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Saving can have Powerful Impact on Retirement

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There are only so many variables to any retirement plan: how much you save; your investment return on investment (ROI); how much you lose in taxes; and the income generated by your savings when you retire. There is a final factor, losses in future stock market crashes.

Before the coronavirus pandemic, Americans averaged a 7.6% (of disposable, after-tax household income) savings rate. The field of financial planning claims that one should save 10%. One must actually save 20-30% of gross income to enjoy the same standard of living in retirement as when working. This article examines the retirement challenges of a high-income couple that starts saving at age 40. If these numbers are too high for your situation, just reduce the numbers by half or 2/3rds.

Example 1: A married couple has $300,000 gross household income. If they save 10%, or $30,000/year and earn a 5% annual ROI for 25 years, the future value will be $1,503,403. This assumes there are no stock market crashes and no tax, which is of course fantasy land. *Source: www-moneychimp.com* shows that 4.57% is the compound growth rate of the S&P 500 stock market index from 1/1/2000 to 12/31/2020.

If one retires at 65 and continues to earn 5% of $1,503,403, that's a $75,170 annual income, not counting Social Security (SS). This is 25% of the $300,000 household income when working. One would need a 30% savings rate for 25 years to generate a $225,510 annual income. When one adds SS, now income approaches one's working income.

Example 2: Suppose that the couple in Example 1 have a 28% average combined federal and AZ tax rate. Now, the assumed 5% ROI becomes a net 3.60% due to a 28% tax rate. The couple still saves $30,000/year for 25 years, but their future retirement fund will reduce to $1,226,792 and annual income is $44,164 (3.6% of $1,226,792). Not counting SS, this $44,164 retirement income is only 15% of their $300,000 working income.

Example 3: Suppose that the couple can earn a 7% steady ROI, but pays no tax on that income. In 25 years, their $30,000 of annual savings becomes a $2,030,294 retirement fund. In retirement, 7% of $2,030,294 becomes a $142,120 annual retirement income, which is still only 47% of working income.

Example 4: Suppose the household with $300,000 gross income has $50,000 of annual deductions, reducing taxable income to $250,000. In 2021, that would result in $48,042 federal tax and around $7,206 of AZ tax, for a total of $55,248 of income taxes. If this household does serious tax planning, saves $40,000/year of tax, and earns an average 7% ROI, in 25 years this becomes $2,707,058. When one adds it to the $2,030,294 retirement fund in Example 3, total retirement savings is now $4,737,352. Retirement income can now become 7% ($4,737,352) = $331,614, which exceeds the $300,000 income while working. If one adds SS that is maximized by waiting until 70 to take it, SS might be $72,000/year even if the spouse never worked. Now total retirement income is $403,614, or 135% of one's $300,000 income while working.

Conclusions: The above four examples show that substantial income tax savings has a much more powerful effect on one's future retirement fund and income than ROI. You don't have to do risky Wall Street investments if you save taxes. This is why many have to work until age 70 or beyond because of their small retirement income.

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