How Good is a Tax-Deferred Retirement Account?

Here's how tax deferral impacts the amount you will have at retirement.

By David Ning | April 9, 2014 | 10:31 a.m. EDT   + More

The recent spotlight on 401(k) fees is a good wake-up call for employers to improve on the current system. But I worry that all the coverage of how bad many 401(k) fund choices are will simply drive even more people away from saving for retirement using these tax-deferred accounts. Our 401(k) system is far from perfect, but contributing money to these accounts is still one of the best moves you can make for your retirement. Here are some of the many benefits of tax-deferred accounts:

Taking money out of a retirement account to spend is much harder. Not being able to access money until you are 59½ without paying a penalty sounds like a bad deal, but it's one of the most powerful features of a tax-deferred account. By forcing you to leave the money in the account and allowing compounding to work its magic, you will be much better off in retirement.

You will probably pay less income tax on the money if you defer taxes until retirement. Most people earn more by working than they will in retirement. When you withdraw money from a retirement account it is likely to be taxed at a lower rate than what you would pay now. And with the many deductions available to seniors, many retirees won't pay much tax at all. While there will be a few exceptions for people who have huge retirement account balances, a good portion of the population won't ever pay much in taxes on the dollars they put into a 401(k).

You won't have to pay taxes on dividends, interest or capital gains every year. Not many people talk about the yearly tax savings they get from their retirement account, but it adds up. Dividends, interest and capital gains can put a serious dent into compounding growth because you often have to pay taxes on them each year. But you don't have to worry about any of that for investments inside a tax-protected account because no taxes are due until you withdraw the money.

The no-tax situation gives you the freedom to make smart investment moves. Some people hold on to a stock because they don't want to pay taxes on the sale, only to see the value of the investment drop like a rock. But within a retirement account you don't have to worry about how various types of investments are taxed, because you don't have to pay annual taxes on it and everything is taxed as income when you take the money out. You're free to select the most appropriate investments, and don't need to worry about the impact on your tax bill until retirement.

Moving to a lower tax state in retirement could save you even more. Relocating is a big decision that shouldn't just be based on trying to pay less tax. But moving to a place with a significantly lower cost of living can stretch your retirement budget. And if the state you pick doesn't have an income tax, you will pay even less on your retirement account withdrawals in retirement.

Reducing taxes now increases financial security. When you save money in retirement accounts, you are both putting money aside for the future and increasing your take home pay by lowering your tax bill. The higher your income and tax bracket, the more money you can save by contributing money to a tax-deferred 401(k) or IRA. But even people in the lowest tax bracket who save for retirement benefit because they can claim the saver's credit for their contributions.

Our tax-deferred retirement system is far from perfect, but the option to defer taxes offers an incredible opportunity for everyone to save for retirement. Using a 401(k) or IRA can allow you to reduce your current income tax bill, avoid paying taxes on the gains each year and potentially pay income tax at a lower rate when you withdraw the money in retirement. There's also a penalty that will prevent many people from dipping into the account too soon, which helps insure that the money will only be used for retirement or true emergencies. The earlier you get money into a retirement account, the greater the benefit you can accrue before withdrawals become required after age 70½, so stop procrastinating and start saving.

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