ICI The Asset Management Industry SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

ICI VIEWPOINTS

September 16, 2013

Retirement Plan Contributions Are Tax-Deferred—Not Tax-Free

First in a series of posts about retirement plans and the policy proposals surrounding them.

In today's fiscal and political climate, taxes are never far from politicians' minds. Whether to achieve comprehensive tax reform or to raise revenue to meet budget deficits, members of Congress are now considering changes to a range of tax code provisions—including those governing retirement policy. Any comprehensive effort to address fiscal policy or tax reform should examine every option, but some discussions of retirement policy have been misguided. The tax treatment of retirement savings—tax deferral— too often has been lumped together with tax deductions (such as the deduction from income of mortgage interest expense) and tax exclusions (such as the exclusion from income of employer-provided health insurance premiums).

But a deferral of tax is neither a deduction nor an exclusion. Tax deferrals reduce taxes paid in the year of deferral, but increase taxes paid in the year that the income is recognized. Deductions and exclusions, on the other hand, reduce taxes paid in the year they are taken—period. This distinction is important because misconceptions about the tax benefit of deferral could lead to misguided and harmful policy proposals. In particular, proposals to limit the tax benefits of exclusions and deductions should not include tax deferrals, because their effect on deferrals would be fundamentally different.

Deferral Changes Taxes at Three Points

The taxation of deferred compensation differs from normal tax treatment at three points:

- First, contributions made by employers or employees to a retirement plan—whether a traditional defined contribution (DC) plan or a defined benefit (DB) plan—are excluded from taxable wages reported on Form W-2.
- Second, investment returns earned on contributions are not taxed when earned.
- Third, all distributions from retirement plans are taxed.

Contrast that with tax deductions or exclusions, which reduce taxes when the deduction or exclusion from income is taken, do not create tax-deferred investment returns, and never increase future taxes. Clearly, the benefits of tax deferral are quite different from those of deducting or exempting income from tax.

For a deduction or exclusion, calculating the benefit is simple: just multiply the amount of income deducted or excluded by the taxpayers' marginal tax rate. For example, the tax benefit of $1,000 in charitable deductions for a taxpayer in the 25 percent bracket is

$250—the reduction in taxes in the year that the deduction is claimed.

But, as I explain in an ICI white paper, The Tax Benefits and Revenue Costs of Tax Deferral, the benefit of tax deferral is not the reduction in taxes when the contribution is made. Instead, the benefit comes from adding the tax savings at the time of contribution and the tax savings on investment returns, then subtracting the tax paid on distributions.

The math can be complex. But boil it all down, and effectively the tax benefit of deferring taxes on retirement savings is equivalent to paying a zero rate of tax on investment returns. (For a simplified explanation, please see the example below —"Different Paths to the Same Destination: Roth vs. Traditional.") Ultimately, that benefit is driven largely by the length of time that the contributions are invested.

This finding has many interesting implications—perhaps the most significant is that upper-income, higher-bracket taxpayers don't always get more tax benefit from their deferrals than their lower-paid counterparts. I'll examine this point in upcoming posts, as well as discuss why proposed methods of limiting the benefits of exclusions and deductions for taxpayers in higher tax brackets should not apply to tax deferrals.

Different Paths to the Same Destination: Roth vs. Traditional

One way to understand the tax benefits of deferral is to compare them to the benefits of an alternative approach to taxing retirement savings—"Roth" treatment.

In the late 1990s, Congress passed legislation sponsored by the late Senator William Roth (R-DE) adding a new type of individual retirement account, known as the Roth IRA, to retirement savers' options. Qualified Roth IRAs—and their more recent counterparts, Roth 401(k)s—can be compared to qualified traditional accounts by looking at their tax treatment at three points:

- With traditional accounts, tax is deferred on contributions, deferred on investment returns, and paid on distributions.
- With Roth accounts, tax is paid on contributions (i.e., contributions to a Roth IRA are made with after-tax dollars), not paid on investment returns, and not paid on distributions.

Despite these differing approaches, if a taxpayer's marginal tax rate is the same at the time of contribution and the time of distribution, then a tax deferral and a Roth contribution produce the same results: the same after-tax retirement income and, thus, the same tax benefit.

Let's consider a very simple scenario. Compare two workers, each in the 25 percent tax bracket, each with $1,000 in pre-tax compensation to save for retirement:

- Worker A defers taxes on the contribution and invests the full $1,000 in a traditional account; the investment returns on the account face no tax when they are earned, but Worker A owes taxes on distributions as they're withdrawn from the account.
- Worker B pays income tax of $250 on the compensation and invests the remainder—$750—in a Roth account; investment returns are untaxed, and the full balance can be withdrawn tax-free.

Twenty years later, when they retire, both workers still have a 25 percent tax rate. Who has more retirement savings?

Well, neither. Assuming a 6 percent return on their accounts, both workers have $2,405 to spend after-tax based on their original $1,000 in compensation.

Comparison of the Tax Treatment of Traditional and Roth Contributions

Compensation of $1,000 used to fund contribution; marginal tax rate equal to 25 percent

Source: Investment Company Institute

Worker A deferred taxes on a traditional account contribution and thus got all of the investment returns on $1,000—but after retiring will end up paying the government $250 from the original contribution, plus 25 percent of the investment returns. By paying taxes up front before contributing to the Roth account, Worker B gave the government $250—but got all of the investment returns on the remaining $750 tax-free. After tax, both workers effectively were left with $750, plus the investment returns generated by that amount—so there's no difference in their outcomes. (Again, in this simplified scenario, this equivalence depends on the worker having the same tax rate when retired as when contributing.)

Both savers got the same benefit in retirement—they just got there in different ways.

It's fairly obvious that Worker B, with the Roth, didn't benefit from any tax savings on the contribution—because there were no such savings. Instead, the benefit of a Roth contribution is that investment returns do not get taxed. But it's also obvious that the benefit of tax deferral is not the tax savings on the contribution. In the example above, Worker A's tax benefit from a traditional contribution is identical to Worker B's tax benefit from a Roth contribution. In other words, the benefit of tax deferral is that it effectively gives Worker A a zero rate of tax on investment returns.

Furthermore, the benefit of this zero tax rate is driven largely by how long the contribution remains in the retirement account—not by the saver's tax bracket. I'll address the implications of this in my upcoming posts.

Additional Resources:

The Tax Benefits and Revenue Costs of Tax Deferral

Other Posts in this Series:

- Marginal Tax Rates and the Benefits of Tax Deferral
- A 'Modest' Proposal That Isn't: Limiting the Up-Front Benefits of Retirement Contributions
- Tax Reforms Should Not Favor DB Plans over DC Plans
- Revenue Estimates of Restricting Tax Deferral: It Ain't Necessarily So