THE IMPORTANCE OF TAX DEFERRED RETURN

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SIMPLE 2-PERIOD CASE. 5% ANNUAL RETURN.

Time	Pay Tax Each Year	Pay tax only at end: "Deferred"
"Time 0"	Invest $1000	Invest $1000
Year 1	5% current return is taxed 20% to give $**40** after tax. $1000*5% = $50 Subtract $50*20% = $10 tax The total is now $1000+$50-$10 = $10**40**	5% current return is not taxed this year. The total is now $1050
Year 2	$1040*5% = $52 Subtract $52*20% = $10.40 The total is now $1040+$52-$10.40 = **Final Value** **$1081.60**	All earnings are taxed this year. $1050*5% = $52.5 Tax will be $50*20% + $52.5*20% = $20.5 Final Value $1050 + $52.5 - $20.5 = **Final Value** **$1082.00**

10-PERIOD CASE: INVEST ONLY AT BEGINNING 5% ANNUAL RETURN

Time	Current Tax	Deferred Tax
"Time Zero"	Invest $1000	Invest $1000
10 years later	Growing at 5% each year but 20% of each year's growth paid in tax Final Value **$1480.24**	Asset grows to $1628.89 Pay tax on the growth: Tax = $628.89*20% Tax = $125.78 Final Value $1628.89 - $125.78 = **$1503.11**

20-PERIOD CASE: INVEST $1000 AT START OF EACH YEAR. 5% ANNUAL RETURN

Time	Current Tax	Deferred Tax
"Time Zero"	Invest $1000 and then $1000/year for 19 more years.	Invest $1000 and then $1000/year for 19 more years.
20 years later	Growing at 5% each year but 20% of each year's growth paid in tax Final Value **$30,969.20**	Asset grows to $34,719.25 Pay tax on the growth: Tax = $14,719.25*20% Tax = $2,943.85 Final Value $34,719.25 - $2,943.85 = **$31,775.40**

30-PERIOD CASE: INVEST $5000 AT START OF EACH YEAR. 8% ANNUAL RETURN

Time	Current Tax	Deferred Tax
30 years later	Dollars Invested = 30*$5000 = $150,000 Final After Tax Value = **$451,515**	Dollars Invested = 30*$5000 = $150,000 Pre tax final amount = **$519,384** Note: If this is withdrawn "early" with a 10% penalty on earnings, then the final value will be **$482,445**

DEFERRED INCOME INVESTMENTS

- **Assets in any type of IRA, 401K, etc…**
  - **Under some conditions, you can invest in a Traditional IRA and not get the tax deduction, BUT you still get tax deferred growth.**
- **Assets in a Health Savings Account, various Education Accounts, etc…**
- **The growth of common stock**
  - **Only the dividend is taxable in the current year.**
  - **All growth is not taxed until sale = tax deferred !**

- **Unfortunately, zero-coupon bond growth is taxable each year if the bond is in a taxable account.**

DEFERRED INCOME INVESTMENTS

- **WARNING: Tax deferral is one of the points emphasized by sellers of Permanent Life Insurance (e.g. Whole Life) and Annuities.**
  - **These assets generally offer lower returns and have high fees.**
  - **Also, it is difficult to get your money out.**
  - **The next two slides illustrate a presentation given by a Life Agent.**

This is an example of an online presentation made by a Life Agent showing how the deferred growth offered by the Universal Life Insurance contract offers a superior result compared to a Term Policy where the difference is invested.

Permanent vs Buy Term and Invest Elsewhere

3 Funding options for UL Insurance vs. Term

Payment Option	Average Yearly Premium for 30 years	After-Tax Amount Returned After 30 years	After-Tax Buy Term and Invest Strategy	After-Tax Gain from Purchasing Permanent Policy	After-Tax Return on Investment
30YT	($795)	$0	$0	$0	0.00%
Minimum*	($1,024)	$29,960	$22,520	$7,440	3.34%
Target**	($4,992)	$241,009	$190,713	$50,296	3.91%
Maximum	($10,546)	$574,434	$443,089	$131,345	4.06%

30 Yr Treasury Rate (3/16/2012) is 3.41% pre-tax, and 2.56% after 25% federal tax rate.

*Minimum Payment Schedule involves $3,072/yr for first 10 years and nothing after that
**Target Premium is the full commissionable premium for the agent.

The term policyholder, denoted "30YT" for 30-year term, pays $795 and **invests <u>$4,992-$795 = $4197</u> per year.**
The yield on that portfolio is an important assumption.

Takeaway: The presentation makes some good points, but it is biased by showing results for the 30YT & invest strategy using a fairly low, current-income return that is all current income.

To it's credit, the presentation points out that the permanent policy does not achieve a positive investment return until after year 10. Even with the biased investment-return assumptions, the 30YT and invest strategy is ahead until year 15. See the table below.

UL policy has $0 cash value in early years

Permanent Insurance Example: Target Return

Return on Investment for Target Premium patterns, $1,000,000 Face, 35MNS

Year	Age at End of Year	Gross Premiums Paid to Date	After Tax Cash Surrender Value at End of Year	After Tax Buy Term and Invest Strategy	Net Gain from Purchasing a Permanent Policy	CSV After-Tax IRR	DB IRR
1	36	($4,992)	$0	$4,304	($4,304)	-	23726.54%
5	40	($24,960)	$0	$22,651	($22,651)	-	173.14%
10	45	($49,920)	$27,379	$48,351	($20,972)	-7.94%	56.26%
15	50	($74,880)	$77,403	$77,509	($106)	2.54%	30.99%
20	55	($99,840)	$125,629	$110,591	$15,037	3.70%	20.48%
25	60	($124,800)	$177,518	$148,127	$29,391	3.84%	14.84%
30	65	($149,760)	$241,009	$190,713	$50,296	3.91%	11.38%

30 Yr Treasury Rate (3/16/2012) is 3.41% pre-tax, and 2.56% after 25% federal tax rate.

UL – portfolio where portfolio return is only 3.41% current income taxec at 25%

SUMMARY AND FINAL THOUGHTS

- Tax deferred growth and income give superior final values (all other things equal)
  - That benefit can take the sting out of the 10% penalty if you have to take an early withdrawal from an IRA or similar account.
  - Beware of "products" that emphasize the tax deferred growth.
    - Look carefully at assumptions in illustrations.
    - Look at the fees and liquidity.
- The growth of a common stock is tax deferred until sale.
- All types of interest (including zero-coupon bond interest) and dividends are taxable in the current year.
  - Note, municipal bond interest is not taxable.

If you have both an IRA and a regular brokerage account, put your current-income assets (except munis) in the IRA and your equity growth assets in your regular brokerage account.