Forbes

The Tax-Deferral Trap

http://www.forbes.com/forbes/2009/0907/opinions-william-baldwin-side-lines.html

William Baldwin, 08.19.09 (Forbes Magazine dated September 07, 2009)

Novel advice on how to save for retirement: Don't put any more money in your tax-deferred retirement savings.

This is heresy in a world where people hate taxes and it is taken as gospel that you should defer them if you can. FORBES has helped spread the gospel. For two decades we have been advising you to maximize your tax-deferred 401(k) accounts and IRA, and, at the other end, to minimize withdrawals. Let your earnings compound tax free , went the thinking. Deferral is magic.

That's not necessarily true anymore. After a year of turmoil in Washington, D.C. and on Wall Street, it's time to rethink savings. You might be better off skipping the 401(k). Maybe you should pay tax on your salary now and put what's left in a mix of high-yielding municipal bonds and low-yielding growth stocks.

In "The 401(k) Rethink" David K. Randall takes aim at the presumption that low-paid young people should be pushed into 401(k)s. Here let's look at strategies for old folks (45 and up).

A threshold question is whether your tax-favored account qualifies for an employer match. If it does, you should probably say yes to it. But what if your employer doesn't chip in, or you are self-employed? Then deferral is not a sure winner at all.

Three things have changed in the past year. One is that the likelihood of rising taxes is much greater now than it was before the recession-crash-election. The old thinking was that you should defer tax bills until "you are in a lower bracket at retirement." Higher bracket is more like it. If you are 45 and prosperous, plan on big federal deficits and higher income taxes when you retire in 2031.

Second change: If you had money in the stock market a year ago, you are probably sitting on a lifetime of capital loss carryforwards now (at least if you follow our usual advice to take losses and let winners ride). So, any capital gains you realize in coming years are effectively exempt from tax.

Third change: Yields on municipal bonds are now competitive with those on U.S. Treasurys. You can earn almost as much aftertax by owning munis in an undeferred account as Treasurys in a tax-protected one.

Tax-deferred 401(k)s come at a cost. There are penalties for early withdrawal and, unless your employer cut a good deal with the operator of the plan, higher fees than you would pay on your own if you know how to comparison-shop. Deferral might still make sense, though, for people planning a retirement move from New York City to Orlando or

Los Angeles to Reno; they have at least a fighting chance of enjoying a lower tax rate.

And what about the Roth 401(k)? With this you don't defer tax on your salary, but your investment returns are exempt. If you have this option, take it and use it for junk bonds and REITs.