gives taxpayers incentives to invest money into retirement accounts such as 401k plans, 403b plans, 457 plans, traditional and Roth IRAs. The list goes on and on.

However, investors must understand that contributing to ones retirement account will lead to a reduction of your adjusted gross income for the current year; therefore, reducing your adjusted gross income will reduce your tax liability as well. Please understand that you will have to pay taxes on these reductions when you take out the funds. But the great thing is that you get tax deferral on any profits until you withdraw monies out.

For example, if you are in a 25% tax bracket and you contribute $10,000 into your 401k plan at work, you get to reduce your taxes by $2,500. (Please note that each taxpayers situation is different; therefore, the actual amount of the reduction in taxes can't be figured until all your facts are known, this example is used for simplicity purposes). Also, please note that I am not taking into consideration any reduction of state taxes.

Let's assume that a married couple both under 55 years old and both contribute to their 401k plans and intelligently max out their 2007 limits of $15,500 each. Their adjusted gross income is reduced by $31,000 and if they are in a 25% bracket they are looking at $7,750 of tax savings without any state taxes. That is a lot of money for a year. Please note that the reduction of adjustment gross income can also put you into a lower tax bracket. Remember that money is accumulating tax deferred.

Now let's look at the flip side if you need money and decide to take it out of the retirement account. This money will be added to your adjusted gross income which in turn may cause you to be placed into a higher tax bracket which costs you even more money than you originally thought. Also, if you are under 59 and a half you will be subject to an additional 10% penalty; therefore, if you take out $30,000 from a retirement account then you will be subject to a $3,000 penalty on top of your tax liability. With federal, state taxes and penalties this could cause you to lose up to half of the money you take out.

Please note that there are certain cases that the 10% penalty will not apply such as taken distributions due to disability, death, unreimbursed medical expenses that exceed 7.5% of adjusted gross income and to pay for higher education expenses. Please note that some of these applied to qualified plans (i.e. 401k plans) and other to IRAs and other to both (there are more exceptions; however, that is beyond the scope of this article)

Now there are ways to avoid this big tax bill:

Take out a home equity loan on your home (interest on the first $100,000 of home equity indebtedness is deductible no matter what the funds are used for, which reduces your tax liability. Please note that this may not apply to everyone due to the Alternative minimum tax, but if Chris Markowski gets into office he will try to do away with it)

Take a loan from your retirement account such as your 401k plan of up to $50,000, which can be repaid up to five years and you repay the interest to yourself. For all intents and purposes you become your own bank. (Please note that certain retirement accounts such as IRAs don't have loan capabilities but if you have substantial monies in an IRA account and you have a 401k plan at work you may be able to transfer the monies into the 401k plan and take a larger loan. (Please refer to your plan administrator at work) However, the disadvantages are if you leave your employer you will have to repay the loan back normally within 60 days.

Uncle Sam offers a few paths to cutting down your tax bill, we suggest taking them