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REVIEW & OUTLOOK

The 401(k) Illusion

After paying taxes due today, no doubt many prospering citizens are comforted by amazing growth in their 401(k) or IRA or other retirement vehicles. But to understand that swelling figure on your screen, do a little calculation: Take $650,000 and subtract the value of your home and other assets. The remainder is how much of your IRA you really own; sooner or later the government will confiscate the rest.

We exaggerate, but only slightly. You can of course spend all your IRA money, in which case the federal government will not take more than about 40%, or including state levies, close to 50% in a tax hell like New York or California. But if you hope to leave some of the money to your kids, they will have to pay not only this bite, but on top of it an inheritance tax that currently applies to estates of more than $650,000—a level reached by your ordinary successful American. The combination of the income tax and the estate tax boosts the death tax to something like 85%.

Consider the odyssey your cash must make before it reaches you and your offspring. When time comes to start withdrawing IRA money—and Washington mandates we start exposing this money to taxation by age 70—every penny is taxed at ordinary income tax rates. If you've been smart and virtuous enough to build an investment portfolio *outside* an IRA, your total income can still reach the top brackets described above, even if you've stopped working at a regular job. These are brackets that Congress and Treasury Secretary Rubin have assured us were "only for the rich."

Indeed, the 401(k) may even be a fool's game. As Tom Ochsenschlager of the accounting firm Grant Thornton points out, politicians give you elaborate terms to play their 401(k) game, but in the meantime they've lowered capital gains rates. So instead of being taxed at the less onerous 20% reserved for treatment of regular long-term capital gains, the long-term capital holdings stuck in our 401(k)s face double that rate. The penalty is particularly high when you've bought and held onto one of those Internet stocks—say, Microsoft—that throws off little or no dividends to tax. Indeed, the better investor you are, the more likely you are to face this penalty. Who's the sucker here?

The next round of trouble comes in trying to share some of the 1990s bull market bounty with children. The estate tax starts with rates of 37% and moves smartly up to 55%. These rates apply to anything above a basic exemption of $650,000, being phased up to $1 million over 10 years. You can leave everything tax-free to a spouse, of course, and with expensive enough lawyers take advantage of the $650,000 exemption twice. But eventually the income tax will take its bite of any tax-deferred assets, though again, outside of a 401(k) unrealized capital gains are not taxed at death. Whatever is left gets taxed again at estate tax rates.

If you think the death tax is confiscatory for the IRA class, it's a real tragedy when it is the family business you may be hoping to pass along. Say you've lived a penurious life and poured every penny you earned back into the farm or the family fast food franchise. You and your heirs have built this business together. But when you depart this earth, those heirs often find they have to dissolve your legacy, just to pay the tax bill on it.

The root of the problem is that you get taxed only once on the money you spend, but repeatedly on anything you save. Economists call this the "definition of income" problem; the current definition was dreamed up by an economist named Henry Simons, who helped create the modern income tax system. The 401(k) and the like are designed to work around the Simons treatment of returns to saving as "income" though taxes were already paid on the principal invested. But while politicians give "savings vehicles" with one hand, with the other they take everything back with the income and death taxes.

Seen from afar, it all looks plenty perverse. Oh yes, just now policy voices from Dick Gephardt to the Christian Coalition are calling for a tax structure that helps the family. The much-discussed "marriage penalty" is billed as anti-family, though in fact it represents a conflict between working moms and stay-at-home moms; the real "anti-family" forces here are the confiscatory high rates born of a graduated rate structure aimed at getting the "rich." And the most anti-family tax of all is the death tax, the only part of the tax code that is specifically designed to keep you from helping your offspring.

This anti-savings, anti-family levy is so odious that "the rich" pay lawyers and accountants small fortunes to avoid it. So it generates a lot of pernicious effects and very little revenue—less than 1% of the federal tax take. The obvious "reform" is to repeal it entirely, as proposed by Rep. Jennifer Dunn (R., Wash.) and Senator John Ashcroft (R., Mo.). Just now the obstacle to their effort is a post-impeachment Administration especially beholden to liberal theology, however outmoded. But with the bull market throwing more and more wealth into the 401(k) tax trap, the practical arguments have more and more force; don't be surprised if over the next few years they actually prevail.