TAX DEFERRAL ESSENTIALS

Every year as April 15 approaches, individuals often rush to select deductions to minimize a tax bill or improve a refund. However, the real work in reducing taxes should occur long before the filing process begins.

Most people are familiar with the taxes taken out of a paycheck. Employer withholding tends to ease the pain of paying taxes, since the money is already in the hands of the IRS at tax time and the filing process is typically an exercise in getting some of that money back. However, an individual with income from sources other than employment faces more complex calculations. Not all income is taxed at the same rate and investment income has different rules and rates depending on the nature of the earnings and other factors.

Because the income from an investment is a smaller percentage of the original investment, it's tempting to think taxes on that portion would be insignificant relative to the investment itself. Nevertheless, because of compounding, these payments can add up and erode the growth potential of savings, making it more challenging for investors to achieve their retirement and legacy goals.

Fortunately, investors can use various methods to reduce their taxes. It is possible to select investments that incur lower taxes. There also are accounts and vehicles that allow investors to defer paying what would otherwise detract from income and gains, allowing them to pay taxes at a later date when their total annual income is lower than during their prime earning years.

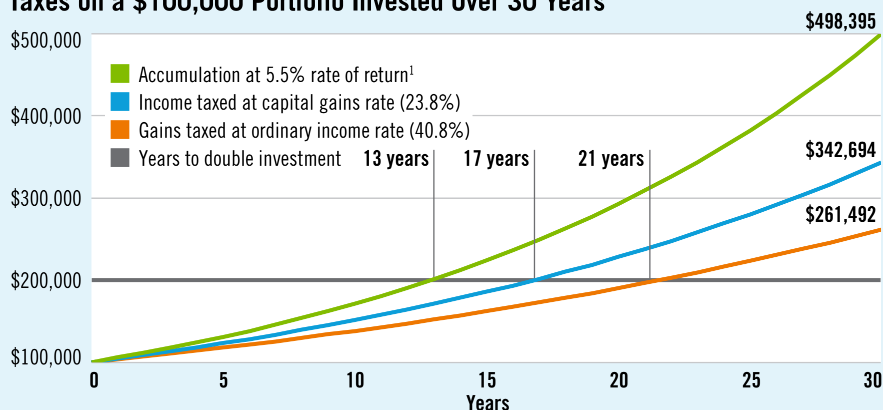
COMPOUNDING PLAYS A POWERFUL ROLE IN TAXATION

Compounding is a key component of retirement savings that can help portfolios grow and potentially provide a better and longer lasting retirement. But compounding impacts both sides of the equation—boosting growth from earnings as well as increasing the taxable income. Furthermore, the effect is not linear but geometric, meaning it gets increasingly more significant over longer periods of time, giving even more weight to the need for tactical thinking around tax planning.

The graph shows what happens to a hypothetical portfolio with annual compounded gains of 5.5% compared to the result when that return is reduced by either 40.8% or 23.8%, the maximum rates as of 2018 for ordinary individual income tax and capital gains tax, respectively. The taxes apply only to the 5.5% annual increase amount, so intuitively it seems like the tax rate might not make a huge difference. However, with compounding, in 10 years, the gap is enough to buy a car. In 20 years, the difference at the highest rate nearly equals the starting capital.

The progressive tax system in the United States is complex and this example does not replace an analysis of an individual's entire income and earnings picture. The example given here uses the highest rates to illustrate the importance of taxation as an element of financial planning. The power of compounding means that taxes play a significant role in one's financial security during retirement.

Taxes on a $100,000 Portfolio Invested Over 30 Years



1. Savings accumulated in tax-deferred investments are taxable as ordinary income at the time of withdrawal. Withdrawals received prior to age 59½ may be subject to a 10% federal tax penalty.

Green line: Accumulated investment with 5.5% rate of return; Blue line: Result after tax at capital gains rate (23.8%); Orange line: Result after tax at ordinary rate (40.8%).

The real tax rate for total household income, including earned income, can be lower than 40.8% because of the progressive tax rate formula. The maximum capital gains rate is 20% but for high earners is subject to an additional 3.8% Medicare tax.

This hypothetical chart is for illustrative purposes only and does not represent past or future performance of a Franklin Templeton fund. The chart assumes a fixed 5.5% average annual rate of return compounded monthly, and no fluctuations of principal. Investors should consider their current and anticipated investment horizon and income tax bracket when making an investment decision, as this hypothetical investment does not reflect these factors. The chart does not reflect the fees and charges associated with any particular investment. Such expenses, when levied, would lower overall returns. You should consult with your tax advisor about your particular tax responsibilities and circumstances. Please see your financial advisor for performance information on specific investments. Investment results fluctuate and can decrease as well as increase.

Taxation of Investment Income Varies

Different types of earnings are not treated equally. Within the category of investment portfolio income, certain income is taxed at the ordinary individual income rate while some is taxed at the capital gains rate. The long-term capital gains rate is always decidedly lower than the income rate. At certain income levels, the capital gains rate is zero. At the highest income levels, there is an additional Medicare tax that raises the total capital gains tax rate to 23.8%. By comparison, the ordinary income tax rate can run as high as 40.8%.

As the compounding exercise shows, the difference between these rates can greatly impact outcomes. For example, interest income is ordinary income for tax purposes, but gains from investments held over a year are taxed at the capital gains rate.

MUTUAL FUNDS PASS TAX LIABILITY TO SHAREHOLDERS

Mutual funds generally do not pay federal income tax on the income and capital gains derived from their investments in portfolio securities. Mutual funds pay out their investment income in the form of dividends to shareholders, who are subject to federal income tax on that income.

Taxes associated with mutual funds are paid on income received from trades, dividends, and interest. A higher portfolio turnover rate may result in higher taxes when mutual fund shares are held in a taxable account. Holdings that generate taxable income like dividends and interest also will have tax implications for investors.

One of the many advantages of investing in mutual funds[1] is the pass-through of certain tax attributes that are beneficial to shareholders. These benefits include: the taxation of the fund's long-term capital gains and qualified dividend income at lower federal income tax rates; the federal income tax exemption on interest derived from the fund's investment in municipal bonds; and the pass-through of foreign income taxes paid by the fund to shareholders who are able to claim an itemized deduction or credit on their individual income tax returns. One potential tax disadvantage of investing in mutual funds is the treatment of short-term capital gains. These gains are treated as ordinary income when distributed to shareholders and thus are taxed at a higher rate.

Mutual funds[1] can be an effective tool in helping investors reach their financial goals. When selecting the right investments, choosing funds with tax characteristics that are aligned with those goals can allow for a more efficient portfolio.

1. Mutual fund investments generally incur sales charges, management fees, Rule 12b-1 fees, and other expenses that reduce their investment returns.

While it is relatively straightforward to understand the tax treatment of investments that are directly held, pooled investments like mutual funds are more complex because the mutual fund itself does not pay any taxes. Instead, income and gains are passed through to investors along with the tax liability on those earnings. Of course, based on management style and other factors, not all mutual funds generate the same income and gains.

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Tax Deferral Is a Feature of Certain Accounts and Products

Tax deferral lets investors avoid paying taxes during the deferral period. This means that dividends and interest, including the taxes associated with mutual funds, are not a consideration within a tax-deferred account. This also includes capital gains and losses from securities sales within the account.

Tax deferral is an incentive to encourage savings, so there are rules that apply to each situation in which tax deferral applies. Accounts offering tax deferral benefits intended to encourage personal retirement savings come with restrictions and penalties against early withdrawal. Before using any strategy for tax deferral, it is important to understand those terms and conditions.

Tax deferral is just that, a deferral, and at a certain point, investors will have to pay taxes. Deferral is an important element of initial planning as is the withdrawal process that will take place at some point in the future.

TAX DEFERRAL COMES IN DIFFERENT FORMS

Tax deferral can apply to both accounts and investment vehicles. This point is critical when considering what types of investments to use within a tax-deferred account. For example, a tax-free municipal bond generally is not an ideal choice within an individual retirement account (IRA) or a variable annuity, because the income would be taxable on distribution. There may be other benefits of a particular vehicle that still make it suitable within a tax-deferred account, but selecting both vehicle and account specifically for their tax deferral properties is redundant.

Retirement savings accounts, such as 401(k)s or IRAs, receive tax deferral at the account level and contain a broad variety of underlying investments. The limitations on the type of investment have more to do with account size and provider than any other feature. Each type of retirement account has specific rules for contributions and withdrawals.

Certain vehicles also have tax deferral associated with them and, of course, their own set of rules. These are especially useful for those who have exhausted their contributions to other tax-deferred accounts. Annuities and life insurance have additional benefits that are important to keep in mind during the planning process. Annuities in particular are geared towards retirement planning and often include features specifically designed to increase retirement security.

Just as mutual funds distribute taxable dividends and capital gains to shareholders, mutual funds that invest in tax-free municipal bonds distribute dividends that generally are free from regular federal income tax for shareholders. Shareholders of municipal bond funds are subject to tax on any distributions of capital gains.

Tax-Deferred Accounts*,[1]		Penalty for Early Withdrawal	Tax Exemption[2]	Contribution Limits
Employer-Based	401(k), 403(b), 457, SIMPLE, Roth (various)	Yes	On either deposits or withdrawals	Yes
Individual	IRA (Traditional, Roth)	Yes	On either deposits or withdrawals	Varies, Income-Based
Education Savings	529 Plan, Coverdell	Federal and state penalties for non-qualified distributions; age restrictions on Coverdell	529 Plans, some states (with a limit)	Plan specific

Tax-Advantaged Vehicles (Products)	Penalty for Early Withdrawal	Reallocation Costs	Taxes on Withdrawals/ Redemption	Beneficiary Taxes at Death
Municipal Bonds	No	N/A	Capital gains	Step-up in basis
Deferred Annuities (Variable, Fixed, Index)	Yes	No transaction fee, taxes on reallocations to funds or strategies	**Withdrawals/surrenders:** Gains taxed at the regular income rate before starting premium is withdrawn **Annuity payments:** Exclusion ratio	Gains are taxable
Life Insurance (Variable, Whole, Universal)	No	No transaction fee, taxes on reallocations among funds or strategies	**Withdrawals/surrenders:** Gains are taxed at the regular income rate **Loans:** Not taxed	Proceeds are free of federal income tax but are included in the estate and may be subject to state taxes

*Tax benefits are conditioned on meeting certain requirements. Federal income tax, a 10% federal tax penalty and state income tax and penalties apply to non-qualified withdrawals of earnings. Generation-skipping tax may apply to substantial transfers to a beneficiary at least two generations below the contributor.

1. Federal tax law now provides that up to $10,000 per year may be withdrawn from a 529 savings plan federal income-tax free, if used for tuition expenses at private, public or religious primary and secondary (K-12) schools. It is not currently clear what public K-12 school costs, if any, will be regarded as tuition for this purpose. State tax benefits and treatment of withdrawals for K-12 tuition may vary by state, may not have been updated for changes in federal tax law and may be uncertain; consult a tax professional concerning your state.

2. Availability of state income tax deductions and other benefits varies by state and is often subject to restriction based on earned income limits. Account owners should seek guidance from the state in which they pay taxes regarding the availability of a state income tax deduction for contributions to a qualified tuition program.

Careful Planning and Monitoring Are Key

Taxes are an important consideration as investors accumulate money for retirement, legacy, and other uses. In order to make the most out of savings, it makes sense to consider tax-deferred strategies whenever possible. However, a thoughtful approach is crucial. Restrictions on withdrawals mean that there may be penalties if investors access their money too early and the tax treatment can vary significantly both on withdrawals and on money passed on as a legacy.

Key considerations when creating a tax deferral strategy include the anticipated use of those assets as well as how other money is allocated. Investments that are taxed at a higher rate should go within tax-deferred accounts or products when possible. For example, mutual funds with high portfolio turnover that generate more capital gains will grow more quickly within a retirement account or variable annuity. Retirement savings accounts are a great tool, but since they have contribution limits, investors often need to seek out other options to expand tax savings opportunities.

Immediate and interim funding needs should come from other sources in order to leave tax-deferred assets untouched, both optimizing their compounding power and avoiding withdrawal penalties.

Sophisticated investors may feel comfortable navigating the nuances of these products without further guidance. However, the more complicated the financial picture, the easier it is to make an expensive or inconvenient error that may not present itself for years. In such instances, professional advice is invaluable—and not just on day one but throughout the life of the investment—to make sure that investors make the most of their savings and enjoy the fruits of their labor.

- **Tax deferral enhances the power of compounding to help investors seek to achieve their goals more quickly and with greater confidence.**
- **Mutual funds pass taxes through to investors, with some strategies generating more taxes than others.**
- **Products that provide tax deferral allow investors additional ways to build tax-deferred savings when they have reached the limits on contributions to tax-deferred accounts.**

Investors should carefully consider college savings plan investment goals, risks, charges and expenses before investing. To obtain a disclosure document, which contains this and other information, talk to your financial advisor or call Franklin Templeton Distributors, Inc., the manager and underwriter for a 529 plan at (800) DIAL BEN/342-5236 or visit franklintempleton.com. You should read the disclosure document carefully before investing and consider whether your, or the beneficiary's, home state offers any state tax or other state benefits such as financial aid, scholarship funds, and protection from creditors that are only available for investments in its qualified tuition program.

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