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Retirement Savings Tax Breaks Aren't Driven Solely by Tax Brackets

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ICI Study Demonstrates That Low-Bracket Savers May Reap Greater Benefits Than Higher-Income Taxpayers; Age Typically Matters More Than Tax Rates

Washington, DC, September 11, 2012 – Individuals' ages are typically more important than their marginal tax rates in determining how much they benefit from deferred taxation of compensation contributed to employer-provided retirement plans, according to a study released today by the Investment Company Institute (ICI).

The ICI study, The Tax Benefits and Revenue Costs of Tax Deferral, shows, for example, that in realistic simulations for a variety of investments, the tax benefits from a one-time $1 contribution to a retirement account are greater for a 45-year-old with a 15 percent marginal tax rate than for a 60-year-old in the 35 percent tax bracket.

Sixty-nine percent of U.S. households report that they have employer-sponsored retirement plans (which include defined benefit and defined contribution plans) and/or individual retirement accounts (IRAs). This study explains the tax benefits that these households receive from setting aside a portion of their compensation for retirement. In light of increased Congressional interest in reforming the federal tax system, the study seeks to enhance understanding among policymakers and the public of these benefits and the foregone tax revenue they entail.

Tax-Deferred Compensation Is Not Tax-Free Compensation

Analysts who write about tax policy frequently equate the tax treatment of retirement savings to that of employer-paid health benefits (which are excluded from income) and mortgage interest (which is deducted from income). As a result, they assert that a taxpayer in the 35 percent tax bracket receives 3.5 times as much tax benefit from deferring $1 in income than would a taxpayer in the 10 percent bracket.

The ICI study, however, points out an important difference: unlike income that is excluded or deducted, deferred income is eventually subjected to tax when it is withdrawn from a retirement account. Because of this difference, the benefits of tax deferral cannot be calculated in the same manner used to determine the benefits of an exclusion or deduction—by simply multiplying the amount of the exclusion or deduction by the individual's marginal tax rate. For tax-deferred retirement investments, according to the study, the benefits calculation is not just a function of the individual's marginal tax rate. Rather, one must assess the effects of deferral over time.

Factors Other Than Marginal Tax Rates Influence the Benefits of Tax Deferral

"Marginal tax rates are just one among a number of factors that influence the tax benefits of contributing to retirement accounts. Other factors include the length of time contributions remain invested, the rate of return earned on investments, and the type of investment income generated," said Peter Brady, ICI senior economist and author of the study. "As Congress considers tax reform next year, it is critical that policymakers understand the true nature of the benefits that retirement savers get from tax deferral."

The study shows that, ultimately, tax deferral is roughly equivalent to exempting from tax the investment income earned on retirement contributions. In addition, the study illustrates that the relationship between marginal tax rates and the tax benefits of deferral is complex. In general, the benefits of tax deferral (and the revenue costs) do not increase proportionately with individuals' marginal tax rates, and can actually decline as marginal tax rates increase. For example, if $1 of compensation were contributed to a retirement plan and invested in corporate stocks, then all else being equal, an individual subject to a 25 percent marginal tax rate typically would benefit more from the deferral of tax than would an individual with a 35 percent marginal tax rate.

This paper is one in a series designed to examine the tax treatment of contributions to employer-provided retirement plans and IRAs. A forthcoming paper will analyze the lifetime benefits of tax-deferred savings for individuals with various levels of lifetime income.
