I recently came across two cases in which clients had maximized their 401k contributions and were making post tax contributions to an IRA account. Making non-deductible IRA contributions to an all stock portfolio only increases your future tax liability compared to, instead, contributing to a taxable brokerage account.

In the example below, $8000 per year (increasing annually with inflation) is contributed to a taxable brokerage account. The same post tax amount is contributed to an IRA. The all stock portfolio growth rate is 6% of which 2% is dividend yield and 4% tax deferred capital growth. The dividend is taxed annually at the 15% federal dividend tax rate in the taxable account but not taxed in the IRA[1]. This results in a lower pretax ending balance in the taxable account. However, the taxable account gain is taxed at the 15% federal long term federal capital gains rate. Any gain in the IRA is taxed at a 24% ordinary income tax rate (single taxpayer earning $200,000) resulting in less post tax. The capital gains tax rate will always be lower than the income tax rate for any level of income.[2]

	After 10 years		
	Taxable		IRA
Pretax	146,033		149,668
Basis	117,029		105,536
Taxable	29,004		44,132
15% Tax	4,351	24% Tax	10,592
Post tax	141,682		139,076
	After 25 years		
	Taxable		IRA
Pretax	638,646		661,299
Basis	396,419		294,603
Taxable	242,227		366,696
15% Tax	36,334	24% Tax	88,007
Post tax	602,312		573,292

Things would turn out differently if a tax inefficient investment were tested. For example, the IRA would have a 2% greater post tax value after ten years if both accounts held an investment paying 4% interest (cash or bonds) which is taxed annually as ordinary income if held in a taxable account. However, the reality is that someone would only consider a post tax IRA contribution if they had maxed out their employer plan contributions (401k, etc.) and had surplus cash flow. In that case, the investor would minimize current and future taxes by holding the cash or bonds in the 401k and stocks in the taxable account.

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[1] Only distributions from IRAs are taxed.

[2] The capital gains rate is zero for singles in the 10%- or 12%-income tax brackets.

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