Unbiased Financial Information Provided by Financial Wisdom.

Taxable, Tax Advantaged, Tax Deferred and Tax Free

Income taxes, while not popular, are an important part of everyone's financial life. They are a complicated issue that many just accept as part of the cost of living in America. While the top marginal federal income tax rate dropped from 70% in the early 1980s to 35% in 2004 and rose to 39.6% for 2013, almost everyone feels they pay more in tax than they would like.

And it is not just federal income taxes. Your income ends up being subject to state, Social Security, Medicare and, in some cases, local or city tax taxation. All in all, many Americans end up paying from one fifth to one half of their income to some governmental body.

Be tax wise, not tax driven

Making financial decisions based only on the income tax implications is almost always a bad idea. The key is to have an understanding of the tax implications and factor them into your decision-making process.

Tax Advantaged

The most common form of tax advantaged investing is using the beneficial income tax rates applied to long-term capital gains on investments held for more than one year and qualifying dividends. The tax rate on long term capital gains and dividends generally depends on one’s level of taxable income.

2020 Taxation of Dividends and Long Term Capital Gains		
Tax rate on long term capital gains and qualifying dividends	Taxable income levels for those filing individual returns	Taxable income levels for those filing joint returns
0%	Under $40,001	Under $80,001
15%	$40,001 to $441,450	$80,001 to $496,600
20%	Over $441,451	Over $496,601

Tax Free

The most common type of tax free investing is with the purchase of bonds issued by a municipal, state or local government agency. The tax laws provide that most types of these bonds are exempt from federal income taxes. However, they may be subject to state or local income taxes. Be sure to ask your financial advisor about this. Because interest from these types of bonds is not subject to federal tax, they often pay a lower interest rate than other taxable bonds of similar quality and duration. Compare your after tax returns to make sure tax free bonds are right for you.

Tax Deferred

Another less well known, but very powerful, tax-reduction strategy is to position your funds so any tax on earnings or appreciation is deferred until later. This results in your ability to continue to earn returns on money that would have otherwise been paid in taxes. With a tax-deferral strategy, you still have to pay the tax some day, but you control when that day is and the power of compounding results in more money in the long run.

Two of the most common ways to take advantage of income tax deferral are through the use of Individual Retirement Accounts and certain insurance contracts called annuities. Below is an example that demonstrates this point with an IRA.

Example. Robin is 30 years old and wishes to save for retirement. In this example, her combined federal and state income tax rates are 28% (25% for federal and 3% for state income taxes). She is evaluating the benefits of $5,500 annual contributions to a "regular" IRA compared to simply saving $5,500 each year in a bank account.

In this example, lets ignore any aspects of deductibility of her IRA contributions and assume the same earnings rate of 6% for the IRA and the bank account. For the IRA option, there are no taxes due annually, but they must be paid when money is withdrawn. For the bank account option, income taxes are paid annually, reducing her after tax return to approximately 4.3%. The example assumes the additions to the IRA and the bank account take place at the end of the year.

The key question is how much money Robin will have at age 60 after all taxes are taken into account.

Year	**Total Contributions**	**IRA Value**	**Savings Account Value**
1	$6,000	$6,000	$6,000
2	$12,000	$12,360	$12,259
3	$18,000	$19,102	$18,789
4	$24,000	$26,248	$25,600
5	$30,000	$33,823	$32,706
6	$36,000	$41,852	$40,119
7	$42,000	$50,363	$47,852
8	$48,000	$59,385	$55,920
9	$54,000	$68,948	$64,335
10	$60,000	$79,085	$73,115
15	$90,000	$139,656	$123,039
20	$120,000	$220,714	$184,719
30	$180,000	$474,349	$355,075
Taxes Due*		-$82,418	None
Net After Tax		**$391,931**	**$355,075**

* Assumes an earnings rate of 6% and that contributions to the IRA were not tax deductible and therefore taxes are not calculated on the total amount of the non-deductible contributions when received. [($474,349 - $180,000) times 28% assumed combined federal and state tax rates]

As the chart shows, Robin will be over $35,000 ahead after paying taxes on distributions by deferring taxes with the IRA option. Tax deferral is a very powerful wealth-building tool.