Financial Wellness
& Education

The power of tax deferral

Building a nest egg for the "golden years" of retirement can be quite a challenge. There are, however, certain retirement programs that give investors a decided advantage when saving and investing for the long term. They offer the advantage of tax-deferred growth and they should be the cornerstone of any comprehensive retirement savings program.

Uncle Sam has conferred on certain financial vehicles a powerful advantage: Tax-deferred growth.

How tax deferral works

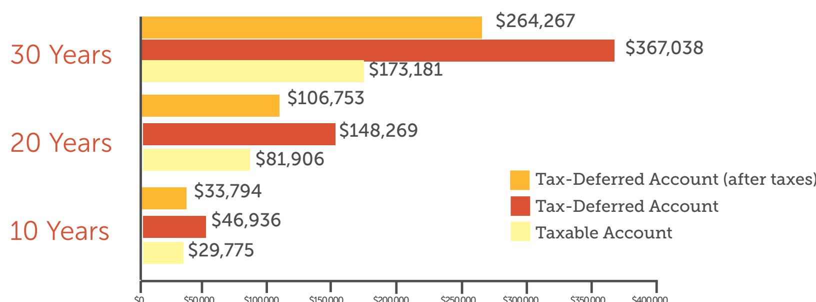
Uncle Sam has conferred on certain financial vehicles a powerful advantage: tax-deferred growth. This means that appreciation, earnings, interest and dividends on assets in a tax-deferred vehicle are not taxed until the funds are withdrawn. As long as the funds remain in the account, they grow without taxes eroding their value. This enables assets to accumulate at a faster pace, giving you an edge when saving for the long term. And, when you withdraw funds after you retire, you may be in a lower tax bracket and be able to keep more of what you've accumulated.

Taxable versus tax deferred

The bar chart below illustrates the powerful advantage of tax-deferred contributions and compounding versus taxable contributions and compounding. In this hypothetical example, after 30 years of regular contributions at hypothetical rates of return, the tax-deferred account had nearly 53 percent more money than the taxable account upon withdrawal, even after taxation. The $367,038 tax-deferred account cumulative total is subject to taxation upon withdrawal, which would net $264,267 for someone in the 28 percent combined tax bracket. A 10 percent penalty may be imposed for withdrawals made before age 591/2. Of course, as with any investment, results are not guaranteed.

What are the benefits of tax-deductible contributions and tax-deferred growth?

The chart below compares a deductible investment of $3,000 made at the beginning of each year with an annual nondeductible investment of $3,000 made into a taxable investment account.



Hypothetical results are for illustrative purposes only and are not intended to represent the past or future performance of any specific securities. Investment return and principal will fluctuate so that shares, when redeemed, may be worth more or less than their original value and does not reflect the impact of fees and expenses. Withdrawals before age 591/2 may be subject to ordinary income tax and a 10 percent penalty.

Lower maximum tax rates on capital gains and dividends would make the return of the taxable investment more favorable; thereby reducing the difference in performance between the accounts.

Changes in tax rates and tax treatment of investment earnings may impact the comparative results. You should consider your personal investment horizon and income tax bracket, both current and anticipated, when making investment decisions as these may further impact the results of the comparison.

ASSUMPTIONS:

Annual contributions of $3,000 made at the beginning of each year.

Hypothetical 8 percent investment return, compounded annually with reinvestment of dividends and capital gains.

28 percent assumed tax rate.

The value of the tax-deferred account after a lump sum withdrawal taxed at 28 percent, is $33,794 if taken after 10 years, $106,753 if taken after 20 years, and $264,267 if taken after 30 years.

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Designed for the long term

What products offer the advantage of tax-deferred growth? Programs specifically designed to help people accumulate funds for retirement—such as 401(k)s, 403(b)s, SIMPLE-IRAs, Traditional IRAs and annuities— are given this valuable tax benefit. Because these products are intended for the "long haul," early withdrawals can create stiff tax consequences. In most instances, withdrawals from tax-deferred vehicles are subject to taxation. In addition, early withdrawals before age 59½ may also be subject to a 10 percent penalty. Keep in mind that these plans are primarily for retirement savings, and using them appropriately will afford you the fullest benefits.

Taking advantage of tax-deferred growth

A number of vehicles offer the power of tax-deferred growth. They include:

Employer-Sponsored Plans—You may be able to take advantage of a tax-deferred plan right at your workplace. Many employers offer retirement plans such as 401(k)s, 403(b)s, SIMPLE-IRAs and others. The many benefits of employer-sponsored plans have made them extremely popular and they can be an excellent place to start your retirement savings. Eligible employees can contribute through the convenience of payroll deduction. Contributions are made on a pretax basis and gains within the plan accumulate tax-deferred until they are withdrawn. Most plans offer a range of investment choices, such as equity, bond and money market funds. In some instances, employers may match your contributions up to a certain percentage, making it even more beneficial to participate.

Individual Retirement Accounts (IRAs)—For more than two decades, millions of Americans have taken advantage of the tax benefits of IRAs. They remain one of the best ways to save for retirement. Depending on your income, your contributions may be tax deductible. However, even if your investment isn't tax deductible, you still benefit from tax-deferred growth. Similarly, with the Roth IRA, your funds grow free from federal income tax and if certain conditions are met, may be withdrawn tax-free. For the Roth IRA, certain income restrictions apply. For both the Traditional and the Roth IRA, penalty-free withdrawals are permitted under certain circumstances, such as the purchase of a first home and for qualified education expenses.

Annuities— In recent years, annuities have gained prominence as an excellent vehicle to supplement retirement savings. An annuity is a contract with a life insurance company that can provide you with a stream of income for life. The annuity can be "deferred," whereby you accumulate money over time, to be paid out at some future date, or "immediate," where payments begin shortly after purchase. The rate of return for an annuity can be "fixed" or "variable." With a fixed annuity, the interest rate is guaranteed for a specific period of time by the insurance company. With a variable annuity, you may choose from a number of investment "subaccounts," which will fluctuate in value. The returns of a variable annuity are not guaranteed and are based on the investment results of the underlying subaccounts. Funds within annuities accumulate tax-deferred, and you can choose from a variety of pay-out options when you start receiving income.

Permanent Life Insurance— Although the primary purpose of life insurance is to provide financial protection, permanent plans also offer the benefit of tax-deferred growth of cash values. Plans such as whole life, universal life and variable life build cash value, which grows on a tax-deferred basis. With innovative variable plans, you may allocate your money across several subaccounts. Although this may help build cash value, returns are not guaranteed and will fluctuate according to investment performance. Many policies offer a loan option that allows you to tap into cash value at competitive interest rates. While this is a valuable feature, keep in mind that borrowing against a policy reduces its insurance protection. Loans will affect your cash values as well.

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- Save and invest for retirement, education and other life events
- Create retirement income strategies
- Protect the ones you love
- Plan your legacy

Together, we can help you achieve financial and family well-being—now and tomorrow, this generation and the next.

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