Practical Investing: Why I Pay Taxes Now

Conventional wisdom says it's better to pay tax later, but I prefer paying the taxes now.

I can hear the collective gasp of disbelief from many wise readers who have studied analyses that show how much more you'll have in retirement if you avoid paying tax today. I don't dispute the math, but I take exception to some of the assumptions. Look closely and you might, too.

Go-To Options

Before we proceed, let's first establish that I have no problem with investing as much as you can in a 401(k) or similar retirement plan **if your employer provides matching contributions** (and you contribute only up to the match) and you make good investment choices (tough to avoid volatility in today's world). The upfront automatic deductions make contributing to these accounts relatively pain-free, and the matching contributions turbo-charge your returns (or may at least cover your future taxes). The next-best option is a Roth IRA, which doesn't provide upfront tax benefits but allows your money to grow tax-deferred and allows tax-free withdrawals in retirement.

But if you've contributed all you can to a Roth—the maximum is $5,000 for those under 50—and you don't get an employer match for your retirement plan (or don't have a retirement plan at work), you may want to consider paying the taxes now versus later. You may not qualify for a Roth (income too high) or you might want to put away a lot more than $5,000 a year. Putting away more is especially true of high-income earners or successful business owners. They want a Roth on steroids. A place that allowed you to put as much away as you wanted, regardless of your income, that would insure that you never paid taxes at any time in the future (more on this later).

Mathematical illustrations that show how your money will grow in a taxable account compared with a tax-deferred account support the conventional wisdom, which says it's always better to pay tax later. By paying tax later, you get more now to compound over time. This also assumes that taxes are the same when you contributed as when you take distributions.

At least that's the way it's supposed to work. But anecdotal evidence suggests that most people don't actually invest the extra money they save when they put off paying the tax bill. Instead, they live a little better—they go out to dinner, buy clothes or "invest" in a big-screen TV.

And that throws the math in those illustrations out the window. In order to show that you save more with a tax-deferred account, the formula must start with an assumption that a person with a taxable account saves less by paying income out of the account, thus reducing the year-end balance that gets reinvested.

For example, if you earned $8,000 for the year on a $100,000 account in a taxable portfolio, the formula would assume that you'd pay, say, $1,600 in tax on the gain and have just $106,400 reinvested after paying Uncle Sam. (To keep things simple, let's ignore state and local taxes, as well as differences between capital gains and ordinary income tax rates.) The person with the

tax-deferred account, however, would have the full $108,000 to reinvest. Thus, this formula shows the person with the taxable account entering retirement 20 years later with just $346,000, while the tax-deferred investor has $466,000. Of course, the tax-deferred investor must pay tax on this income in retirement and, assuming the same bracket and gains, would pay out $73,000 of the difference but still have $393,000 after tax, or $47,000 more.

But here's the question: Do you pay taxes on investments out of your account, or do you find the money to pay them elsewhere—out of your annual income, for instance? If the latter, your taxable account will be worth $466,000 in retirement, too—and you won't still owe the tax on your gains, making you richer in retirement. We have discovered that most people pay these taxes from their normal income, not from the account. If you think taxes are going up in the future (how can they not with demographics and our government spending) then you should consider paying the taxes now (they may be a low as they are ever going to be).

What if there was place to save/invest those after tax sums where it would grow tax-deferred and be withdrawn tax-free? What if you could put in as much as you wanted, regardless of your income? What if this place wasn't susceptible to market volatility (no losses)? What if it guaranteed your return even if you only contributed for one period (this is a biggie)? What if it was a place that wasn't susceptible to creditor actions? What if is was a place where there were no penalties for early withdrawals? What if was a place that allowed you complete liquidity, use and control of the money – at all times? What if it was a place that allowed you to use the money as collateral – thus insuring the compounding would continue uninterrupted? What if it was a place that guaranteed that the value would be transferred to your heir's income tax-free? If there were a place like this, would you want to know about it?

Of course you would, so contact us and we will help you understand how to implement this valuable financial tool into your financial plan.

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