ROTHIFICATION-LITE: A SKEPTIC'S TAKE ON TAX REFORM

My former life as an auditor has left me with an ever-questioning and critical mind, especially when it comes to money. Though I tend to be a skeptic with a very analytical way of thinking, that doesn't mean that I'm not open to new ideas. Actually, it's quite the contrary. I make a point of keeping my eyes open for innovative ways of approaching finance in hopes of learning something new and using that knowledge to grow as a person.

With that being said, today's topic is one that a lot of Americans are watching eagerly: proposed tax reform.

Short-term solution, long-term problem

Putting less money towards paying taxes means more money in our bank accounts, right? Though that's what most people have been led to believe, even I know that we should expect to pay some form of taxes for bare necessities. Otherwise, tax increases will come back to haunt us.

To be quite blunt, the 'Cut Cut Cut' bill seems to be *cutting* taxes rather than reforming them. Much like the Chinese philosophical system of Feng Shui, the government has mastered the art of rearranging policies and legislation to maintain their current spending levels. This, ladies and gentlemen, is what we've come to know as *reform*.

Tax reform aims to strengthen the economy through tax revenue-neutrality. This concept of revenue-neutrality increases and decreases various tax revenue streams that achieve a zero-sum game. Since it is highly unlikely that any politicians would ever vote for a decrease in government revenue, it is also highly unlikely that the government would ever manage their bottom line the same way a corporation does. This would threaten more than just the funding for the platform; it would also threaten the legitimacy of the promises elected officials based their entire campaigns on.

So, if there's a popular bill that promises tax breaks for the masses but no one in Washington is willing to give up on their campaign promises (spending) to offset these revenue cuts, ***are we setting ourselves up for increased taxes in the future?***

Rothification-Lite

A topic that has gained quite a bit of traction during the discussion of tax reform is the concept of Rothification.

Essentially, the Rothification model involves decreasing the up-front benefits of contributing to a 401(k) or an IRA. Instead, contributions would be directed into Roth-type accounts. In theory, Roth 401(k) owners would benefit from the tax-free growth and withdrawals that Roth accounts provide. Meanwhile, the government is currently enjoying the windfall of tax revenues to offset tax cuts.

Ultimately, Rothification was squashed and everyone was able to step back from the ledge with the knowledge that their tax-advantaged account contributions were safe once again. Even so, this situation got me thinking: *In a low tax rate environment, is it possible that Rothification (or something similar) actually holds some merit?*

Okay, hear me out:

While tax cuts sunset over 10 years, it is safe to assume that tax increases and other policy changes will take effect upon expiration. In this case, it would be sensible to **pay taxes while they're in a low rate environment and invest in Roth-type accounts or other tax-free streams of income. If all goes well, this will result in a tax-free retirement.** If we don't do this now, we are positioning the withdrawals from our tax-deferred retirement accounts in a high tax rate environment. That is sure to put a damper on your retirement party.

Don't get me wrong, I'm a huge fan of 401(k)s and IRAs. I would be a fool not to recognize the power of compounding pretax dollars. With that in mind, I think we should consider a hybrid approach to Rothify ourselves.

One scenario I've considered is that you only contribute up to what your company matches rather than maxing out the 401(k). The difference between the match and max would then be taxed (at a low rate) and then directed into a Roth account. Just before the tax cuts expire, a backdoor Roth-IRA conversion could be made on your 401(k).

Why should you consider doing this?

1. ***Greater Liquidity.*** What is the one thing that enables people to be financiall independent or to retire early in life? Liquid assets. The chance of someone retiring before the age of 59 ½ because they have over $1,000,000 in their 401(k) or IRA is very slim. Roth accounts allow you to access your money five years after inception and taxable accounts allow you to access your money immediately.
2. ***Increased Investment Options.*** Compared to a 401(k), Roth IRAs and brokerage accounts are more flexible and have a greater selection of investments options. There are also no limitations on the number of transactions that can be executed each month. 401(k) plans, on the other hand, may not always offer the best nor the lowest cost funds.
3. ***Lower Fees.*** Large financial institutions such as Vanguard and Fidelity charge a percentage of assets under management. They would prefer non-Rothified retirement accounts over brokerage accounts due to the fierce competition in that category. **Making your dollars work at the lowest possible cost is smart money.**
4. ***Lower Taxes During Retirement.*** If the theory of a high tax rate environment proves to be true (especially for those who are retired) being invested in a Roth account or other tax-free streams of income should keep you in one of the lower tax brackets albeit in a high tax environment.

What are your views on the tax environment? How, if at all, does that reshape your financial plan in 5, 10, 20+ years?