Taxes: Pay now or pay later?

Most people invest in tax-deferred accounts – such as 401(k)s and traditional IRAs – to defer taxes until money is withdrawn, ideally at retirement when both income and tax rate usually decrease. And that makes good financial sense because it leaves more money in your pocket. But consider this: If tax rates rise considerably by the time you retire, does tax-deferred investing – rather than paying taxes now – still make sense?

The X factor: Future tax rates

In today's volatile economic and political environment, anticipating your future tax rate is an X factor in your retirement planning equation. As Congress grapples with meeting the increased costs of Social Security and Medicare while millions of baby boomers become eligible for benefits, potential tax increases loom on the horizon. And that means you may be facing a heavier tax burden than current retirees carry.

To defer, or not to defer? That is the question. These numbers may help you decide on an answer.

Deferring to the numbers

Hypothetical scenario

- You're saving for retirement.
- You're currently in a 25% tax bracket.
- You're anticipating a tax rate between 25% and 42% in retirement.

You have two options:

Plan A

Pay taxes now.

Plan B

Pay taxes at retirement.

For illustrative purposes only

Let's look at the numbers. The chart on the next page shows outcomes for tax rates ranging from 25% to 42% for both Plan A and Plan B in our hypothetical scenario.

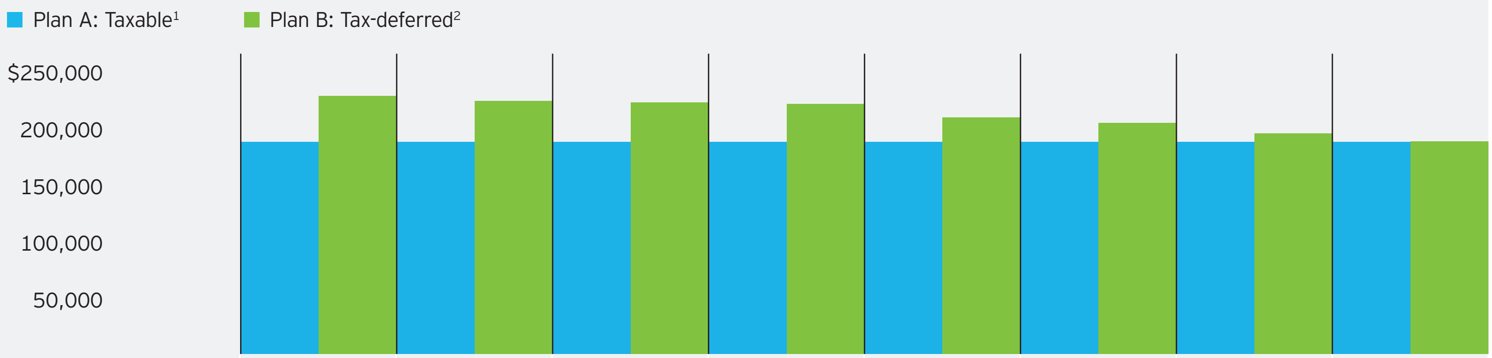
Analysis and finding

For this hypothetical situation, we assumed the following:

- An original investment of $50,000 of after-tax assets
- 30 years of tax-deferred growth versus taxable growth
- 6% annual growth rate on assets
- 25% tax rate during years prior to retirement
- 25% to 42% tax rates at retirement

As you can see, opting for deferring taxes until retirement offers a financial advantage even if tax rates have risen to 42% when you retire.

Tax-deferred beats taxable even if tax rates are higher (25%-42%) at retirement



Hypothetical tax rates at retirement[3]	25.0%	27.0%	27.5%	28.0%	33.0%	35.0%	39.0%	42.0%
Tax-deferred[2]	$227,881	$223,137	$221,952	$220,766	$208,907	$204,163	$194,676	$187,561
Taxable[1]	$187,266	$187,266	$187,266	$187,266	$187,266	$187,266	$187,266	$187,266
Tax-deferred advantage	$40,615	$35,871	$34,686	$33,500	$21,641	$16,897	$7,410	$295

1 After-tax account value
2 This is the net amount and assumes the investors paid the hypothetical tax rate at retirement on all earnings.
3 These were some of the actual tax rates paid by middle income earners between 1972 and 2017.
Federal or state tax penalties may apply for early withdrawals from an IRA or annuity.

Talk with your financial professional

Of course, there's no sure way to accurately predict future tax rates. That's why the best plan is talking to your financial professional about a balanced strategy of taxable and tax-deferred investing that's appropriate for your financial situation.

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Note: Not all products, materials or services available at all firms. Financial professionals, please contact your home office.

Your tax bracket may be different from the ones used in this illustration, or may change over your lifetime, which will affect the outcome. This illustration does not reflect the performance of or fees and charges associated with any specific investment, and it does not take into account the effect of inflation. The tax-deferred account will be taxed as ordinary income upon distribution while potentially lower maximum tax rates on capital gains and qualified dividends could make the return on the taxable investment more favorable, thereby reducing the difference in performance between the accounts shown. The assumed rate of return in the example is not guaranteed; investment returns fluctuate over time and losses can occur. This hypothetical is based partly on current tax laws, which are subject to change, and on hypothetical tax rates, which may differ or may be implemented.

Invesco does not provide tax advice. Investors should always consult their own legal or tax professional for information concerning their individual situation.