Playing the 401(k) game

You may be choosing the wrong funds and saving too much

BY JAMES M. PETHOKOUKIS

What's not to love about 401(k) retirement plans? Fill out a few forms, the pre-tax dollars go pouring in, and the magic of compounding takes over. The only real decision is figuring out which funds to put inside the plan—and that's not hard. Then you relax, knowing that your beloved 401(k) and its tax-deferred halo will protect your savings from Uncle Sam's grasp and make sure your money gets the best return possible.

Don't get too comfortable. You may shortchange yourself by following the old rules of thumb. Recent studies show that the 401(k) is such a mighty investment vehicle that almost anyone can amass an impressive amount of savings, and that could mean a big tax bite when you cash in. What's more, you may be picking the wrong kind of mutual fund to put in your tax-deferred plan.

37% of Americans say they have a 401(k) plan, and **30%** own stocks or bonds. But **47%** of Americans ages 30-49 say they won't be prepared for retirement.

Let's say you want to diversify your portfolio by owning a taxable bond fund and a growth-stock fund. Standard advice calls for putting the bond fund in the 401(k) to avoid having the interest income it generates taxed at a rate as high as 39.6 percent, the top marginal income-tax rate. A growth fund, on the other hand, doesn't need the tax shelter as much because the stocks it invests in typically don't pay dividends. Growth-fund investors have to worry only about the 28 percent capital-gains-tax rate assessed when a stock that rises in price is sold. But a 1996 study from mutual fund company T. Rowe Price suggests that investors would reap more over the long term—at least 10 years—taking the opposite approach. The T. Rowe Price researchers pretended to invest $10,000 in a growth fund and $10,000 in a taxable bond fund from March 31, 1976, to March 31, 1996, a period when the average growth fund earned 14 percent and the average taxable bond fund garnered 9 percent. Putting the bond fund in the 401(k) and leaving the growth fund outside—and plugging in the average fund returns—would have left you with $128,000 after the funds were sold and taxes paid.

Now switch. The researchers then placed the growth fund in the 401(k), leaving the bond fund vulnerable to ordinary income-tax rates. In this scenario, the pair of funds earned $142,000. Chalk it up to the incredible power of compounding, says Sam Beardsley, the T. Rowe Price tax expert who conducted the study. While you are losing a portion of the bond fund's return to taxes by leaving it outside the 401(k), the loss is more than offset by the tax-free compounding of the higher-earning stock fund. The same was true for balanced, equity-income, foreign, growth-and-income, and small-stock funds when compared with taxable bond funds.

The popular index funds, which mimic the performance of indexes such as the Standard & Poor's 500 by buying the stocks that make up the benchmark, didn't fare as well in the study. These funds do little buying and selling of stocks. That means capital-gains taxes aren't much of a threat, so index funds don't need to waste valuable space in the 401(k). Moreover, an unspecified capital-gains-tax cut is part of the tentative federal budget agreement. Although the details are still being ironed out, the rate could drop to as low as 20 percent. Such a cut would erode the tax-deferred advantage of stock funds in a 401(k), since they would be subject to a fairly low tax outside the plan.

When you start dipping into

ILLUSTRATION BY RUSS WILLMS FOR USN&WR

401(k) game

vrong funds and saving too much

from March 31, 1976, to March a period when the average nd earned 14 percent and the xable bond fund garnered 9 utting the bond fund in the l leaving the growth fund out- plugging in the average fund re- uld have left you with $128,000 inds were sold and taxes paid.

itch. The researchers then growth fund in the 401(k), bond fund vulnerable to ordi- ne-tax rates. In this scenario, funds earned $142,000. Chalk he incredible power of com- says Sam Beardsley, the T. tax expert who conducted the le you are losing a portion of und's return to taxes by leaving he 401(k), the loss is more than he tax-free compounding ier-earning stock fund.

The same was true for balanced, equity-income, foreign, growth-and-income, and small-stock funds when compared with taxable bond funds.

The popular index funds, which mimic the performance of indexes such as the Standard & Poor's 500 by buying the stocks that make up the benchmark, didn't fare as well in the study. These funds do little buying and selling of stocks. That means capital-gains taxes aren't much of a threat, so index funds don't need to waste valuable space in the 401(k). Moreover, an unspecified capital-gains-tax cut is part of the tentative federal budget agreement. Although the details are still being ironed out, the rate could drop to as low as 20 percent. Such a cut would erode the tax-deferred advantage of stock funds in a 401(k), since they would be subject to a fairly low tax outside the plan.

When you start dipping into your 401(k), you may take more of a tax hit than you ever imagined. A 1996 study by Stanford University's Center for Economic Policy Research shows that even low- and middle-income workers who stick with their 401(k)s and other tax-deferred pension plans for the long haul can get pinched. Take a 25-year-old who makes $25,000 a year and socks away 10 percent of his salary in a 401(k). According to the center's study, the beauty of the 401(k) means he could retire at age 70 with a whopping $2.4 million.

ILLUSTRATION BY RUSS WILLMS FOR USN&WR

That sum is subject to two little-known taxes. One is a 15 percent tax that kicks in when retirees withdraw more than $160,000—the figure rises with inflation—from a tax-deferred plan in any one year. Current retirees don't have to pay the tax, as it is taking a three-year hiatus. Congress hopes that retirees will withdraw greater sums during the window and the requisite income taxes they will pay on those funds will fatten the government's coffers. But the tax resumes in 2000.

Sharing the wealth. The other tax doesn't affect you during your lifetime, but it can help eviscerate your offspring's inheritance. The estates of people who die without a spouse and with too much in pension plans can get socked with a 15 percent excess-accumulation tax. The government has a complicated formula to define "too much," crunching factors like life expectancy. For a 70-year-old, for example, any amount over $1.2 million is too much and would face the extra tax. All you loyal 401(k) investors may have more than enough in your plans to trigger the tax.

People nearing or in retirement, of course, should start thinking about how to prevent getting clobbered by these taxes. Unfortunately, "there is no quick-and-dirty, you've-got-to-do-this answer," says financial planner Judith Lau of Wilmington, Del. Some investors may even want to ponder contributing less—or nothing more—to their 401(k) plans. For example, a 60-year-old investor with no savings other than a fat 401(k) might want to use the funds to start financing another type of savings or investment account.

Younger investors shouldn't fret a whole lot about these taxes—yet. Lawmakers might rewrite tax law several times before investors in their 50s or younger are ready to retire. Nonetheless, in the future all those billions in 401(k) plans might be a tempting target for a cash-strapped government, so baby-boom investors should watch carefully for changes affecting post-retirement taxes. It's OK to have a love affair with your 401(k), just don't take it for granted. ■