Wondering if retirement plans are still worth using? The answer is usually an emphatic yes

NEWS

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Guest columnist

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Q: If I think I might be in the same marginal tax bracket in retirement as I am now, is it still worth using a retirement plan?

A: Usually the answer is an emphatic yes! There are several benefits to contributing to a pretax retirement plan during your earnings years. Perhaps the largest benefit for most people is the fact that your marginal (highest) tax bracket in retirement is likely to be lower than during your working years.

For example, in 2022 a couple that earns $200,000 a year would find themselves in a 24% marginal tax bracket (that is, they would incur an income tax of 24% on each additional dollar they make).

In retirement, most people find themselves with both a lower income and expenses (often no life insurance or disability payments, no Social Security payments, often no mortgage payments, etc.).

This also means that their marginal tax bracket may be lower despite the same amount of lifestyle expenses that are still necessary and desirable. All the money deferred during the working years will then be distributed slowly and taxed at least partially at the new lower bracket. This “arbitrage” of deducting a higher income while later paying taxes at a lower bracket can be very powerful in building wealth.

But, as you suggest, perhaps your income and marginal bracket are the same in your earning years and retirement years. This usually means a high income that continues into retirement-which might be mostly from retirement plan distributions. Let’s see why using the retirement plan is still a plus.

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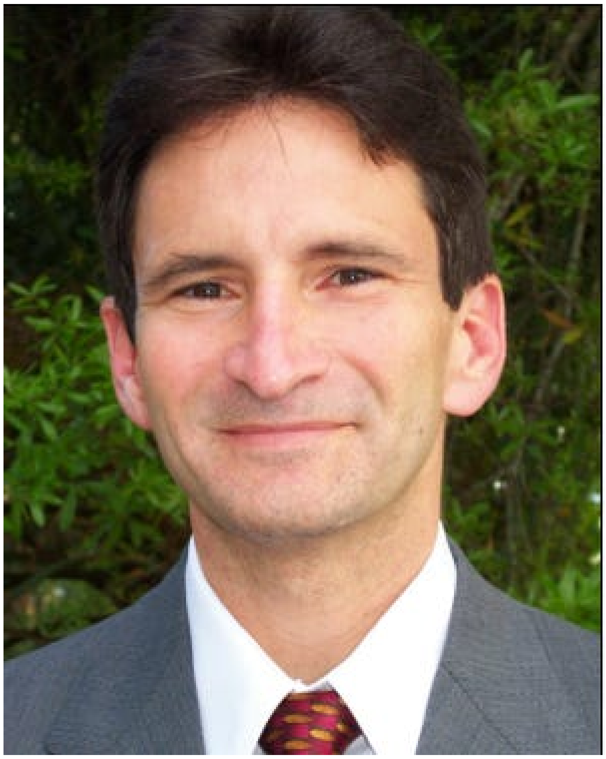
When you were earning $200.000, most if not all of your retirement plan contribution would have been otherwise taxed at the highest marginal rate, or 24% currently. When the money comes back out as your retirement income, it may instead is subject to multiple lower brackets on the way up (10%, 12%, 22% and then 24%). So the deduction you took at a 24% tax avoidance is usually “paid back” in retirement at a lower blended rate even if your top marginal rate is the same in retirement. And the entire time you were accumulating your retirement account (and then even for many years in the distribution phase), the government essentially “lent” you the money you would have paid instead in income tax to invest and grow over decades.

In addition, while your funds are in the retirement plan they are offered excellent asset protection from both federal and state law. This is almost never the case for after tax investing.

If you happen to be a business owner, then the presence of a retirement plan may offer significant recruitment and retention opportunities for your employees.



Finally, while the funds are in the retirement plan, they are not subject to the tax drag of dividends, interest, and capital gains that would occur outside of a pretax account. There are no taxes while the funds are inside the retirement plan even if you trade frequently!

It is a rare occurrence that we find a family that will not benefit from a pretax retirement plan. A final benefit might just be the discipline of regularly saving and the difficulty and cost of using those funds for less important purposes.

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