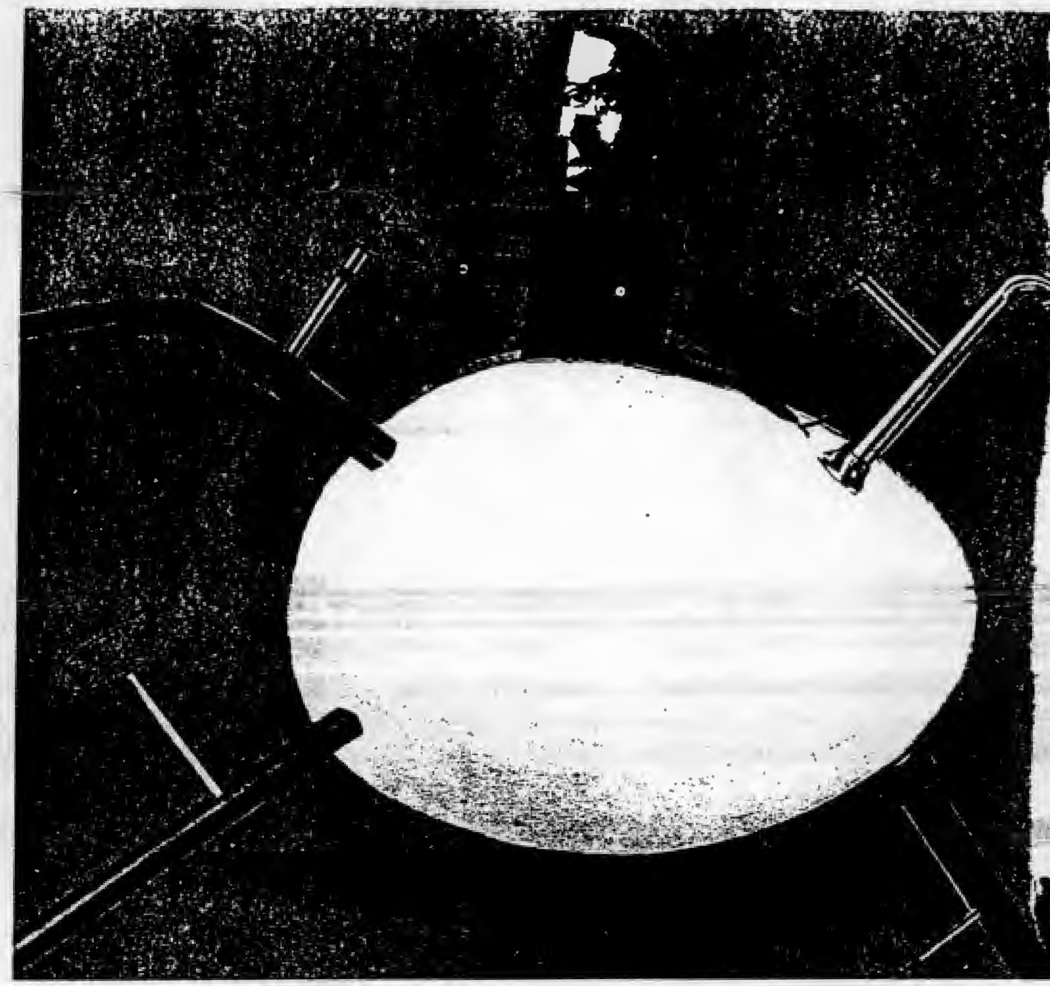
UNCLE SAM WANTS YOUR 401(K)!

And IRA and Keogh, too. Ever heard of saving too much money? Washington has.

BY JEFF BLYSKAL

With some 52 percent of 401(k) assets invested in equities, the recent market rally has injected plenty of instant gratification into the otherwise ascetic chore of saving for retirement. ★ Consider the case of a diligent investor who has been steadily putting money for his retirement into a 401(k) plan or some other tax-deferred pension vehicle, such as an IRA or Keogh. Let's say that his salary was $50,000 a year in 1990 (when the current rally began), that he had already socked away $100,000 in savings, and that he has received annual raises of 2 percent. If he has faithfully contributed 10 percent of his income to the plan and invested totally in the big-company stocks of the Standard & Poor's 500 Stock Index, his nest egg would have grown to over $345,000 by January 31, 1997, according to Ibbotson Associates.



It is practically a sacred canon of personal finance that workers who have the option of saving for their retirement through a tax-deferred plan such as a 401(k) should take full advantage of the opportunity. They should max out their contributions, putting the highest legally permissible amount—$9,500 in 1996—into their plans each year.

This advice is based on two beliefs: (1) the power of tax-deferred compounding and (2) the wisdom of deferring taxes until after retirement.

In and of itself, tax-deferred compounding is certainly a good thing. Investment returns, whether in the form of income or capital gains, always multiply faster when fully reinvested—as opposed to partly reinvested because some portion of earnings has been taxed. Walter Gowens, president of Prudential Vanguard Financial Services in New York, estimates that an investment will generate, on average, 15 percent more in earnings (even after deferred taxes are ultimately paid) inside a tax-sheltered plan like a 401(k) than within a non-sheltered vehicle, such as a typical brokerage account. It is also generally true that deferring income until after retirement is smart, since most people are taxed at a lower rate in retirement (because their income falls) than they were while working.

Nevertheless, this conventional wisdom happens to be flat-out wrong for the most diligent and most successful retirement savers. According to a startling new study conducted by the Center for Economic Policy Research at Stanford University in conjunction with the National Bureau of Economic Research, investors who by retirement have accumulated as little as $1.2 million (in today's dollars) in a tax-deferred retirement vehicle could face excess-distribution levies from the Internal Revenue Service that can ultimately push their marginal tax rates up to 60 percent. What's more, if too much money is left over in a retirement account that becomes part of an estate (when the retiree and spouse both die), an excess-accumulation tax kicks in that can push marginal rates above 90 percent.

Call these success taxes. And thanks to the stock-market rallies of the 1980s and 1990s, more and more retirees (even those who had working incomes as modest as $40,000 annually) will be encountering these surprise levies on what they thought was going to be their reward for diligent saving.

John B. Shoven, dean of Stanford's School of Humanities and Sciences and co-author of the CEPR study with Harvard's David A. Wise, notes that these taxes hit successful investors especially hard. "Pensions are widely thought to be attractive tax shelters, but when the assets are taxed on withdrawal or pass through an estate, the shelter can become a trap," says Shoven. In other words, the tax-deferred accounts most people think of as the sure path to financial security in retirement can sometimes actually produce a smaller nest egg than non-tax-advantaged saving.

"Most people are surprised to learn the government can confiscate pension assets like this, but it's the law," says Steven Lockwood, a New York pension attorney whose firm deals exclusively with success-tax problems. "This is going to be a major issue in retirement planning for the next 20 years."

With proper planning, investors can minimize or beat the success tax altogether. But many of them won't because they've always been told that it just isn't possible to save too much money inside a retirement account like a 401(k). People who expect to have high incomes from their savings need to calculate when they'll hit the ceiling that triggers the success tax, limit their contributions accordingly, and put any additional savings into a non-tax-advantaged account. Insurance policies and other planning strategies can help to slash the success taxes on estates that include leftover retirement moneys.

One lesson in all this: There's a genuine risk associated with any savings or investment strategy that's predicated on government tax policy. Tax law is always subject to change.

Loopholes can open or close. Rates can change on any class of asset. It all depends on which way the wind is blowing in Washington. Americans need to understand that the $1.225 trillion that they have shoveled into their defined-contribution plans is not entirely safe.

Although most investors remain unaware of the two success taxes, this time bomb and the complex equations necessary to pin down its repercussions are not new. Shoven has been writing the formulas on the blackboard in his public-finance classes for years. Lockwood and other pension attorneys who serve wealthy clients have known about the problem since the excess-distribution and excess-accumulation taxes were enacted as part of the Tax Reform Act of 1986.

In theory, the two taxes are pretty simple. Both are intended to penalize people who use the favorable tax treatment afforded to retirement plans—such as 401(k)s—to accumulate wealth beyond what the government thinks is reasonably required for a comfortable retirement.

Under current law, withdrawals and payments from all pension and retirement accounts that exceed $160,000 per year (that's the level in 1997; it's indexed to inflation) get hit with a stiff 15 percent excess-distribution tax. Moreover, because the minimum size of withdrawals from 401(k)s and similar accounts is mandated by a formula based on life expectancy, retirees with large balances are forced to make withdrawals that trigger the tax.

The second tax—the excess-accumulation tax—kicks in if a retiree dies with what the government considers too much money in a qualified account. The definition of "too much" changes with age. It's currently about $1.2 million for a 65-year-old and $1 million for a 75-year-old. Any amount over this produces an extra 15 percent tax penalty. (The excess-accumulation tax can be deferred if assets are transferred to a surviving spouse, so it affects only single people, widows, and widowers.) "These taxes got very little attention in the '80s because baby boomers never thought they'd have the amount of money in their pensions necessary to trigger the success tax," says Shoven. Generally speaking, you're an evil robber baron in Uncle Sam's eyes if your pension is worth $1.2 million by the time you reach 65 or as little as $794,000 by age 80.

"Everyone thought that was a threshold for Bill Gates—not ordinary folks—to worry about. But the tremendous run-up in the financial markets has changed all that," says Shoven. The Dow has climbed from 1200 in 1986, when the law was passed, to above 7000 in February.

Lockwood estimates the tax affects 100,000 to 200,000 well-off pension holders today. But Shoven expects that millions of today's middle-income employees will be penalized for their thrift when they retire in 20 years—all thanks to the power of tax-deferred compounding. According to the CEPR report, people with annual incomes as low as $30,000 to $40,000 today will likely get hit with the success tax in years to come. "These taxes are certainly not limited to the rich," says Wise. "In fact, the group most likely to face these penalties includes long-term lifetime savers."

For example, a person who began faithfully contributing 10 percent of his salary to a 401(k) plan at age 25 and who earned $41,000 a year by age 50 could hardly be considered a Rockefeller. But do the math: This person could accumulate $900,000 in his pension account by age 60 if the contributions were invested in growth stocks. By 63, the person could have enough in a 401(k) to face a success tax on distributions from the account; by 70 he could have a $2.4 million nest egg—an "excess accumulation" of more than $1 million, according to the IRS.

Success taxes are all the more onerous because of the way they interact with other taxes. The excess-distribution tax, for example, isn't deductible against either state or federal taxes—so the investor's retirement income bears the full brunt of the tax. This can catapult a California resident, for example, with a 46.4 percent marginal state and federal tax rate right up to 61.4 percent.

When a tax-deferred retirement account passes through an estate, the excess-accumulation tax piles on top of state and federal estate taxes as well as the excess-distribution tax. In 1982, before the success taxes were fully implemented, $100,000 of what would later be considered an excess accumulation of retirement assets faced a marginal combined estate- and success-tax rate of 0 percent. In 1996, the same $100,000 faced a marginal combined rate of 53.25 percent, which would produce a painful $29,160 tax bite. "Everyone thinks, If I die, my children will get my pension account. That's true, but they won't get anywhere near as much without proper planning," says Gerald Reich, a retirement- and estate-planning attorney at the Portfolio Strategy Group in New York.

"No one appreciates that retirement planning and estate planning are two very different things," says Shoven. "Pension

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accounts are good for providing income in retirement, but are a horrendous estate-planning device; they don't work very well as a vehicle for transferring wealth to heirs."

When the income taxes that heirs pay on an inherited tax-deferred-pension nest egg were also factored in, marginal triple-whammy tax rates jumped to 85.4 percent in 1996, up from 39.2 percent in 1982. According to Shoven and Wise's calculations, the total marginal tax rate can run as high as 96.4 percent, leaving heirs with less than one-sixth the amount they would have received had the assets been kept outside a pension.

"I don't think legislators realize how the success taxes interact with other taxes," says Shoven. "You can't look in a tax table and find the resulting 90 percent tax rate on pension withdrawals. You find 15 percent here, 45 percent there, another 15 percent somewhere else. You don't see the 90 percent rates until you add up all the taxes. I don't think any congressman could vote for a 90 percent tax."

All this turns one of the principal arguments for tax-deferred investing utterly upside down. The theory, of course, is that savers should defer paying taxes during their working lives—when they are in a high income-tax bracket—until after retirement, when they are in a lower income-tax bracket. Yet workers who systematically build a nest egg so big that it triggers the success tax will find themselves in the top brackets when it comes time to begin withdrawing their money.

Under current law, the cumulative effects are startling. At the $160,000 level of income that triggers the success tax, taxes on Social Security benefits kick in as well. Meanwhile, personal exemptions and partial itemized deductions are phased out. Result: The effective marginal federal income-tax rate can rise to 41 percent from the published 39.6 percent top rate. Many retirees thus will actually find themselves in a higher effective tax bracket than they were while working.

Of course, that's assuming tax rates remain where they are now. As the baby-boom generation retires, fewer workers will be paying into Social Security and Medicare, so taxes to pay for those programs—if they still exist—are almost certain to climb. Both of those changes would make tax-deferred compounding more valuable but would also take a bigger chunk in taxes out of retirement incomes.

Certainly investors who are saving for retirement shouldn't pin their strategies on hopes of repeal: The government will more likely be forced to hike success taxes. The huge pool of baby-boomer retirement assets will be a tempting target for cash-strapped politicians. Congress will go after pension distributions for the same reason crooks rob banks: It's where the money is. "I think the government is looking forward to imposing all these taxes on the coming largest transfer of wealth in history," says Lockwood.

"People who invest through a pension are exposing their assets to uncertain future tax rates that could be substantially worse than they are now. If taxes rise, pension returns can work out even worse than our results indicate," says Shoven.

What should you do?

Here are four principal strategies. The first three are for investors relatively close to retirement and are designed to minimize taxes while preserving wealth under the existing laws. The fourth is best suited to younger employees with plenty of years left until retirement. These are the folks who have the most to fear about the effects of current rules and the possibility that the rules of the game will change between now and the time they're ready to cash out.

Strategy No. 1. If you are nearing retirement (age 59 and a half or over) and heading into success-tax territory, pull money out of your tax-deferred plan to take advantage of the current three-year moratorium on the excess-distribution tax. This was inserted into the 1996 legislation that raised the minimum wage.

Depending on your age, life expectancy, and rates of return, you should withdraw the amounts over $160,000 that will keep your tax-deferred plan below excess levels in the future. That way, you'll avoid both the excess-accumulation tax and the excess-distribution tax in coming years. The money can continue to grow tax-free if you put it into a municipal-bond fund.

Climbing out the three-year window is also a good idea for older retirees who risk having tax-deferred retirement-plan assets pass through an estate. For example, a single 75-year-old with $1.05 million in excess assets would give his heirs only $84,300 of that after success taxes, estate taxes, and income taxes are paid. But if he withdraws the $1.05 million during the next three years, he can bestow more than $310,000 after taxes.

Strategy No. 2. This one is designed to help savers pass on their assets to their children or grandchildren. In this instance, you don't worry about incurring excess-accumulation taxes. Instead, you let your assets compound to the max and then purchase a second-to-die universal or whole life-insurance policy to pay the estate taxes.

The alternative is pretty bleak. For example, suppose you die and then your spouse dies with a large part of the estate's liquid assets made up of a $3 million balance in a tax-deferred retirement account. Without proper estate planning, your heirs would have to yank $2.7 million from the account to pay the estate taxes ($2 million) and their own income taxes ($700,000) on the amount received. "Taxes can obliterate the whole thing," says Lockwood.

A better approach: When you die and the nest egg rolls over to your spouse tax-free, he or she can name the children as beneficiaries. That reduces the size of required annual withdrawals, because distributions are based on the joint life expectancy of the spouse and children. When the surviving spouse dies, a $2 million second-to-die insurance policy covers the estate and success taxes, enabling the estate to pass intact to the children. The excess-accumulation tax comes due, but the excess distribution would not apply and the heirs' income taxes would likely be reduced.

That's because the beneficiaries—in their 50s, say—can further stretch distributions out over the ensuing 30 years, making each withdrawal much smaller than if the original retirement-account owner had to make withdrawals over 10 or 20 years or if the heirs had to liquidate the account in one fell swoop. With a 30-year distribution time line, the heirs have to withdraw only 3.3 percent of the fund the first year. If the assets in the account are earning 8 to 10 percent a year, it will continue to grow in value even given the withdrawals. Under such a setup, the $3 million pension could ultimately throw off some $50 million during the life of the heirs.

"If you really want to get fancy, you can do generation skipping and pass the pension to grandchildren, who may be in their 20s and thus able to stretch withdrawals out over a 50-year span," says Lockwood. A $1 million pension handled that way could provide $65 million in payments over the grandchildren's lifetimes.

Strategy No. 3. This one is for people who arrive at this game too late. They didn't plan, they can't fix the estate problem with insurance, or they have no children who need the money.

Leave the tax-deferred account to charity. You've done something worthwhile, the charity gets the assets, and the IRS gets only the excess-accumulation tax of 15 percent.

Strategy No. 4. The investor with plenty of time left until retirement can adopt pieces of any of the first three methods. The only trouble is that no one knows if these options will even be available in the future. The tax code, as noted, is always subject to change.

To address this very real risk, consider re-allocating your investment assets both inside and outside of tax-deferred retirement plans now. The idea is to maximize the value of the final accumulated total retirement account and minimize the risk of near-confiscatory tax rates. To do this, begin by limiting the size of your tax-deferred nest egg. Plan to accumulate no more than $1.2 million in 1997 dollars by age 65. (Warning: Don't use this as an excuse to put aside less for your retirement. Instead, invest in other vehicles, outside the plan, what you would have put into your tax-deferred retirement account.)

Some assets should always go inside tax-deferred retirement accounts. Bonds, whose interest is taxed as ordinary income whether earned inside or outside a tax-deferred plan, should always be kept inside the plan to reap the advantages of tax-deferred compounding. For a person who began contributing to a pension at age 30, retired at 70, and lived to make 15 years' worth of withdrawals, bonds would throw off net after-tax gains that are 24 to 168 percent better inside a tax-deferred plan than outside one.

Equities and mutual funds that throw off dividends and realized capital gains should also be kept inside the tax-deferred plan since they offer ways to compound the current returns from these investments tax-deferred.

For example, using the same investor as in the example above, Shoven and Wise calculate that a person who bought stocks that paid dividends and mutual funds that realized capital gains every year would net (after taxes) 7.8 to 10.2 percent more by investing in a tax-deferred plan rather than outside the plan.

But if the same person scored only pure capital gains from the stocks, he could net (after taxes) 4.4 to 10.9 percent less by keeping these assets inside a 401(k) or similar plan instead of in a regular taxable investment account.

On the other hand, investment vehicles that enjoy special tax treatment, such as growth stocks or tax-free municipal bonds, should be kept outside of a tax-advantaged account. Remember that pure capital gains aren't taxed until they're realized at the sale of the stock. Holding a growth stock until retirement is an effective way to defer taxes. The realized gains from that stock aren't taxed as income, which is how all gains (even capital gains) inside a tax-deferred pension account will be taxed when the time comes to pay the piper. Instead they're taxed as capital gains at the lower rate of 28 percent—and capital-gains rates could be headed even lower.

Even better, when appreciated assets outside a pension account pass through an estate, their cost basis is stepped up free of income tax. That means unrealized capital gains can escape being taxed as income altogether. Not so for the same assets inside a 401(k).

Keeping non-dividend-paying, aggressive growth stocks outside your tax-deferred retirement plan makes sense on a risk-reward basis, too. Why take the higher risks associated with equities inside a tax-deferred account, where higher gains will just spark success taxes? "If your pension is too aggressively into stocks, you're taking all the extra risk, but the government may get 90 percent of the upside," says Reich.

Tax-deferred retirement accounts such as 401(k)s have changed how Americans save for the years after they've stopped working. But they are still new instruments, and investors haven't yet fully explored all of their potential and risks. One thing we surely do know is that they put greater responsibility for our future in our own hands.

Contributing editor Jeff Blyskal wrote "The Richest Towns in America" for the July/August 1996 issue.

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