



Is it Always Better to Save in a Retirement Account?

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Retirement accounts offer some nice tax benefits, namely the ability to make pre-tax contributions and enjoy tax-deferred compounding. The trade-off is that all withdrawals are taxed at income tax rates, whereas most distributions from taxable accounts are taxed at (generally) lower capital gains tax rates. In addition, with retirement accounts one is forced to take a required minimum distribution (RMD) annually once the account holder reaches age 73. There is no such requirement with taxable accounts.

Clients who are 10-15 years from retirement will periodically ask me whether it is still worth it to max out their retirement account every year given the limited time remaining to benefit from tax-deferred compounding. After crunching some numbers, I've concluded that continuing to fund retirement accounts is generally the better deal.

To illustrate this finding, I constructed a simplified model that compares investing \$30k annually in a

retirement account over 15 years versus making the same contribution (net of income taxes due) into a taxable account over the same time period. I assume that the accounts are identically invested, each earning 6% annually over the investment period. I also assume that the account holder is in the 35% income tax bracket prior to retirement and that long-term capital gains are taxed at 15%. For simplicity, I also assume that the investments made generate no ongoing taxable distributions of income and capital gains (e.g., investments in municipal bonds and growth stocks).

The first half of Table 1 below shows the balance in each account type at the end of the 15-year investment period after the account holder has withdrawn the entire balance from both accounts and paid all taxes due. Since many retirees end up in a lower tax bracket during retirement, I show the result at differing tax brackets with the first assuming no difference between the pre-retirement and post-retirement tax brackets.

Table 1. Superiority of Retirement Acct. Saving Over a 15 Year Period –
End Balance (35% tax bracket while working)

	<i>Tax bracket in retirement</i>			
	35%	32%	24%	22%
Retirement Acct.	481k	503k	563K	577K
Taxable Acct.	453k	453k	453k	453K
Difference	\$28k	\$50k	\$110K	\$124K
<i>With full tax loss harvesting:</i>				
Retirement Acct.	481k	503k	563K	577K
Taxable Acct.	481k	481k	481k	481k
Difference	\$0k	\$22k	\$74k	\$96K

The result illustrates that even when the account holder's pre-retirement tax bracket is the same as the post-retirement bracket, the retirement account yields a higher end balance. This is because with the taxable account, the income tax on the contribution is paid annually versus all at the end so the taxable account holder does not earn the full deferral benefit (i.e., on both the contribution and the deferred tax obligation).

As a further illustration, I then assume that the account holder can eliminate a final tax bill on the appreciation in the taxable portfolio by tax-loss harvesting (i.e., having and selling enough losing positions to offset gains elsewhere in the portfolio), eliminating the final capital gains tax bill on withdrawal in the taxable account. In this case, the end account balances of both accounts are the same when the pre- and post-retirement tax brackets remain the same. And, as is also shown in Table 1, the retirement account continues to win when the retirement account tax bracket is lower than the pre-retirement tax bracket.

What might tip the scale in favor of the taxable account? While not illustrated here, the shorter the investment period, the less advantageous is the retirement account relative to the taxable account. There is simply less time for tax-deferred compounding. The quality of one's retirement plan might also be a factor. To the extent the retirement account only offers a limited menu of high-cost, poorly performing funds, the benefit of investing in a retirement account will be reduced. On the other hand, you might have noted that I haven't included any employer match in

my calculations. It's an absolute no-brainer that saving in a retirement account to obtain the maximum employer contribution is better than saving in a taxable account. Employer matches are free money – no one can beat that.

Beyond the above, there are some important qualitative factors to consider such as the fact that one does not have to take RMDs from a taxable account, providing the account holder more flexibility to optimize their tax burden throughout retirement. Conversely, saving in a retirement account provides the potential for more Roth conversions during those first few years of retirement before Social Security and RMDs kick in.

Bottom Line:

It's hard for a taxable account to beat a retirement account over any given time horizon but the amount of the benefit is very dependent on relative income tax rates and the length of the investment period. The lower the tax rate is projected to be in retirement and the longer the investment period, the greater the benefit of saving in a retirement account. But the qualitative factors mentioned above can make a difference suggesting that there is no one-size-fits-all answer.

Please get in touch if you would like to learn more.