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The Value of Investing in Taxable Accounts

Many people invest for their retirement years through various tax-deductible/pre-tax (Pay Later) retirement plans such as 401(k)s, 403(b)s, IRAs, and annuities. These accounts are great for reducing taxes today, but because they grow tax-deferred, many people may face a tax bomb in retirement when they start taxable distributions at future unknown tax rates. On the other hand, the after-tax, taxable (Pay Now) accounts can be valuable for tax planning later in your retirement to provide tax-efficient distributions and income. Gains and income are taxed in the year earned, reducing the taxable amount when distributed.

Investors have many choices in the types of accounts to invest their dollars. One of the most valuable for future tax planning behind the Roth account is the after-tax/taxable account. Contributions to taxable accounts are made with after-tax dollars and are not tax-deferred. Owners are taxed on the interest, dividends, and realized gains in the year received or recognized within the account. The owner will receive a form 1099 yearly, regardless if funds were distributed or not. However, current tax law allows preferred tax rates for qualified dividends and long-term capital gains (held for at least one year). The preferred tax rates may allow for more tax-efficient growth over the years. When funds are distributed, the owner will not be taxed on the portion of the account already taxed in the previous years, allowing for more tax-efficient distributions and income. Reducing taxable income in later retirement may allow for various income tax planning considerations when the account owner is in a lower marginal tax bracket. See Figure 1.

There are several advantages of taxable accounts that can benefit the account's owner(s) and the beneficiaries of those accounts.

First, long-term capital gains (held for at least one year) and qualified dividends are taxed at lower rates (0%, 15%, or 20%) than marginal income tax brackets.

Second, as interest, gains, and dividends are realized and taxed, the cost basis increases. When distributions are made in later years, only the new realized interest, gains, and dividends for that particular year are taxed, potentially reducing one's overall marginal income tax bracket. This strategy is beneficial in early retirement to provide tax-efficient income and to allow for potential Roth IRA conversions at lower tax rates.

Third, beneficiaries are allowed a stepped-up cost basis upon the death of taxable account owner(s). ***Example:*** Beth invested in a taxable account with an initial cost of $1 and later passed away. On the date of her death, her taxable account was valued at $100.

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Therefore, her beneficiaries get a stepped-up cost basis of $100, and if they sell the holdings in the account later for $110, they will pay only $10 in capital gain since their new stepped-up cost basis is $100.

Retirement accounts and annuities also offer tax deferral until distributions are made, allowing for the compounding of the funds that would otherwise be used to pay taxes. Having one's contributions tax -deductible and growing tax-deferred looks appealing until you realize how much tax you may owe in the end.

Figure 1.

1.Roth IRA distributions are qualified if you held the account for at least 5 years, AND the distribution is made after age 59 ½.
2. Life insurance death benefits and cash value policy loans are received income tax-free if structured properly.

The future tax risk, coupled with Required Minimum Distributions (RMDs), requires careful consideration of each person's situation and objectives. It should motivate investors to consider after-tax contributions Roth (non-tax deductible) to their retirement plans, if available, as well as taxable accounts (individual, joint, or trust) that may allow for attractive tax planning options in our later years.

Pre-tax only Example: If someone has only tax-deductible/pre-tax IRAs and 401(k)s and earn $100,000 per year income and plan to retire with living expenses of $100,000, they cannot reduce their marginal income tax rates because the pre-tax IRA distributions for income will be 100% taxable just like their pre-retirement income keeping them in the same marginal income tax bracket.

Pre-Tax and After-tax Example: If someone has both pre-tax IRA accounts as well as after-tax/taxable accounts, they may be able to take distributions from their tax-efficient taxable accounts and possibly drop their marginal income tax bracket down to lower brackets that may provide numerous tax planning strategies including possible being able to covert some the pre-tax IRAs to Roth IRAs at lower income tax rates. The optimal time to do so may be in early retirement when the 100% taxable salaries stop and before starting Social Security, since up to 85% of benefits may be taxable, and before age 72 when Required Minimum Distributions begin.

Below is a Table 1. that illustrates the various taxation of these accounts. In most cases, these accounts can utilize the same investment (CD, mutual fund, brokerage account, managed account, and annuities). The account title (individual, joint, IRA, Roth IRA, trust, etc.) determines the account's taxation.

Table 1.

Summary of Account Types

Account	Contributions	2022 IRS Contribution Limit	Tax-Deferred	Distribution Taxation	Stepped-Up Cost Basis at Death	Required Minimum Distributions (RMDs)[1]
Pre-tax 401(k), 403(b), 457	Tax-deductible/ Pre-tax	<50 $20,500 50+ $27,000	Yes	100% Taxable at the highest marginal tax bracket	No	Yes
After-tax Roth 401(k), 403(b), 457	Non-tax deductible/ After-tax	<50 $20,500 50+ $27,000	Yes	Qualified distributions are tax-free[2]	No	Yes
Traditional IRA	Tax-deductible/ Pre-tax Or Non-tax deductible/ After-tax	<50 $6,000 50+ $7,000	Yes	Tax deductible IRAs are 100% taxable. Or Non-tax-deductible IRAs are non-taxable and prorated among all IRAs.	No	Yes
Roth IRA	After-tax	<50 $6,000 50+ $,7000	Yes	Qualified distributions are tax-free[2]	No	No
Annuity	Pre-tax or After-tax	None	Yes	Pre-tax is 100% taxable After-tax is prorated	No	No
Taxable Examples: Individual Joint Trust	After-tax	None	No	Earnings and gains are taxed when realized. Qualified Dividends and Long-term Capital Gains get preferred	Yes	No

1. Required Minimum Distributions (RMDs) are required to begin at age 72 (age 70 ½ for those who were 70 ½ on January 1, 2020). RMDs are not required from 401(K) plans if the participant is still employed with that 401(k)-company sponsor. Roth IRAs DO NOT have RMDs, but Roth 401(k) plans DO.
2. Qualified distributions from Roth accounts must meet two criteria; 1) the participant must be over age 59 ½ AND 2) the account must have been established for 5 years.

All the account types listed above provide various tax benefits and add value depending on each person's situation and objectives. Having various account types, including taxable accounts, may help us grow and distribute our wealth tax-efficiently while providing more tax planning options.

The challenge for many is the pleasure of immediate tax savings with the tax-deductible/pre-tax accounts is hard to pass up, which can lead to potential tax bombs later when RMDs are required at future unknown tax rates.

In conclusion, think of it this way—pre-tax and tax-deferred accounts provide tax

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savings on the seeds/dollar contributions, but the harvest/distributions from these plans will be 100% taxable. Remember that qualified Roth distributions can be 100% tax-free; taxable accounts are only taxable on the realized interest, dividends, and gains not previously taxed.

Remember, Forward thinking is good planning!

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