

The Deferral Trap

Do you really want all your liquid assets in your 401 (k) and IRA? Are you sure how it will be taxed years hence?

BY JANET NOVACK



WHILE WORKING FOR THE INTERNAL REVENUE Service in the 1990s John J. McGovern Jr. poured all his savings into the feds' version of a 401(k). As a newly minted CPA he understood the value of contributing pretax money and letting it grow tax deferred. When he quit to attend Villanova law school, he rolled \$15,000 of his federal balance into an Individual Retirement Account and used the remaining \$12,880 for tuition. Oops.

The U.S. Tax Court ruled last year that McGovern owed a 10% (\$1,288) early withdrawal penalty in addition to normal tax, because he hadn't moved all the money into an IRA first. Congress, in its wisdom, has decided that the penalty for withdrawals before age 59 1/2 should be waived when a regular IRA, but not a 401(k), is

tapped for tuition. Now 33 and building his own Scranton, Pa. tax law practice, McGovern draws two lessons from his embarrassing goof: 1) "You don't want to touch money in a retirement account, because it's more trouble than it's worth"; and 2) "You're better off having another pot of money, too, that isn't deferred." These days he takes a more calculated approach to deferral. His wife, Michele, contributes to a 401(k) to capture her employer's match. But considering the 2001 and 2003 tax cuts and his own situation—three young kids and a new solo practice—McGovern might not fund a retirement plan himself this year. He figures his marginal tax rate now is lower than it will be in the future.

It sounds like heresy to workers who have been unremittingly lectured for the past two decades to save more in their IRAs and 401(k)s, but the truth is that there is such a thing as too much tax deferral.

Tax policy is volatile. Diversify among account types to manage your tax policy risk.

In 2005 a two-job couple, both 50 or older, can together put as much as \$36,000 in pretax salary into their 401(k)s; a younger couple can sock \$28,000 away. A self-employed taxpayer can shelter even more up to \$42,000 in a one-person 401(k) or other defined contribution plan, plus an extra \$4,000 if the saver is 50 or older. (Some business owners put many times that amount into specially designed defined benefit plans.) Over time most families could end up with nearly all their financial assets in tax-deferred accounts.

All that deferral works wonders if you or your heirs withdraw money decades hence at the same or a lower rate than you would have originally paid. But federal taxes on salary and other ordinary income are comparatively low now. The top marginal rate is just 35%; only 5% of tax filers pay a rate above 25%, and 79% of families pay at 15% or less. Considering the current budget deficits and the coming bulge of retirees who will run up Medicare and Social Security costs, it seems likely taxes will climb.

Even more striking: Dividends and long-term capital gains are now taxed at a top federal rate of just 15%, the lowest for gains since 1933 and for dividends since 1916. Yet every penny you eventually take from a pretax 401(k) or a deductible IRA is taxed at the much higher ordinary income rate.

Three years ago Boston University economics professor Laurence J. Kotlikoff and two colleagues did some controversial calculations showing that couples earning \$50,000 stood to raise their lifetime tax burden by contributing to 401(k)s, in part because of the way Social Security is taxed. At that point 401(k)s were still a boon to the better off. Now, Kotlikoff says: "Given how low the rates are on capital gains, even people with \$100,000 in income might do better saving outside a 401(k)." The professor himself wishes he had more nonretirement cash available to fund his business selling the ESPlanner life cycle financial planning software.

"People become very illiquid," he grumbles. And then the penalties get them. Consider a thirtysomething couple taxed at the 25% marginal rate. (For 2005 it will cover taxable income, after all exemptions, deductions and deferrals, of up to \$119,950, CCH Inc. projects.) They have a spare \$10,000 in pretax income they want to invest in stocks. They can add it to their 401(k) or put \$7,500 post tax in a taxable brokerage account. Assume stocks return 7% a year, dividends continue to be taxed at 15% and the effective tax rate on accruing capital gains in a taxable account works out to 7.5%.

Should this couple take the money out after ten years to start a business and get hit with a 10% penalty on top of their 25% rate, they'll end up with 7.5% less than if they'd invested in a taxable account and paid Uncle Sam each year, calculations based on the work of MIT economics professor James Poterba show. If they prosper and withdraw money after 30 years at a 35% rate, they'll simply break even by using the pretax account.

Deferral looks better for a couple already paying the top 35% rate, which kicks in at \$326,451 of taxable income on a joint return in 2005, CCH says. If their money can grow tax deferred for 30 years, they'll be ahead 16%, even after forgoing the benefit of the lower capital gains/dividend rate. Deferral looks smarter, too, if either couple uses their retirement account to hold taxable bonds; interest from these is still taxed at ordinary income rates.

Of course, all this assumes that the low dividend and capital gains rate, now set to expire at the end of 2008, is made permanent and that the highest tax rate of 35% for ordinary income doesn't rise. President Bush has said

he'll push for some sort of tax reform during his second term. What if Congress lowers income tax rates and imposes a consumption tax-perhaps a national sales or value added tax-to make up the difference? Depending on the transition details, folks with money in deferred accounts might do very well or might not. "We're in a more volatile time than usual when it comes to tax policy risk," Poterba observes.

So, just as you own different asset classes to reduce your portfolio's volatility, you should diversify among account types to manage your tax risks. Fund your tax-deductible 401(k) at least up to the employer match, but also invest in stocks through taxable accounts and grab any opportunity you have to stick assets into a Roth IRA. You put after-tax dollars into a Roth. Then after five years and age 59 1/2, anything you withdraw is tax-free. In a pinch, you can take back your contributions (but not earnings) without taxes or penalties. Early withdrawals of earnings for college or a first-time home purchase are taxed, but there's no penalty.

Not everyone can open a Roth. In 2005 couples with adjusted gross income of up to \$150,000 can contribute \$4,000 each to a Roth (\$4,500 if they're 50 or older). For singles the cutoff for full contributions is \$95,000. But beginning in 2006 employers can offer Roth 401(k)s to workers at all income levels. So start lobbying your boss now. Meanwhile, pay attention to these other deferral traps

Exotic Investments

In November the Tax Court held that an Atlanta CPA who made loans from his accounting firm's 401(k) to businesses in which he held minority interests, including a sports-theme restaurant and a golf club, had violated rules prohibiting self-dealing in retirement plans. It didn't matter that the loans were repaid; the IRS hit him with hundreds of thousands in taxes and penalties. The case wasn't as odd as you might think. As stock returns lag and pension and IRA balances grow, more folks want to invest their IRA's or retirement plans in real estate, businesses and exotica.

Phoenix CPA Edward Zollars has a standard response: "You're going to pay a ton of attorneys' fees, accountants' fees and everything-else fees, and then you're walking a tightrope to keep this from violating the rules on prohibited transactions." Even if there's no potential self-dealing conflict-you're investing in someone else's can't-lose deal-you're better off doing it through a taxable account. That way, your big gains will be taxed at just 15%

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and, if the venture bombs, you can at least deduct some of your losses (subject, of course, to a whole set of rules). Keep enough in taxable accounts so you won't be tempted to play games with your IRA. "I get uncomfortable if clients don't have an equivalent amount sitting outside the retirement fund as in it," Zollars says.

Employer

You've heard that when you retire or leave a job, you should roll your 401(k) or profit-sharing plan into your next company's plan or into an IRA. Not always. Think about taking an "in-kind" distribution of any of your ex-employer's stock that is sitting in the plan, particularly if it has appreciated a lot,

You will owe ordinary income taxes and, if you're under 55 (that's right, it's a different age than for IRAs), an extra 10% early withdrawal penalty, but only on the value of the stock when it went into your account. Any appreciation is taxed as long-term capital gains, but not until you sell the stock, and it isn't subject to the 10% penalty. Meanwhile, you can still roll over the other investments in your account into an IRA.

Estate planning

"The people who have the easiest estate planning have some assets in retirement accounts and some outside them," says Boston lawyer Natalie B. Choate, an expert in the arcane and trap-strewn area of inherited IRAs. Affluent couples usually have wills designed to preserve the estate-tax exemption (now \$1.5 million) of the first

spouse to die, without leaving the survivor short of funds. On the death of the first, the exemption amount goes into a "bypass" trust for the kids, with the rest going to the surviving spouse. The earnings and, if need be, principal of the trust are available to the survivor. But at her death what's in it bypasses her estate and goes to the kids, free of estate tax.

A traditional IRA is a rotten asset to put into a bypass trust. You've wasted a third of the exemption-the third that will eventually go to the taxman. But if the IRA gets left outside a trust, and after the second spouse dies is part of a taxable estate, it will get whacked by both estate and income taxes. True, when heirs make taxable withdrawals from an IRA, they can claim a deduction for the estate tax that was paid earlier. But too often their accountants don't know they're entitled to it "I call this America's forgotten tax deduction," says lawyer Choate. (Worse, the deduction isn't allowed at all when calculating the alternative minimum tax.)

Choate suggests that older couples with large traditional IRAs try to convert some of that money into a Roth IRA. You pay tax immediately on the full amount converted, but any further growth is tax-free. And you don't have to take "required minimum distributions" from a Roth after turning 70", as you do from a traditional IRA. This works particularly well if you can pay the taxes on the conversion from your taxable accounts. You'll leave the kids a smaller estate, but it will be worth more after tax.

Unfortunately, you can only convert if your income before the conversion is \$100,000 or less. Even if you can't convert, "if you're over weighted in an IRA, you should always be looking for a low-tax way to get the money out," says Choate. Example: A wealthy retiree who normally pays at the 35% rate might have so many deductions one year that he's caught in the AMT. That means extra IRA distributions may be taxed at an AMT rate of 26% or 28%.

College money

You can't take money out of your 401(k) for your kids' tuition, although if your company permits it you can borrow up to half the account's value, or 50,000, whichever is less. Be careful: If you leave your job, you often must repay the loan right away or it will count as an early distribution subject to tax and penalties. You can tap a traditional IRA without penalty to pay college tuition, but will have to pay tax at ordinary rates. Warning: Money you take to pay freshman tuition counts as income when a school reassesses whether your child is still eligible for aid in his sophomore year, points out Harvard assistant professor of public policy Susan Dynarski. With a taxable account, you can control the timing of income.

What about saving in a 529 state college savings plan? These are like special purpose Roth IRAs- contributions aren't federally tax deductible (sometimes there's a state deduction), but money can be withdrawn for college tax free. Before you rush to contribute, however, make sure you won't need the cash for another purpose.

Earnings of withdrawals for noncollege uses are usually taxed at ordinary income rates and hit with a 10% penalty. If you're eligible, fund a Roth first. And watch out for the high fees in some 529 plans; you could end up giving your tax savings to the broker.