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Tax savings of 401(k) plans can be misleading

Some participants will pay more taxes over their lifetime

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Most people know that participating in a 401(k) retirement-savings plan lowers current taxes, and they would probably guess that this tax benefit lasts all their lives.

But they might be wrong.

Participation in a 401(k) plan lowers current taxes all right, but a new study indicates that for low- to middle-income workers, it can result in higher total lifetime taxes. And the better the plan's investment return, the more likely the participant is to pay higher taxes.

Of course, long-range taxes are far from the only consideration in 401(k) participation, which is increasingly becoming a mainstay of retirement security. And one of the authors is quick to say that the study's findings do not amount to a recommendation that workers opt out of their savings plans.

But tax savings have been a key selling point of 401(k) plans, so the finding runs counter to many workers' assumptions when they sign up.

The explanation, the authors said, lies in the interaction of other tax provisions with contributions and withdrawals from the 401(k) plan.

These plans operate by allowing workers to contribute part of their pay to an investment account during their working lives and then requiring them to withdraw the funds in retirement.

The contributions are made on a pretax basis, meaning they are made before taxable income is calculated. The earnings — dividends, interest and capital appreciation — in the investment account are not taxed as they occur, allowing them to compound without subtracting taxes. In retirement, the account holder withdraws the money, and it is taxed as ordinary income.

Generally, workers — and the policymakers who devised these plans — figure they will be in a lower tax bracket in retirement than when they were working. Thus, they will not only defer taxation of a part of their incomes but also pay at a lower rate in retirement.

Unfortunately, it doesn't always work that way.

First, the plan contributions lower taxable income when many workers have lots of other deductions, such as mortgage interest. To the extent that the worker's tax liability is lowered by the 401(k) plan, those deductions become less valuable.

(Remember, when workers in the 28 percent bracket deduct $1, they save 28 cents. If they are in the 15 percent bracket and deduct $1, the savings is only 15 cents.)

Second, a very large 401(k) plan balance, which might well be achieved by workers who participated for many years and had good investment success, could actually put them into a higher bracket in retirement than during their working years.

Third — and most important — Social Security benefits are subject to steeply progressive taxation. Thus, a healthy 401(k) balance can result in withdrawals that, in turn, cause taxes levied on Social Security benefits to rise sharply.

You may have forgotten about this one, which dates to the 1980s. Social Security benefits for low-income beneficiaries are untaxed. But when other income, plus a portion of Social Security — there's a complicated formula for calculating this — exceeds a threshold of $25,000 for a single taxpayer and $32,000 for a couple, as much as half of the benefits become subject to income tax.

And if the income calculation tops $34,000 for a single taxpayer or $44,000 for a couple, as much as 85 percent of Social Security benefits are subject to tax.

The Social Security taxation formula creates unstated but very real marginal tax rates for retirees. When these are factored into retirees' tax situations, the result may be that they are in a substantially higher bracket in retirement than when they were making their pretax 401(k) contributions.

In contrast, the study notes, very-high-income workers do get a substantial lifetime tax benefit from participating in a 401(k) plan because they are in the highest brackets anyway, so they get the full time value of deferring tax payments.

But "the point is not that participation is bad," said Jagadeesh Gokhale of the Federal Reserve Bank of Cleveland, who conducted the study along with Laurence J. Kotlikoff of Boston University and Todd Neumann of the Cleveland Fed.

Instead, the study shows how difficult it is to build incentives and tax breaks into our complicated tax code without ending up with unintended consequences.

The tax results are "not intentional" on the part of policy-makers. "It's all well-intentioned, but it shows how difficult it is to understand fully how this interacts with the tax code," he said.

Indeed, a number of assumptions in the study don't mirror workers' real choices. For example, the researchers noted that 401(k) participants often receive matching contributions from their employers. To level the playing field in their calculations, they added a corresponding level of income to the nonparticipants.

The idea, Gokhale said, was to compare the tax consequences of 401(k) participation with what workers' tax situations would be if such plans did not exist. And the assumption was that if 401(k)s did not exist, the equivalent of matching contributions would be distributed to workers as pay.

Of course, that's not the choice workers face in real life, and the employer match, if offered, results in participants receiving what amounts to higher pay than nonparticipants.

Also, the study used tax rates in effect before the recent tax-cut bill passed. The researchers are updating their study with the new rates, but the basic conclusion remains the same, Gokhale said. But the twists and turns of the law do appear to introduce a "nonlinearity," meaning that some lower-income workers might benefit and some might not, depending on their exact situation.

The study also found plan participants end up with substantially more money and spending power in retirement.

That is the key factor in the higher taxes, but it also adds importantly to their economic security, a factor the researcher did not address.

Also, they did not try to take into account many other complicating factors of modern life, such as college financial-aid calculations, which may exclude retirement accounts from the expected parental contribution, benefiting families that save in 401(k)s vs. those who save in taxable accounts.