The Power of Tax-Deferral

By Patrick H. Yanke, CFP

Taxes can take a big bite out of investment returns. Although investment decisions shouldn't be driven solely by tax considerations, the benefits of tax-deferral are significant.

TAX-DEFERRED AND TAX-FREE INVESTMENTS

Tax deferral is the process of delaying (but not necessarily eliminating) until a future year the payment of income taxes on income earned in the current year. For example, the money put into a traditional 401(k) retirement account isn't taxed until it is withdrawn, which might be 30 or 40 years down the road! Tax deferral can be beneficial because:

- The money that would have spent on taxes remains invested.
- An investor may be in a lower tax bracket when making withdrawals from accounts (in retirement, for example).
- More dollars may accumulate due to compounding.

Compounding means that earnings become part of underlying investments – and they also earn interest. In the early years of an investment, the benefit of compounding may not be that significant. But as the years go by, the long-term boost to total returns can be dramatic.

TAX-ADVANTAGED SAVINGS VEHICLES FOR RETIREMENT

One of the best ways to accumulate funds for retirement (or any other investment objective) is to use tax-advantaged (*i.e.,* tax-deferred or tax-free) savings vehicles, when appropriate.

Traditional IRAs. Anyone under age 70 ½ who earns income or is married to someone with earned income can contribute to an IRA. Income levels and whether an individual is covered by an employer-sponsored retirement plan determines the deductibility of contributions, but the contributions always grow tax-deferred. Contributions are limited to $5,500 (for 2018) and individuals age 50 and older can contribute an additional $1,000.

Roth IRAs. Roth IRAs are open to individuals with incomes below certain limits. Contributions are made with after-tax dollars, grow tax-deferred, and qualified distributions will be tax-free when withdrawn (as long as owners are 59 ½ or older and have held the Roth IRA for at least five years). The contribution limits are the same as for traditional IRAs.

SIMPLE IRAs and SIMPLE 401(k)s. These plans are generally associated with small businesses. As with traditional IRAs, contributions grow tax-deferred. Contributions are limited to $12,500 (for 2018) and individuals age 50 and older may contribute an additional $3,000. SIMPLE 401(k) plans can also allow Roth contributions.

Employer-sponsored plans (401(k)s, 403Bs, 457 plans). Contributions to these types of plans grow tax-deferred. Contributions are limited to $18,500 (for 2018) and individuals age 50 and older can contribute an additional $6,000. Employers can generally allow employees to make after-tax Roth contributions, in which case qualifying distributions will be tax-free.

Defined-Benefit plans (Pensions and Cash-Balance plans). Although pension plans are an endangered-species in the financial world, they still have much to offer. Based on life-expectancies of participants, these plans may allow businesses to contribute significantly for older employees. These can be an excellent vehicle for older attorneys to accelerate retirement savings.

Insurance Products. By nature, insurance products are tax-deferred financial products. In permanent life insurance products, policy cash values grow tax-deferred while issuers (the insurance companies) promise an inheritance to beneficiaries of the death benefit. Annuities are an insurance product in which an issuer promises an income for the remainder of an insured's life in exchange for a deposit of funds. There is no limit to the amounts that may be invested but benefits are subject to the financial strength and claims-paying ability of the issuer.

TAX-ADVANTAGED SAVINGS VEHICLES FOR COLLEGE

For college, tax-advantaged savings vehicles include (for each of these, investors should consider whether the investor's or the beneficiary's home state offers any tax or other benefits in that state):

529 plans. College savings plans and prepaid tuition plans let investors set aside money for college that will grow tax-deferred and be tax-free at withdrawal (at the federal level) if the funds are used for qualified education expenses. These plans are open to anyone regardless of income level. Contribution limits are high – typically over $300,000 – but vary by plan.

Coverdell education savings accounts. Coverdell accounts are open only to individuals with incomes below certain limits, but those who qualify can contribute up to $2,000 per year, per beneficiary. Contributions grow tax-deferred and be tax-free at withdrawal (at the federal level) if the funds are used for qualified education expenses.

Series EE bonds. The interest earned on Series EE savings bonds grows tax-deferred. When redeeming the bonds for college, those who qualify will be free from federal income tax. The income is always exempt from state tax.

Congress has exempted selected types of accounts for specific purposes. Depending on planning needs, investors should take advantage of available tax-deferred vehicles. All tax and legal matters should be discussed with the appropriate professional. Scenarios described are hypothetical and are included to show the benefits of tax-deferral. Investments involve risk and a profit or loss may be incurred.

Patrick Yanke is a Raleigh financial planner with a simple business philosophy: Treat others as he wants to be treated. He has a national business with clients in every American time zone. He delivers newsletters and speaking programs on a wide range of financial topics and regularly presents at the NCBA and NCAJ on financial topics. Opinions expressed here are Patrick Yanke's and not necessarily those of Raymond James. www.yankefinancial.com.