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Are deferrals worth it?

Deferring into a higher tax rate makes sense with double-digit returns or long time frames

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Last time, I discussed the rationale behind accelerating the payment of taxes rather than deferring taxes for as long as possible. In some cases, early payment makes sense.

However, paying a tax early entails voluntarily depleting the money you have invested. I pointed out that a 20% tax paid many years in the future might be preferable to a 15% tax paid now, if you invest the money wisely in the interim.

This time, I'd like to focus on the benefits of deferring tax on investment income. If tax rates were constant, the decision on using tax-deferred vehicles would be easy.

You'd simply measure the annual costs of the deferring mechanism (the cost of a non-deductible individual retirement account or an annuity, for example) versus the appreciation that occurs when compounding takes place outside the tax man's reach.

Consider what happens to an investment in a 35% tax environment. If income generated by the investment is deferred, $100 of investment income will get reinvested instead of $65 (the $100 minus a 35% tax).

Profits from the deferral come exclusively from the earnings on the $35 spared from current taxes. If the cost of deferral is 1%, the investor need only earn a 3% return for the deferral to make sense at today's 35% tax rate. The math is easy if that is all there is to it.

Most investors who analyze deferral mechanisms assume that the tax rates in effect when funds are withdrawn from deferred accounts will be the same as the rates when money is deposited. If history is any guide, that assumption should prove wrong. When I started in the brokerage business, investment income was taxed at 70%. That's right, 70%, right here in the United States.

When the 16th Amendment introduced the income tax in 1913, the top rate was only 7%. Within a decade, it rose to 77%. At the end of World War II, the top marginal rate was 94%. President Kennedy lowered it to 70%, where the rate basically remained until 1981. Ronald Reagan sliced it to 28%. The rate that prevails in your retirement years may depend on who is president at the time.

Today's top rate of 35% doesn't look so bad when you look at it in the context of where we've been or where we might find ourselves as baby boomers age. Remember the line from The Beatles' song "Taxman"? It went, "There's one for you, 19 for me," reflecting the United Kingdom's 95% tax rate.

No matter the rate, if money is deferred long enough and profitably enough, the wonders of compounding can overcome even very high tax rates. Let's look at some examples.

Assume that investment income will be taxed at 50% when withdrawn. At that tax rate, an investor has to earn 15% annually over 10 years or 7% annually for 20 years for the deferral to make sense.

Alternatively, an investor can calculate the future tax rate that would turn his or her plans upside down if lots of income were deferred until the golden years. For example, someone cashing out 20 years from now in an environment with a 70% tax rate will have to earn more than 18.5% a year on his or her money over those two decades to overcome the effect of such a high rate.

Deferral mechanisms and the magic of pretax compounding can be tantalizing, but the decision to utilize these strategies should be tempered by analyzing the devastating effects of higher future tax rates. An interactive tool to make the calculations is available at http://www.twenty-first.com/deferral.htm

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