DallasNews.com
The Dallas Morning News

Socking it away in 401(k)? There could be a hole in it

Many surprised by how much it raises taxes in retirement

01/19/2003

By PAMELA YIP / The Dallas Morning News

President Bush's proposal to cut the tax on stock dividends has investors rethinking their strategy for retirement savings.

If stock dividends aren't taxed, the theory goes, then what's the benefit of saving in a tax-deferred account such as a 401(k) or an individual retirement account?

Personal finance experts say that even if the dividend tax is completely eliminated, using pre-tax dollars deducted from your paycheck is still the best way for most people to build a substantial nest egg.

But some warn that the trusty old 401(k) has a surprising tax pitfall for many retirees.

What's tripping up more retirees every year is a rule that triggers taxes on Social Security payments. If retirees make enough money, their effective marginal tax rate on 401(k) withdrawals can jump as high as 50 percent. In other words, their taxes on the savings could be higher than if they hadn't sheltered it in a 401(k) at all.

"You hear all your life to put money away and put money away for the main reason that you will be at a lower tax bracket when you hit retirement age," said Frank Howard, head of the Howard & Waltrip PC accounting firm in Addison. "For a lot of people, that's not the case."

To make matters worse, some financial advisers believe that tax rates in general will be higher in the future, as the baby boomers retire and Social Security and Medicare costs balloon.

What's a saver to do: Pay taxes up front? Defer taxes? Chuck it all and buy dividend-paying stocks?

First of all, no one is saying that workers should abandon tax-deferred savings vehicles.

Second, since no one knows what will happen with tax rates, many experts say it's unwise to make decisions based solely on tax considerations.

Still, some experts say that workers who are saving solely in 401(k)s and traditional IRAs may want to review their retirement savings plans with these future tax risks in mind.

Savings options

What makes a 401(k) still the most attractive savings vehicle, experts say, is that most companies match a portion of your savings. Give that up, and you're giving up free money.

Also, the money is taken from your paycheck before you see it, and it's not easy to get to.

And since you're using pretax dollars, you have lower taxable income, and your money grows tax-free until you need it in retirement.

The 401(k)'s elder cousin, the individual retirement account, allows individuals to save outside the workplace while still using pre-tax dollars.

The Roth IRA, created by Congress in 1997, allows workers to invest after-tax dollars during their working years. The savings then grow tax-free, and withdrawals after retirement are not taxed.

There are other considerations, but one way to choose between a tax-deferred account such as a 401(k) or IRA and an after-tax Roth IRA is to decide whether you will pay a higher tax rate during your working years or during retirement. Most people have been led to believe their tax rate in retirement will be lower.

But more and more retirees are finding that isn't the case, thanks to the taxation of Social Security benefits. The benefits were first taxed under a law passed in 1983 and updated in 1993.

In 1985, some $9.6 billion in Social Security benefits was subject to taxation, affecting about 3 million filings, the Internal Revenue Service says. By 2000, 10.6 million taxpayers reported $90 billion in taxable benefits.

If your income other than Social Security is modest, you won't have a problem. But if your income from other sources exceeds certain levels, the tax works so that each dollar of additional income is taxed for itself and causes between 50 and 85 cents of Social Security benefits to be taxed.

In effect, this makes for a possible marginal tax rate on non-Social Security income of 50 percent. The other income can be from 401(k) withdrawals, pension income and wages. The marginal tax rate is the amount of tax imposed on an additional dollar of income.

"It's basically a back-door tax," said J. Richard Joyner, a partner in personal financial counseling at Ernst & Young in Dallas. "Most people won't even have a general awareness this issue is there."

Particularly hard hit by the tax on Social Security benefits are people who are working and collecting Social Security benefits at the same time, Mr. Howard said.

. "If they're making money that, in more cases than not, is putting them in the upper tax bracket, effectively they're not getting their Social Security because they're giving it back in income taxes," he said.

The issue roils people such as Wade Vick of Addison, who at 73 still works negotiating oil and gas leases. His Social Security benefits are taxed because of his extra income. In effect, that's an additional tax on that extra income.

"It makes me damn mad," Mr. Vick said. "I've been paying into Social Security all these years, and now I'm paying taxes on it again."

Unseen costs

Here's how the tax works:

Social Security benefits start getting taxed when "provisional income" exceeds $25,000 for taxpayers filing as a single person or a head of household or $32,000 for married couples filing a joint return.

If "provisional income" exceeds $34,000 for single or head-of-household taxpayers or $44,000 for married taxpayers filing jointly, then up to 85 percent of Social Security benefits is taxed.

"These base amounts are not indexed for inflation, and Social Security is indexed," said Jim Smith, a principal and certified public accountant with Lane Gorman Trubitt LLP in Dallas. "Assuming all other factors stay the same, the increase in Social Security each year will mean that more and more taxpayers are taxed on part or all of their Social Security.

"Also, as inflation affects living expenses, more taxpayers will have to pull more from their retirement funds each year to make ends meet, or get a job, both of which will cause more of their Social Security to be taxed."

Imagine, Mr. Smith said, a taxpayer living on Social Security and 401(k) money who is just below the income threshold for taxation of Social Security benefits.

"If they have a large medical bill not covered by insurance or Medicare, and pull out more from their 401(k) to pay this bill, they will pay income taxes on the additional 401(k) distributions, along with part of their Social Security," Mr. Smith said.

In another example, a retired husband and wife, both over age 65, collect a total of $27,000 in Social Security benefits each year. With $44,473 in 401(k) income, their marginal tax rate on the next $6,000 of income will be 50 percent.

"If Social Security benefits go up, if they sell stock and have a gain, every additional dollar is taxed at 50 percent for that $6,000 range," Mr. Smith said.

Once all 85 percent of your Social Security benefits are taxed, then your tax rate starts to drop back down to the listed marginal rate corresponding to your income.

The example illustrates the importance of projecting what your income will be when you start drawing Social Security benefits or when you start taking money out of your 401(k), he said.

"A 401(k) has many more positives than negatives, but it is possible that a 401(k) can cost you more in taxes than it saves you," Mr. Smith said.

The tax quirk deflates the wisdom of some long-held retirement advice, say those who've studied the issue.

"The premises behind tax deferral are the beliefs that people will be in a lower tax bracket during their retirement years than during their working years and will in effect have an interest-free loan on tax payments," Jagadeesh Gokhale and Laurence J. Kotlikoff wrote in a research paper last year for the National Center for Policy Analysis, a Dallas-based think tank. "Therefore, tax deferral represents an opportunity to avoid taxes when the rate of taxation is high and pay them when the rate is low."

Twenty-five years ago, that assumption was "probably valid," wrote Mr. Gokhale, a senior economic adviser with the Federal Reserve Bank of Cleveland, and Dr. Kotlikoff, an economics professor at Boston University.

"But for millions of low- and moderate-income families today, the assumption is no longer true," they said. "The federal income tax levied on Social Security benefits will cause many low- and moderate-income families to face higher tax rates after they retire."

There may be another side to the problem.

"When you retire, the tax rates might be increased, and it's extremely likely that when baby boomers retire, their taxes are going to be a lot higher than what they are because the government can't afford the policies it's engaged in," Dr. Kotlikoff said.

No definite answers

Experts caution that many factors go into determining a person's extra income during retirement, and not everyone will be affected. For example, said Mr. Joyner of Ernst & Young, with 401(k) balances down, many retirees may be cutting back on their withdrawals.

"If the value is down, they are more likely to reduce or defer their distributions from those plans, which lowers the income base for determining the taxability of the Social Security benefits."

Still, the Social Security phenomenon is a "sleeping giant" and raises the urgency to closely monitor your retirement savings, Mr. Howard said.

"They need to pay attention to how much is going in and at what rate, and what it's doing," he said. "You just can't blanket put in there, leave it in there and not even give a thought to the planning of it until you reach age 65."

Indeed, he said, "it may not be advantageous to max out your contribution."

One way to protect yourself from the Social Security tax specter is with a Roth IRA.

"Nonretired people – if they can put money in a Roth IRA – that gives them non-taxable income when it comes out," Mr. Smith said.

Michael Busch, president of the Dallas-Fort Worth chapter of the Financial Planning Association, said that withdrawing a combination of 401(k) funds and money from taxable accounts would help cushion the blow of the tax on Social Security benefits.

You take out as much money as you can from your 401(k) before your Social Security benefits begin to be taxed, or before you're thrown into the next-highest tax bracket, he said. If you need more to live on, withdraw the rest from a taxable account.

"It would allow you to control the amount of income you pull out," said Mr. Busch, a certified financial planner with Vogel Financial Advisors in Dallas. "With your taxable account ... it's being taxed all along, so there's no extra tax hit to pull money out."

In any case, Mr. Busch favors the Roth IRA (post-tax dollars) over the traditional IRA (pretax dollars): "If you qualify for a Roth, that is still the best option. The longer you're in it, giving up the deduction on the front end is not a big deal."

But don't write off a traditional IRA altogether, he said: "It's not as good as the Roth because it's eventually taxed when you do pull it out. I would use it only after I've maxed out the 401(k), because you can take full advantage of the employer contributions."

Keep deferring taxes

The last thing you want to do, experts say, is try to save for retirement yourself with after-tax money in a non-tax-deferred account, banking perhaps on the assumption that stock dividends won't be taxed.

"We need to remember that the taxation of dividends has not been eliminated," said Viktor Szucs, a certified financial planner with Quest Capital Management in Dallas. "Even if the House and Senate do support the proposal, any final law may well take a different form than the proposed complete elimination."

Besides, with such an account, it would be easier for you to get to the money and blow it all.

"There still is no question that you want to use a tax-deferred vehicle," Mr. Busch said.

Diversifying your retirement accounts can reduce your risk of losing more money than you had planned to the tax man.

But if you want to keep it simple, many experts say, you should use the one retirement-savings vehicle that will give you the biggest bang for your buck without giving more to Uncle Sam than you must, and that's the 401(k).

"If I could have all of them, I would," Mr. Joyner said. "If I were making the decision personally, it would be a decision to fund the best one first."

E-mail pyip@dallasnews.com