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The Benefits of Tax-Advantaged Savings Vehicles

Taxes can take a big bite out of your total investment returns, so it's helpful to look for tax-advantaged strategies when building a portfolio. But keep in mind that investment decisions shouldn't be driven solely by tax considerations; other factors to consider include the potential risk, the expected rate of return, and the quality of the investment.

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 you earn in the current year. For example, the money you put into your 401(k) retirement account isn't taxed until you withdraw it, which might be 30 or 40 years down the road!

Tax deferral can be beneficial because:

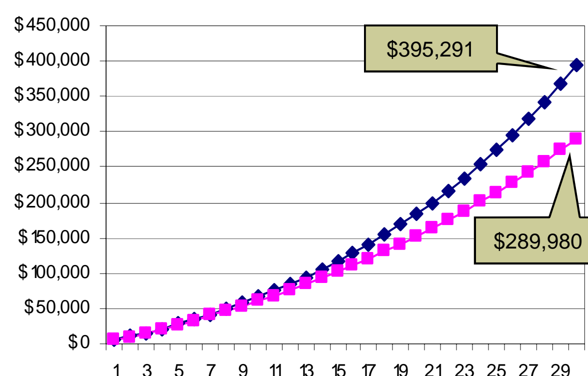
- The money you would have spent on taxes remains invested
- You may be in a lower tax bracket when you make withdrawals from your accounts (for example, when you're retired), and
- You can accumulate more dollars in your accounts due to compounding

Compounding means that your earnings become part of your underlying investment, and they in turn 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 your total return can be dramatic.

Keep in mind that tax deferred is not the same as tax free. "Tax deferred" means that the payment of taxes is delayed, while "tax free" means that no income taxes are due at all. Some savings vehicles, like Roth IRAs, can generate tax-free income.

Taxes make a big difference

Let's assume two people have $5,000 to invest every year for a period of 30 years. One person invests in a tax-free account like a Roth 401(k) that earns 6% per year, and the other person invests in a taxable account that also earns 6% each year. Assuming a combined federal and state income tax rate of 30%, in 30 years the tax-free account will be worth $395,291, while the taxable account will be worth $289,980. That's a difference of $105,311.



This example is hypothetical and is not intended to reflect the actual performance of any specific investment. This example assumes the reinvestment of all income dividends and capital gains distributions, and any resulting taxes are paid with funds from the account. Investment fees and expenses, which are generally different for tax-advantaged and taxable investments, have not been deducted. Investors should consider their time horizon and current and future tax rates before making any investment decision.

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. There are several to choose from when planning for retirement:

- *Traditional IRAs*--Anyone under age 70½ who earns income or is married to someone with earned income can contribute to an IRA. Depending upon your income and whether you're covered by an employer-sponsored retirement plan, you may or may not be able to deduct your contributions to a traditional IRA, but your contributions always grow tax deferred. However, you'll owe income taxes when you make a withdrawal (and a 10% additional penalty tax if you're under age 59½, unless an exception

applies). In 2008, you can contribute up to $5,000 to an IRA, and individuals age 50 and older can contribute an additional $1,000.

- *Roth IRAs*--Roth IRAs are open only to individuals with incomes below certain limits. Your contributions are made with after-tax dollars, but they will grow tax deferred and qualified distributions will be tax free when you withdraw them. The amount you can contribute is the same as for traditional IRAs. Total combined contributions to Roth and traditional IRAs can't exceed $5,000 each year for individuals under age 50.
- *SIMPLE IRAs and SIMPLE 401(k)s*--If you're self-employed or the owner of a small business, you may be able to take advantage of these retirement plans. As with traditional IRAs, your contributions grow tax deferred, but you'll owe income taxes when you make a withdrawal. For 2008, you can contribute up to $10,500 to one of these plans; individuals age 50 and older can contribute an additional $2,500.
- *Employer-sponsored plans (401(k)s, 403(b)s, 457 plans)*--Contributions to these types of plans grow tax deferred, but you'll owe income taxes when you make a withdrawal. For 2008, you can contribute up to $15,500 to one of these plans; individuals age 50 and older can contribute an additional $5,000.
- *Annuities*--An annuity can supplement the other vehicles listed here. Under an annuity contract, in exchange for your lump sum or periodic contributions, the annuity issuer (typically an insurance company) agrees to pay you or your named beneficiary an income stream for life (subject to the claims-paying ability of the issuer). There's no limit to how much you can invest, and your contributions grow tax deferred. However, you'll owe income taxes on the earnings when you start receiving distributions.

Worth noting:

Employers can allow employees to make after-tax Roth 401(k) contributions, and qualifying distributions will be tax free.

Tax-advantaged savings vehicles for college

For college, tax-advantaged savings vehicles include:

- *529 plans*--College savings plans and prepaid tuition plans let you 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.

Note: *Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans. More information about specific 529 plans is available in each issuer's official statement, which should be read carefully before investing.*

- *Coverdell education savings accounts*--Coverdell accounts are open only to individuals with incomes below certain limits, but if you qualify, you can contribute up to $2,000 per year, per beneficiary. Your contributions will 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. But if you meet income limits (and a few other requirements) at the time you redeem the bonds for college, the interest will be free from federal income tax too (it's always exempt from state tax).

An all-purpose tax-advantaged investment

Tax-free municipal bonds--Interest earned on tax-free municipal bonds is generally exempt from state tax if the bond was issued in the state in which you reside, as well as from federal income tax (though earnings on certain private activity bonds may be subject to the alternative minimum tax). But if purchased as part of a tax-exempt municipal money market or bond mutual fund, any capital gains earned by the fund are subject to tax.

Bottom line

Though tax considerations shouldn't be your only concern when investing and building a portfolio, by putting your money in tax-advantaged savings vehicles and investments when appropriate, you'll keep more money in your own pocket and put less in Uncle Sam's.

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