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ICI's Guide to Avoiding a Common 401(k) Tax Trap

By Mike McNamee

A tax trap for retirement savings is catching many smart people unaware. If allowed to go unchecked, it could harm the retirement savings of millions of Americans. A columnist for the *Washington Post* was just the latest in a long list of victims.

This trap, however, has nothing to do with IRS rules. It boils down to a basic misunderstanding about how the tax incentives for 401(k)s and similar retirement plans work. The trap is the notion that the tax treatment of 401(k)s benefits only the wealthy—or, more broadly, that the benefits are driven by a saver's tax bracket.

As we near the start of a new year, we invite you to learn the facts about tax deferral—and join us in the pledge to let the facts guide any debate over retirement taxation in 2014.

An Important but Poorly Understood Benefit

The problem arises from a basic misunderstanding of tax policy. The tax treatment of retirement savings—tax deferral—is often lumped together with tax deductions (such as the deduction of mortgage interest expense from income) and tax exclusions (such as the exclusion of employer-provided health insurance premiums from income).

But a deferral of tax is neither a deduction nor an exclusion. Tax deferrals reduce taxes paid in the year of deferral, but *increase* taxes paid in the year that the income is recognized. Deductions and exclusions, on the other hand, reduce taxes paid in the year they are taken—period. Because of this difference, the benefits of tax deferral cannot be calculated in the same manner used to determine the benefits of an exclusion or deduction (by simply multiplying the amount of the exclusion or deduction by the individual's marginal tax rate).

This distinction is important because misconceptions about the tax benefit of deferral could lead to misguided and harmful policy proposals.

Many analysts apparently don't understand this difference, and thus fall victim to the trap.

For example, in "Fixing Upside-Down Tax Breaks Should Be a No-Brainer, But…", Monique Morrissey, a retirement analyst at the Economic Policy Institute, says, "Current tax breaks are very poorly targeted. For the same dollar contribution to a 401(k), high-income taxpayers in the 35 percent tax bracket get a tax break that's three-and-a-half times larger than the tax break received by moderate-income taxpayers in the 10 percent bracket."

That "clang!" you hear is the sound of the tax trap claiming another victim.

What Matters Most: Age and Time

In fact, recent ICI research in *The Tax Benefits and Revenue Costs of Tax Deferral* finds that individuals' ages are typically more important than their marginal tax rates in determining how much they benefit from the deferred taxation of compensation contributed to employer-provided retirement plans.

The study shows, for example, that in realistic simulations for a variety of investments, the tax benefits from a one-time $1.00 contribution to a retirement account are greater for a 45-year-old with a 15 percent marginal tax rate than for a 60-year-old in the 35 percent tax bracket.

For more about the true roles of tax bracket, age, and time in saving for retirement, check out this blog post by ICI Senior Economist Peter Brady.

Why Avoiding This Tax Trap Matters

As policymakers grapple with federal deficits and other long-term challenges, like funding Social Security and Medicare, it’s critical that they understand how 401(k) taxation works. Americans overwhelmingly support the 401(k), and they support the tax incentives that help them to achieve their savings goals. The U.S. retirement system is strong and is working for millions of Americans—but we can and should do more to build on its successes. That includes preserving 401(k) taxation for all savers working to build their nest eggs.

Visit our Retirement Resource Center to find the report and other useful information.

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