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Today's Economy May Make Tax-Deferred 401(k) Plans A Bad Deal

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For decades, advising your clients to invest as much as possible in tax-deferred, employee-sponsored 401(k) plans seemed to make great sense. Designed to reduce taxable income in pre-retirement years when participants' tax brackets are typically at their highest, this convenient savings vehicle enables investors to pay taxes on their assets in post-retirement when tax brackets are likely to be lower than in earning years. But in today's economic climate, many of your clients face a new challenge: one in which the bulk of their pre-retirement years are taking place in a time of historically low tax brackets. Suddenly this "no brainer" investment approach may need some serious rethinking.

401(k) plans were first introduced back in 1978 when the top tax bracket was a mind-boggling 70%. In that environment, deferring taxes created a significant advantage since it was unlikely high-income earners would be taxed at an equivalent tax rate in post retirement. But 2013 presents a very different picture. Today's top tax rate is 39.6%—nearly 30% less than in 1978. But this rate is unlikely to remain for long. The January 1 enactment of the American Taxpayer Relief Act (ATRA) was the first sign of an upward shift. Historically, tax rates have increased substantially in the decade following every major U.S. war. The U.S. has been engaged in the War Against Terror since 2001 at a cost of more than $1.5 trillion. As government debt continues to mount, increases in tax rates are inevitable. For today's investors, this means tax rates may very well rise during their retirement years, reversing the assumed value of a tax-deferred savings plan.

Changing tax rates aren't the only stumbling block for 401(k) investors. As tax rates have decreased over the past decade, stock values have plummeted. While inflation-adjusted stock values generally rose between 1978 and 1997, stock values are lower today than in the prior decade. With 401(k) plans performing at the worst levels in history, "wise" investors who diligently poured their savings into 401(k)s during that period saw their account values steadily decline for a decade. And while it is assumed that stock values will climb again, no one can say how much and how soon, or when yet another bear market may jolt the market again.

So what's the answer? There is no simple solution, but guiding your clients toward an approach that hedges against the risk of both tax rate increases and decreased stock values may give them a much safer path toward protecting their retirement savings.

To begin, it may make sense to forgo the small deduction that comes with deferring taxes on savings today in favor of much larger tax benefits later. In other words, it may be better to pay tax on the "seed" instead of paying tax on the "harvest"—especially when taxes are likely to be considerable higher when that harvest is reaped. The good news is many employers have recently added one or both of the following enhancements to their company-sponsored 401(k) plans:

- Roth Provision 401(k)—This new option allows participants to choose from the same investment options and choices in their company plan. Rather than deferring taxes, the employee pays current taxes on all income earned, making the Roth 401(k) portion of the account tax free during retirement—including both contributions and growth. Unlike the Roth IRA, there is no income limit for participation or mandatory distribution cycle, and building this large, tax-free nest egg greatly simplifies retirement income planning during the distribution phase.
- Company Plan In-Service Withdrawals—In the past, money saved in a 401(k) plan was held captive until the employee left the company. The in-service withdrawal option allows participants to rollover existing 401(k) savings into an IRA (which can then be converted to a Roth if desired) while still working for the employer. This flexibility helps investors by opening the door for greater investment diversification, while also taking advantage of tax diversification.

Both of these options can provide significant benefits by enabling your clients to take full advantage of their employee-sponsored 401(k) plans—including company match programs when available—while also making smarter choices about how and when to pay taxes on their savings. Both options also provide the opportunity for much greater portfolio diversification.

No one can see the future. You and your clients know the direction of tax rates and stock values in the coming decades is fixed only by speculation. The rules have certainly changed, but by carefully considering the role these new company plan options play in each clients' financial plan, you can help them make smarter choices that accurately reflect today's economic landscape and help support a more comfortable, tax-efficient retirement.

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