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Erman Retirement Advisory

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Higher Tax Rates Loom for 401(k) Savers

"Delaying the tax hit on retirement-plan contributions, a much vaunted benefit of 401(k)s, isn't as valuable if you face higher income-tax rates when you retire. Yet higher tax rates are all too likely in the years ahead.

The standard thinking has been that people drop to a lower tax bracket in retirement. Thus, with a 401(k), you get years of investment returns building on money that otherwise would have gone to taxes, and when your tax bill on 401(k) withdrawals comes due, you pay at a lower rate.

"For the longest time, it seemed like almost a no-brainer that people, when they were in their income-earning stage, would be in a higher tax bracket," said Marcia Wagner, an attorney in Boston. "That may or may not be true in the future."

While it's difficult, if not impossible, to predict how lawmakers will handle future tax rates, some say a future increase in federal income-tax rates appears inevitable. "If you look at the federal deficit, I don't see any way the tax rate is going anywhere but up," said Jack VanDerhei, research director with the Employee Benefit Research Institute.

Smaller accounts less likely to be affected

What does that mean for 401(k) savers? If your nest egg is small, and Social Security will provide the bulk of your retirement income, you're likely to be in a lower tax rate when you retire. It may well be low enough that any changes to federal income-tax rates won't make a big difference to you.

But those with a heftier retirement account, large enough to pay an income not far below what they earned while working, may find themselves in the same tax bracket in retirement. And they may take a hit if lawmakers raise income-tax rates in the interim.

Also a factor: the amount of time you have until retirement. The longer you have, and the smaller the tax increase when you get there, the likelier it is that contributing to a 401(k) will work out to your benefit, VanDerhei said.

That's because your investments have time to grow. "The longer you're in the plan, the smaller the differential between the two [income-tax] rates, and the higher the rate of return, the more likely it is to stay in the favor of the employee to make the contributions," VanDerhei said.

But "if you're too close to retirement and the gap between the tax rates pre- and post-retirement is too large, it [may not] work out to the benefit of the employee," he said.

Another wrinkle: In retirement, distributions from tax-deferred accounts such as a 401(k) become part of your adjusted gross income, and can lead to higher taxes on Social Security benefits.

Don't drop your 401(k)

This isn't to suggest that you forgo your 401(k).

"The 401(k) savings vehicle is ridiculously robust and important to our retirement security, regardless of the tax ramifications," It makes saving easy."

Others agree. "Even though you might have to pay a higher tax rate when you take out the money, you have earned all of the buildup in the accounts tax-free," said Teresa Ghilarducci, professor of economics at the New School for Social Research in New York.

Given the tax-rate outlook, savers should assess ways to diversify their tax situation in retirement. That means at least considering putting a portion of the amount they save for retirement into a Roth individual retirement account — or a Roth 401(k) if one is offered by their employers.

The maximum Roth IRA contribution is \$5,000 in 2011 (\$6,000 if you're 50 or older), but that amount is reduced for single individuals with modified adjusted gross income of \$107,000 (\$169,000 for joint filers). And contributions aren't allowed at all for singles with income above \$122,000 (\$179,000 for couples). For a 401(k) with a Roth option, your contributions are limited to the maximum for the plan over all: \$16,500, or \$22,000 if you're 50 or older, for 2011.

"If you think taxes are going up, it makes sense to pay your taxes when rates are low, put the aftertax amount into the Roth and take out your money tax-free when tax rates are high," said Alicia Munnell, director of Boston College's Center for Retirement Research.

Mind the tax hit

Either way, be aware that a tax bill is coming on your 401(k) savings. "People have forgotten that they're going to owe taxes on this money," Munnell said. "It's really going to be a shock when you pull it out and you find you can only keep two-thirds."

One of Wagner's clients, when his savings reached the \$1 million mark, told her that he considered himself rich, and ready for retirement. Said Wagner: "I said, 'Listen, after taxes, this is essentially half a million bucks.'" http://finance.yahoo.com/focus-retirement/article/112433/higher-tax-rates-loom-for-401k-savers;_ylt=Ah7qYEhdrDb1hAeh_8wdBgm7YWsa;_ylu=X3oDMTE1cGI2cDNIBHBvcwMzBHNIYwNmaWRlbGl0eUZQBHNSawNoaWdoZXJ0YXhyYXQ-?mod=fidelity-managingwealth&cat=fidelity_2010_managing_wealth

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We are offering a consultation on your 401k allocations. Are you positioned properly? Are you taking on too much risk without knowing it? How can you do a better job to protect yourself against adverse markets? Call us to discuss solutions.

As a general update, the 30 year treasury index closed on Friday, April 8th, at 4.63%. (finance.yahoo.com). The November, 2010, average completed at 4.19% (21 data points). This number will comprise 20% of the 2011 rate for lump sum calculations. The barrel price of crude oil futures, May, 2011 delivery, on the New York Mercantile Exchange dropped \$.11 and is now quoted at \$112.68 (Friday close).

If you know of another co-worker or associate who is interested in receiving these daily interest rate updates, especially #1 which describes how interest rates affect the lump sum (still applicable with PPA '06), please send me an email with their email address so I may add them to the list.

Howard is also a holder of the CRC (Certified Retirement Counselor) designation as well as the ATP (Accredited Tax Preparer) designation. He undertook the requirements for this education to better meet the needs of retirees.

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