WHAT IS THE COST OF YOUR DAILY ROUTINE?

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Say that you just graduated college and your starting annual salary is $60,000. Every morning you purchase a $5.24 smoothie ($4.99 x 5% sales tax). Then you buy lunch for $10.50 ($10.00 + 5% sales tax), and every afternoon you also need that $3.81 latte ($3.63 + 5% sales tax). The total cost for these three items is $19.55. Note that this $19.55 is the after-tax cost of your daily routine.

A Pre-Tax Mindset

So what is the pre-tax cost of the same daily routine? There are two ways to calculate the pre-tax cost. The first way is the gross-to-net of tax calculation. The second way is less commonly used but is what I believe to be the more important way of thinking about the pre-tax cost: by grossing up for the taxes incurred. We will use this second method for our purposes.

First, we start by looking at the total tax burden. In our above example, the total effective tax burden is 35.15% (Figure 1) calculated as follows: 22 % for federal income taxes + 6.20% for FICA tax + 1.45% for Medicare tax + 5.50% for state income taxes). To gross up to the pre-tax amount, we take the after-tax cost of the items purchased and divide by one minus the effective taxes (Figure 2). Thus,$19.55 / (100%-35.15%) = $30.15 (Figure 3).

We can now back into the first calculation method for a better understanding. Figure 4 breaks down each individual tax incurred to reach the same pre-tax cost of $30.15 (Figure 4). Again, most people do not think about the gross cost of a purchase, and this example shows you that the daily routine of $19.55 is $30.15 of your pre-tax earnings.

Continued on back...

Figure 1.

Tax Rates	
Federal Income Tax	22.00%
FICA Tax	6.20%
Medicare Tax	1.45%
State Income Tax	5.50%
Total Effective Tax	35.15%

Figure 2.

$$\frac{\$\text{ After Tax Cost}}{(1 - \text{Effective Tax Rates }\%)} = \$\text{ Before Tax Cost}$$

Figure 3.

$$\frac{\$19.55}{(1 - .3515)} = \$30.15$$

Figure 4.

After tax cost	$19.55				
Federal income Tax	$6.63	=	22.00%	x	$30.15
FICA Tax	$0.44	=	6.20%	x	$30.15
Medicare Tax	$1.66	=	1.45%	x	$30.15
State Income Tax	$1.66	=	5.50%	x	$30.15
Total Before Tax Cost	$30.15		35.15%		

The Pay Yourself First Principle

It is recommended that a college student elect to save 15% of their salary for retirement based on a $60,000 salary, or $9,000. If you don't pay yourself first by making that 15% election, you will never find the money to save for retirement if the money is not deducted first from your paycheck.

Let's see what percentage of your salary is being spent in this example. The $30.15 cost is multiplied by five days a week. The pre-tax weekly cost is $150.75. Assume that after vacations and holidays you only work 48 weeks. The yearly pre-tax cost is $150.75 x 48 weeks, or $7,236, which is 12% of your gross salary.

I want to challenge your thinking so that you can reach the 15% or $9,000 of your salary goal by looking at your daily routines and associated costs to determine if you can cut some expenditures out. For example, have breakfast (including your coffee) at home and/or start brown-bagging your lunch to free up cash. Food brought from home is always cheaper than buying it at your local restaurant or coffee house. Watching your daily purchases carefully and becoming wiser with your money can help make for a more enjoyable retirement.

For our example, assume further that your employer provides a 3% match. Taking your 12% contribution, you have now reached the 15% target. If your employer does not have a 401(k) option, you can fully fund a Roth Ira of $5,500.

While this assumes you have cut out the costs in my daily routine example, I would not recommend doing that since we all need to eat and drink. What I do recommend is that by reviewing the cost of your choices (e.g., paying for a comprehensive cable package while only watching a couple channels a few times a week, paying ATM fees, having credit card debt with high interest rates, buying a car with a moonroof you never use, etc.), you can isolate that retirement money with little to no discomfort. By making the conscious choice to defer consumption, you will find extra money that can be used for savings.

Of course, our current culture wants you to live for today, and you will be continually blitzed with advertisements and commercials to get you to pay now for those luxury items that you think you need. It can be difficult to avoid the trap of keeping up with the "Joneses", and holding fast to a savings plan can be admittedly challenging at times. However, cutting out the daily costs for convenience can be the first – and most important – step in helping you fund your retirement goals.

In another article, I will show you the power of compounding and why it is important to start investing for retirement today. You work hard for your money and if you save and invest wisely your money will have the chance to work for you in your retirement.

Content in this material is for general information only and not intended to provide specific advice or recommendations for any individual.

The Roth IRA offers tax deferral on any earnings in the account. Withdrawals from the account may be tax free, as long as they are considered qualified. Limitations and restrictions may apply. Withdrawals prior to age 59 ½ or prior to the account being opened for 5 years, whichever is later, may result in a 10% IRS penalty tax. Future tax laws can change at any time and may impact the benefits of Roth IRAs. Their tax treatment may change.

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