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Johnny Appleseed

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Do you remember the story of Johnny Appleseed? He was the legendary character who planted apple seeds and was never there to harvest the crops. He would just go around planting apple seeds wherever he could. I have had a burning question that I wish Mr. Appleseed could answer for me. I will ask you since I don't know how to get him to answer my question. My question is this: If he had his choice, would he rather pay taxes on the seed or on the harvest? Do you think you can answer that question? Before you do, maybe I need to give you more information.

Based on what we usually find in nature, the seed is small in comparison to the harvest. Apple seeds are quite small and you can hold many of them in one hand. The apples, which are the harvest, are much larger and you may find it hard to hold more than one in your hand. A tree can produce hundreds of apples at every harvest. My thought is that based on those facts, Mr. Appleseed would probably agree with me that it is better to pay taxes on the seed instead of the harvest. What are your thoughts?

You are probably wondering what this discussion has to do with finances and why it is in a financial column. Well, the same question I would pose to Johnny Appleseed arises when one is accumulating money in a retirement plan. Would you rather pay taxes on the seed or the harvest? When retirement plans first came on the scene, the government felt that it would be better if people paid taxes on the harvest. They allow people to deposit money into these plans and not pay taxes on those dollars. Those dollars represented the "seeds." The government figured that, just like the apples, the "harvest" would be much larger - and so would the tax. The government was right!

The problem was that the government had to convince everyone that this was a better plan. It put out lots of propaganda to show how much you could save on taxes on your deposits (seeds). The government must have done a good job, because everyone ran to set up the plans to save some taxes. People never thought about how large the "harvest" would be and how much taxes they would have to pay later. Immediate gratification was the key.

This plan of immediate gratification worked well for many years and the government was happy to "invest" a few dollars on the "seed," knowing full well that one day, the taxes would come due on the "harvest." The government knew that it could give up a few dollars now and reap a much larger harvest of dollars later.

These plans were popular for years, until the government came out with a plan that taxed the seed instead of the harvest. These plans are known as "Roth IRAs." Your deposit is made with "after-tax" dollars, and the "harvest" comes out "tax-free." Once people saw how the plans worked, they ran to convert their old IRAs into the "new and improved" IRAs. They could now look forward to a flow of dollars at retirement without any tax burden.

There are, however, some shortcomings in these Roth IRAs. The limits on the deposits are low and there are restrictions on when you can get to your money without being taxed. Everyone is also concerned that the government might realize that it made a big mistake coming out with these plans and eventually eliminate them. The government is not happy with letting a harvest go without any taxes.

Some plans can be set up that work just like a Roth IRA, but actually have fewer limitations. These plans are usually referred to as "nonqualified" retirement plans. In other words, the laws that control qualified retirement plans do not control nonqualified plans. The plan uses a life insurance product that has within it a portfolio of mutual funds, ranging from very conservative money markets to mutual funds that invest in growth companies. They run the full gamut and you have over 50 to choose from. By virtue of being within an insurance policy, the returns are sheltered from current taxation, so there are no capital gains or dividends to pay taxes on. The other advantage is that in most states, this money is protected from creditors.

Most retirement plans will not allow you to access your money prior to age 60 without some tax being involved. That is not the case with these nonqualified plans. You can get to your money and use it for whatever you want to. When you do start drawing a retirement income, the money flows out totally tax-free. This is truly a plan that taxes the seed and not the harvest.

Unlike normal retirement plans, you do not have to include any employees, so no deposits are required on them. You are not limited on the amount you can deposit into the plan for yourself. You also do not have to file forms every year, which you are required to do on any qualified plan. The plan is sweet and simple! I think if Johnny Appleseed were alive today, he would want such a plan and would talk about these plans in every community as he planted his apple seeds.

So now I ask you, if you had your choice, would you rather have a plan that taxes the seed or the harvest? My other question is this: If you have a retirement plan, how does your plan currently work?

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