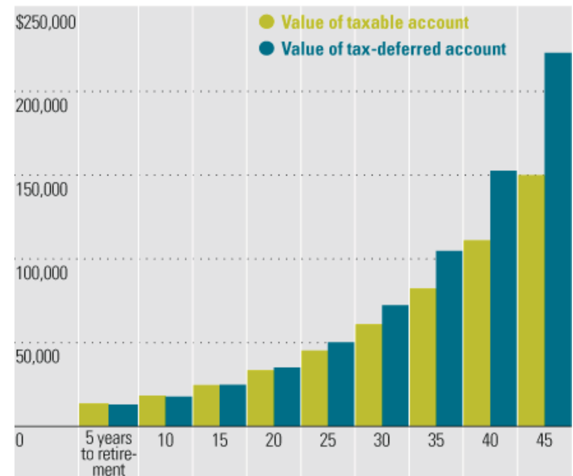
Take Advantage of Tax-Deferred Accounts

- One distinction not outlined in the article is the difference between tax-free Roth IRAs and tax-deferred Traditional IRAs.
- Contributions to a Roth IRA are made with after-tax dollars and thus are subsequently free of taxes during the owner's lifetime.
- Roth IRAs can be a wise choice for those below the income threshold (or who have converted non-Roth IRAs), especially if your income tax rate will be higher in retirement.

One of the main reasons why retirement accounts are so beneficial is the power of tax deferral. In a tax-deferred investment vehicle such as a 401(k) plan or an IRA, your earnings are not taxed until you begin withdrawing money from your account in retirement. Consider the image. A hypothetical value of $10,000 is invested in both a taxable and a tax-deferred account. The difference in value between the two accounts becomes quite substantial after 20+ years. For investors with a long investment time horizon, a tax-deferred portfolio is an excellent choice.

Please keep in mind that once you begin to withdraw money from your retirement account, you will be taxed accordingly. However, since you will most likely earn less in retirement, withdrawals from a deferred portfolio may be taxed at a lower rate.

Benefits of Deferring Taxes



Withdrawals of tax-deferred accumulations are subject to ordinary income taxes. A 10% federal tax penalty may apply to withdrawals made before age 59½. Returns and principal invested in stocks are not guaranteed.

Source: This hypothetical example is for an investor in the 28% bracket using the 2010 tax code (estimated to become the 31% tax bracket in 2013). $10,000 is invested in stocks at the beginning of year 1 (2011). Assumes an 8% annual total return (6% price return and 2% income return) and a 15% tax rate on capital gains and dividends in year 1 (2011) and year 2 (2012), after which the rates revert to 20% and the investor's marginal tax rate, respectively. The investment is taxed at a 28% marginal tax rate in year 1 (2011) and year 2 (2012), and then reverts to 31%. Taxes are assessed yearly on the taxable account but only at the end of the period on the tax-deferred account. Estimates are not guaranteed.

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