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The Sound Investor Series #32 (Corrected 2-8-06)

### One Way to Compare Tax-Qualified Investment Plans

By Ed Hynes, CFA

January 11, 2006

This time of year we are bombarded with tax information and advice about how to save our money in tax-qualified plans such as 401(k)s, IRAs, Roths and by extension, annuities.

These plans are termed tax-qualified because they were created to encourage savings by purposely “altering” the tax code. Most of these plans are good, but it is very difficult to predict how good since the final outcome is determined by your tax rate when you withdraw funds in 20 or 30 years.

What will your tax rate be in 20 years? If the system doesn’t change, most investors over 50 can assume their rate will be the same or lower. But what if the system does change?

One difficulty comparing plans is the number of moving parts – including current and future tax rates, investment returns and types of income generated.

To make this more understandable I’m going to create a hypothetical investor: “Mary.” Mary is a “long term buy and hold” investor who wants to figure out which plans might be best for the next 20 years.

Like most of us, Mary has no clue what her tax rate will be in 20 years. So she decided to compare various plans and see where tax rates have to be for the plans to be equal.

Mary’s first comparison is between a 401(k) and a regular taxable account. With a 401(k) Mary invests pre-tax dollars and pays taxes when money is withdrawn. As you can imagine, investing pre-tax dollars is very attractive. With Mary’s marginal tax rate of 25% she can invest \$100 in the 401(k) for every \$75 she could put into a taxable account.

In 20 years the distributions from the 401(k) will be taxed at ordinary income rates while earnings in the taxable account will have lower, preferential rates. Mary asks herself: How high would ordinary tax rates have to go to offset the advantage of investing pre-tax earnings? We will call that point her breakeven level where both plans are equal.

Using the 20 year time horizon Mary’s breakeven point is 45%. If her marginal tax rate stays under 45%, the 401(k) is the better deal. At 45% they are equal and above 45% the taxable account is better.

Now let's add in that Mary's employer matches her 401(k) contributions up to 10% of her salary. This "free money" obviously makes the 401(k) even more valuable. It turns out employer contributions raise the breakeven point on an approximately one for one basis. So a 10% contribution increases the breakeven 10 points from 45% to 55%. Will Mary's future tax rate be above 55%? I don't know, but it seems like a reasonable proposition that Mary's tax rate will not go that high and she should choose the 401(k).

Mary next compares 401(k)s and Roth plans. With a Roth plan, Mary deposits after-tax earnings and is never taxed on any gains. If Mary's tax rate today and when she withdraws the money stays the same, both plans are equal. If she thinks her tax rate will increase the Roth is the better plan. The 401(k) is better if her tax rate goes down. Vanguard published an excellent report "Tax Diversification and the Roth 401(k)" for readers looking for more information.

Mary needs to ponder the likelihood of early withdrawals and associated penalties if she needed the money before age 59½. Early withdrawals from a 401(k) are taxed at ordinary rates plus a 10% penalty. With a Roth, contributions (but not earnings on those contributions) can be withdrawn tax-free without any penalty. So if Mary's company does not match (or she has already qualified for all its match) and she thinks she might withdraw money before she's 59½, the Roth and 401(k) are about even.

Finally, let's compare a taxable saving account to a variable annuity, which is a type of tax-qualified plan offered by insurance companies. In this case, both accounts start on the same footing with after-tax dollars being invested. Gains in the taxable account get preferential tax treatment while gains from the annuity are taxed as ordinary income. Since Mary is a "long-term buy and hold" investor, her taxable account is very tax efficient and annuities always come up short due to their taxation. It gets even worse if the average 7% sales charge is taken into account. Annuities would need ordinary tax rates to fall 3 percentage points below capital gains rates to be equivalent to a taxable account. Not impossible, but unlikely.

To be fair the analysis looks different if Mary alters her investment strategy and generates large capital gains year in and year out. But Mary is pretty smart and has already learned that buying and holding low-cost Exchange-Traded Funds (ETFs) is the way to make money in the market. Please call for more information.

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