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Guidance

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The 401(k) Tax Disadvantage

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One of the biggest missteps that folks make when saving for retirement is putting all their retirement investments in qualified accounts. With these, you deduct your contributions from your income at tax time, so it seems like a good deal. But it isn't. The tax collector gets you in the end.

Qualified accounts, also known as tax-advantaged or tax-deferred accounts, include: individual retirement accounts (IRAs), 401(k)s and 403(b)s. As an advisor, I am constantly working on strategies to deal with getting money out of clients' qualified accounts during retirement.

All the money in your qualified accounts is taxable at regular income tax rates. Unless you are expecting to live on a lot less than you make today, you will most likely be in the same or (depending on what Congress does) a higher tax bracket.

This could mean the loss of tens of thousands of dollars during your retirement. Most families have the majority of their savings in qualified accounts, originally thought of as a great way to save for retirement. Retirees are finding out that these accounts can actually devastate their retirement income.

Imagine you are retired and need to put a new roof on your house for $20,000. Being a good saver, you have accumulated $250,000 or more in your 401(k), which you rolled over into an IRA when you retired. If you are in the 25% tax bracket, you need to withdraw over $26,000 to pay for that roof. Ouch.

It can get worse. Since a distribution from your IRA is considered income, it could cause you to pay more taxeson your Social Security income, which is partially taxable depending upon your combined retirement income.

What many of us forget is that retirement savings are not what you have in the bank. They are what will end up in your pocket after the taxman takes his share.

What can you do about this?

Well, if you are age 65 or younger, it's not too late to diversify your retirement accounts among tax-deferred, taxable and tax-free accounts. When you sell taxable fund shares in retirement, the taxable amount is the difference between what you bought and sold them for. But because you bought the shares at different times, there are different taxable gains. So you can cash in what is most advantageous to you.

With a tax-free account – it helps to have a financial advisor to set one up – you invest in municipal bonds. Issued by state and local governments, these are not taxed on the federal level. Munis from a state other than your own are taxable on your state returns.

Also, if you are in the under-65 set and still working, you should convert at least some of your 401(k) plan to a Roth account, if your employer offers it. With a Roth, you pay taxes on converting a regular IRA into it, but the appreciation from there on is not taxed.

For those of you over 65, it is more important than ever that you have a distribution plan. Your plan should help minimize the taxes you will pay now and in the future.

For those over 65, you might think about withdrawing some money from your 401(k) before you reach 70½, when you are required to start taking it out. Just make sure that you don't pull any money out before 59½. Otherwise, you face a 10% penalty. You can also do a tactical Roth conversion of your 401(k).

Before attempting any of these strategies you should consult a qualified tax and financial expert. Everyone's situation is different so find out which strategy works best for your situation.

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