

The Shocking Truth About Taxes & Retirement

DEATH BY 1099



The Stunning Disparity Between Taxable and Tax Deferred Investments

Brought to you by
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DEATH BY 1099:

THE STUNNING DISPARITY BETWEEN TAXABLE AND TAX DEFERRED INVESTMENTS

Choosing the right retirement investment vehicle is a lot like choosing the right car. They come in many different shapes and sizes, and offer many different features. You do your research, determine your priorities, and test drive a few models before making a selection that's right for you, today. However, the car you buy today may not be right for you five or ten years from now. Who knows? You may have more children, or your children could grow into adults needing cars of their own. Gas prices may spike. Or, you may start a business that requires more room to haul equipment. Fortunately, when it comes to cars, you don't have to worry too much about the future because you know you can always trade in your old car for a new one, if and when your circumstances change.

But What About Retirement Plans?

Can you trade in your retirement accounts like you trade in cars as your needs change?

Actually, yes you can. Similar to trading in your old car for one that better fits your needs, retirement savings vehicles can also be upgraded or traded in for more appropriate accounts to maximize gains and minimize taxes. In fact, when it comes to the tax treatment of various types of retirement vehicles, this may well be one of the most important and yet often-overlooked features.

From a taxation standpoint, the growth, gains and or interest earned in every investment option available to you is treated in one of three ways: taxable, tax-deferred or tax-free. Ideally, investors should strive to move money from taxable investments into tax-deferred investments and from tax-deferred investments into tax-free investments as shown in the diagram below. When you spend less of your investment returns on taxes, the net result is more money to spend in retirement.

TAXABLE



TAX-DEFERRED



TAX-FREE



"It's not how much money you make, but how much money you keep, how hard it works for you, and how many generations you keep it for."

~ Robert Kiyosaki



Three Categories of Taxation:

>>> Fully Taxable:

Taxable investments include any accounts from which you receive a 1099 at the end of each year to report gains or earnings. If you own CDs, bonds, dividend-paying stocks, money market accounts or any other interest-bearing accounts NOT in IRAs or qualified plans, the gains in these accounts are considered fully taxable each year as earned. With these types of accounts, you pay taxes in the same year that earnings are received. The main disadvantage of taxable accounts is lost opportunity.

Paying taxes each year on your growth and interest reduces your balance available to earn in-

terest in future years. While the amount lost to taxes may not seem like a big deal in any given year, it adds up quickly to a huge difference when you look at the effect after years of compounding. Taxable investments can be beneficial for short-term investing as in many cases, most investments that fall into this category have no restrictions on liquidity and allow you to withdraw contributions at anytime without penalty. However, from a tax perspective they can put you at a disadvantage and hinder your ability to maximize long-term investments gains.

>>> Tax-Deferred:

Tax-deferred investment accounts include qualified retirement plans such as 401(k)s, 403(b)s, 457s as well as IRAs and non-qualified annuities. As long as your interest or gains are left in these accounts, there are no taxes owed on the gains or interest each year. The taxes are not owed until you withdraw the gains in the future. This allows for the triple compounding of your money, a huge advantage over taxable accounts. While the benefits of tax-deferred investment accounts are significant, the fact remains that at some

Triple compounding = Interest on your principal + Interest on your interest + Interest on the money that would have been paid to taxes in a taxable account.

point taxes must be paid. When you begin taking withdrawals, every dollar taken from a qualified retirement plan is fully taxable at your ordinary income tax rate. When money is withdrawn from tax-deferred annuities, taxes are owed on gains and interest as money you contributed to these accounts was on an after-tax basis. While tax-deferred investment accounts offer significant advantages over taxable accounts, there is still an even better option and that is the third category, tax-free!

>>> Tax-Free:

Tax-free investments include things like Roth IRAs, municipal bonds, as well as some life insurance products. These accounts are considered tax-free because as the investor, you pay zero taxes on the growth and accumulation in the account. In past years, converting investments otherwise taxable, or tax-deferred to tax-free was not always an option for many investors

as certain income limitations applied to those with incomes over certain amounts. However, in 2010 Congress removed these income limitations making Roth IRA conversions possible for anyone. The conversion process from a traditional tax-deferred retirement account to a tax-free Roth IRA can be a little tricky but in many cases can be very advantageous.

Maximize Gains. Minimize Taxes

The big picture strategy is simple. Your goal is to reposition assets from left to right, from taxable, to tax-deferred or tax-free when possible in order to decrease your tax burden and maximize your investment gains. Taxable investments are the least tax-friendly category of investments due to the annual tax bill (1099) you get at the end of each year.

In many cases, it's much more beneficial to reposition these accounts into tax-deferred accounts to delay taxes owed until you need the income in the future. And, of course, the most advantageous move is to shift tax-deferred investments into tax-free accounts, where you keep 100 percent of the accumulated growth and interest.

\$100K INVESTED

The following diagram illustrates what happens to \$100,000 invested in each of the three different tax categories, assuming a 25 percent tax bracket. As you can see, the net gain on the tax-free investment is much greater than the net gain on the taxable investment.



SO - WHAT'S THE CATCH?

Now you're probably wondering – what's the catch? It can't be that easy to move investments into tax-deferred or tax-free accounts, can it? The truth is it's not difficult to reposition assets. However, before doing so, it's important to get a detailed analysis of the potential impacts. Be aware that any time you reposition assets from one investment account to another, there are a number of factors to consider, including but not limited to; tax consequences, time required to leave money invested in the new account as well as fees you may incur to move money. Please do NOT make any

changes until you have met with a qualified financial advisor who can assist you in looking at all of these variables.

It's critical that you understand it's not an all-or-nothing deal – you don't have to reposition all your money at once, and in many cases there are good reasons not to. A seasoned advisor can help you run projections and create a plan to incrementally reposition your money into more tax friendly investment options, without adversely impacting your current income tax situation or Social Security income.

It's never too late to find the best retirement accounts for you. Just as you trade in your old car for a new one better suited to your current needs, you can make informed decisions to transition existing retirement accounts to more advantageous accounts as is appropriate. However, before you make a move, consult with a financial advisor to determine the best course of action and avoid unintended consequences.



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