FRANKLIN TEMPLETON

MAPPING THE TAX DEFERRAL LANDSCAPE

Tax deferral can come in different forms and can apply either to a specific product or an entire account. Individual retirement accounts (IRAs) benefit from tax deferral and can contain many different kinds of investments that differ depending on the employer or IRA provider. For many investors, these are the primary source of tax-deferred savings and they give the added benefit of either tax-free contributions or tax-free payouts.

However, after maximizing contributions to these accounts, many investors are still looking for ways to avoid or minimize taxes while their investments grow. Other tax-advantaged vehicles include annuities, municipal bonds, life insurance and college savings plans.

When choosing investments for placement within tax-deferred accounts, it may make sense to pick those subject to the highest tax rates. Such investments include those that generate taxable income, that may be taxed at higher rates, or mutual fund strategies that generate more annual tax liability. Thoughtfully allocating assets that do and don't benefit from tax deferral helps to fine tune an investor's overall strategy.

The quest for tax deferral can be complex and is shaped by individual circumstances and goals. In all cases it is important to have a solid grasp of how these investments will be used and conduct periodic checks to make sure that the strategy is on track. The need for changes can come from many directions, whether it is because of new circumstances for the investor, tax law changes, or a major variance in investment performance.

SUMMARY OF TAX-DEFERRED OPTIONS IN 2020

Account Type	Tax-Free		Contribution Limit	Catch-Up Contributions (≥50)	Age-Based Distribution Requirement
	Contributions	Withdrawals			
Employer-Based					
401(k), 403(b), 457	■		$19,500	$6,500	72**
Roth Accounts—401(k), 403(b), or 457		■	$19,500	$6,500	72**
SIMPLE 401(k)/IRA	■		$13,500	$3,000	72**
Individual (IRA)					
Traditional	■		$6,000	$1,000	72**
Roth		■	$6,000	$1,000	none
Tax-Deferred Products					
Deferred Annuities			no limit	N/A	none*
Life Insurance		■ (loans)	no limit	N/A	none
Tax-Advantaged					
Municipal Bonds			no limit	N/A	none

*Deferred annuities mandate annuitization at advanced age (i.e. age 90 or older), though some contracts waive this if there are periodic withdrawals.

Limits currently in effect and are subject to change.

**The Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act) became law on December 20, 2019. The Secure Act made major changes to the RMD rules. If you reached the age of 70½ in 2019 the prior rule applies, and you must take your first RMD by April 1, 2020. If you reach age 70½ in 2020 or later you must take your first RMD by April 1 of the year after you reach 72.

Tax-Deferred Accounts

Retirement savings accounts, such as 401(k)s or individual retirement accounts (IRAs), are tax deferred at the account level and can contain many different investments within them. The limitations on the type of investment tend to be related to account size or provider. These accounts have penalties for early withdrawals or distribution of retirement savings.

Retirement accounts can be based with an employer or the individual investor. Many investors are able to contribute to both, though employer accounts often benefit from the employer matching contributions to some degree. Investors can avoid taxes either on contributions or on withdrawals, depending on the account type.

Since these accounts are designed to encourage retirement savings, they are structured to prevent investors from either accessing them too early or failing to use them for their intended purpose. In short, savers shouldn't take their money out until they are at least 59½ but must start taking money by the time they are 72.**

Early withdrawal penalties apply to distributions before age 59½, though there are some exceptions for different personal situations. For details on exceptions to early withdrawal penalties by plan, see: https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-tax-on-early-distributions.

All but Roth IRAs have a required minimum distribution (RMD), which means that retirees must begin withdrawals in the year they turn 72.**

RETIREMENT ACCOUNT RMD, EARLY WITHDRAWAL PENALTIES

Account Type	Early Withdrawal Penalty		RMD	
	Contributions	Earnings	Owner	Beneficiary (after death)
Employer-Based				
401(k), 403(b) or 457	10%	10%	■	■
SIMPLE 401(k)/IRA	10%/10% (25% within first 2 years)	10%/10% (25% within first 2 years)	■	■
Roth Accounts— 401(k), 403(b), or 457	no penalty	10%*	■	■
Individual (IRA)				
Traditional	10%	10%	■	■
Roth	no penalty	10%		■

*For Roth accounts, 10% penalty applies only to withdrawals that don't qualify for an early withdrawal exemption.

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Tax-Deferred and Tax-Advantaged Products

All contributions into specific products that provide tax deferral are made with after-tax dollars and are then subject to taxes once distributed or sold. These products do not have contribution limits, but they have to meet certain requirements in order to retain tax deferral status. In addition, each product has different tax treatment for withdrawals and inheritance.

Vehicle	Taxation of Sale/Withdrawal	Partial Withdrawal Treatment	Taxation at Death
Deferred Annuities	Income	first in/last out (FILO)	Taxes on gains
Life Insurance	Income	last in/first out (LIFO)	No federal tax; inheritance tax in certain states
Tax Advantaged			
Municipal Bonds	Capital gains	N/A	Step-up in basis

Not FDIC Insured | May Lose Value | No Bank Guarantee

Deferred Annuities

Deferred annuities come in various forms and some have additional benefits that can provide income or principal guarantees or a death benefit that can play an important role in deciding whether a contract is right for a specific investor's situation. Benefits depend on the claim-paying ability of the insurance company; some benefits add fees or expenses. Variable annuities (VAs) may be of particular interest because they provide for investments that have performance corresponding to that of underlying mutual funds. Direct investment in mutual funds subjects investors to certain tax liabilities passed through to investors from the mutual fund, so the tax deferral feature of VAs can be useful for strategies that carry a high annual tax bill. There is a broad array of products suited to different investor needs, including those looking specifically for tax deferral. When considering later income needs, many annuities offer the benefit of annuitization, which allows the investor to take payments from the insurance company in exchange for all or part of the cash value. Lifetime annuities receive special tax treatment, as a portion of each payment is returned as principal and is therefore not subject to federal income tax. This differs from the treatment of regular withdrawals, where gains come out before principal.

Life Insurance

Life insurance policies may not allow withdrawals and, if they do, the withdrawals will reduce the death benefit. Loans taken against the accumulated cash value are not taxed but reduce the death benefit. Nevertheless, these products are very useful for estate planning and provide tax deferral for those who are interested in leaving a legacy.

Municipal Bonds

Municipal bonds and mutual funds that invest in these bonds are generally free from regular federal income taxes and state-specific bonds are generally also state tax-free for investors living within the state of issue. These instruments are subject to unique tax rules that must be taken into account. Tax-free bonds fill a narrow niche but are useful for investors in a high tax bracket.

RED FLAG: TAX-DEFERRED VEHICLES WITHIN TAX-DEFERRED ACCOUNTS

Annuities benefit from tax deferral, yet they are often components of employer-sponsored plans and can be used within IRAs. Why would an investor want to invest in a product that provides tax deferral within an account that does as well?

There are valid reasons to use an annuity within a retirement account, but the issue of potentially "doubling up" on tax deferral has been coming under greater scrutiny. The Department of Labor's recent conflict of interest rule (the DOL rule, for short) highlights the suitability of products, and "doubling up" is a red flag issue. If tax deferral is the sole reason that an investor is selecting an annuity, then there is no rationale to use it within a qualified tax deferral account. There are variable annuity policies designed specifically to suit investors who are primarily interested in tax deferral, offering lower fees and limited extra benefits.

The main reason that investors would want to select an annuity within a qualified plan is to take advantage of certain key benefits, typically either guaranteed income or guarantees against loss of principal. These are available both in fixed and variable annuities and can come in various forms. Investors might also want to use an unconventional annuity that does not itself offer tax deferral. For example, contracts that invest in individual securities such as exchange-traded funds (ETFs) are no longer qualified for tax deferral but provide a specific combination of investment options and features.

EDUCATION SAVINGS PLANS

Education savings plans offer tax advantages for investors who plan on paying education expenses for family members or themselves. Contributions to such plans are made with after-tax funds. The tax savings mainly come from no federal income taxes on income and gains prior to withdrawals and then federal tax-free withdrawals for qualified education expenses. The rules for each type of account vary, so it's important to be aware of them when considering whether a given account is appropriate for an investor's specific circumstances.

For example, Coverdell Education Savings Accounts have age restrictions that affect contributions and withdrawals. Contributions cannot be made once the beneficiary reaches age 18. An excise tax of 6% can apply to contributions made in excess of the annual limit. Withdrawals must occur when the beneficiary reaches age 30 to avoid additional taxes and penalties.

	Federal Income Tax-Free Qualified Withdrawals for…*		Tax Exemption on Contributions			
Savings Plan	Primary, Secondary School	College	Federal	State	Contribution Limits by Income	Contribution Limits
529 Plan	yes, up to $10,000 per year for tuition expenses only[1]	yes	no	some[2]	no	overall plan limits apply
Coverdell Education Savings Account	yes	yes	no	no	yes	$2,000 annually

*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.

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Franklin Templeton Distributors, Inc.
One Franklin Parkway
San Mateo, CA 94403-1906
(800) DIAL BEN® / 342-5236
franklintempleton.com

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