TAX ADVANTAGED ACCOUNTS

CHAPTER 10

WHAT IS MY BEST ADVANTAGE TODAY?

ACTION

Act like an Invest-OR, open a Roth account and grow your investments – tax free!

OVERVIEW

10.1: How to Prune Your Tax Tree

10.2: Types of Investment Accounts

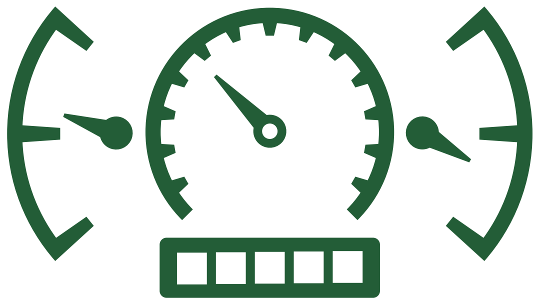
10.3: Your Best Investment Vehicle: Roth Account

DRIVING YOUR MONEY VEHICLE

Once you finish reading your driver's manual, you start to think about what makes your car so great—its sunroof, its racing stripe, the dice that hang from its mirror…What's truly great about your car is that you have autonomy over it, not to mention the time to get where you want to go. But you are probably wondering if you can upgrade Your Money Vehicle to get even more mileage out of it, this leads us to the option of a Hybrid!

SECTION 10.1

HOW TO PRUNE YOUR TAX TREE



TERMS

SECURITIES INVESTOR PROTECTION CORPORATION (SIPC): the insurance provider for money in your brokerage account. Like the FDIC with banks, the SIPC will cover up to $500,000 ($250,000 in cash).

401(K): an employer sponsored 'defined contribution' personal pension account that is provided by a company you work for as a W2 employee, with a tax advantage for retirement savings.

DEFINED CONTRIBUTION: an account where contributions are made regularly by employer and employee, with a limit of how much you can contribute.

INDIVIDUAL RETIREMENT ACCOUNT (IRA): an individually owned defined contribution personal pension account that provides a tax advantage for retirement savings.

ROTH IRA: a type of IRA allowing after-tax savings up to a specified amount, where the contributions and earnings can be withdrawn tax-free after age 59.5.

ROLLOVER IRA: a type of IRA that allows you to move money from a former employer sponsored plan (401k) into an IRA.

TAX ADVANTAGE: an economic bonus to certain accounts or investments that can reduce your taxes, defer your taxes, or grow without taxes.

TAX DEFERRED: a type of tax advantage that allows you to delay paying taxes until later.

TAX FREE: a type of tax advantage that allows you to grow after-tax dollars tax-free

Think about how far you have come and all that you have learned. To connect the dots and take our final action Money Vehicle wants to introduce you to three types of investment accounts: Brokerage accounts, 401(k) or IRA accounts, and Roth accounts. We will want you to see the advantages and disadvantages of each type of account and to do that we are going to have to get a little dirty.

THE MONEY TREE EXPO: TAX ADVANTAGED INVESTMENT ACCOUNTS

The annual Expo for Money Trees is only a few weeks away, and you know you have three baby trees that could be in the running for 'Biggest Tree of the Year'!

You grab a shovel and head out to plant the young trees in the optimal place in your backyard. But just before you start digging, you think to yourself, "My goal is to grow the biggest tree I can, I wonder how each tree would grow if I treated each differently?"

1 2 3

You decide to conduct an experiment in which you trim each plant differently and even let them grow in different types of soil. The three different methods are:

Tree One: This will be your base case and grown the traditional way you usually grow a tree. Before putting Tree One in the ground, you trim it into what you hope are the ideal growing dimensions. Then you plant it in normal soil and let it grow.

On the day of the Tree Expo, you will trim it again to give it the best vertical frame just before the judges come to measure it.

Tree Two: This is where you begin to explore—how big would the plant get if you didn't trim it at all before you plant it in the ground? You take Tree Two and get it in the ground without trimming it into ideal growing dimensions, then sit back and let it grow.

On the day of the Tree Expo, you know that you will need to trim it quite a bit to give it the best vertical frame you can.

Tree Three: With two trees planted in the normal soil, you feel like you can try something new with Tree Three. This is where you will try out a secret soil called 'Roth Advantage' soil. The secret to the Roth Advantage soil is that once your tree is trimmed and placed in this special soil, you will never have to trim it again no matter how big it gets. Knowing this, you trim Tree Three today, pack some Roth Advantage soil around it, and let it grow.

On the day of the Tree Expo, you will NOT need to trim anything as your tree will already be in the best vertical frame you can.

ARE WE GOING TO TALK ABOUT INVESTMENT ACCOUNTS AND NOT TREES?

Fine! Let's move into how these three trees translate from a garden to your plan.

The three trees represent three different types of investment account with three different ways they are taxed. Let's discuss the types of accounts first.

BROKERAGE

We introduced brokerage accounts in chapter 6, but to refresh a brokerage account is a type of investment account that allows you to buy and sell (or broker) securities such as stocks, bonds, mutual funds, and index funds. Brokerage accounts can be opened by individuals or legal entities and are provided by a 'Brokerage Firm' which acts as an intermediary between the investor (you) and the investment (market).

Brokerage accounts can come with services such as research or analysis tools, some investment guidance, or other planning services such as a cash management tool. But be prepared as the more services available, the more fees will be available as well. There can be fees for trades, account maintenance, transfers, and even for the actual investment you are investing in.

These accounts will follow the rules set by the Financial Industry Regulatory Authority (FINRA) and are governed by the Securities and Exchange Commission (SEC). Where the FDIC insures money in your bank account, money in your brokerage account will be insured by **SECURITIES INVESTOR PROTECTION CORPORATION (SIPC).**

401(K)

The 401(K) account was introduced in 1978[41] and is named after the subsection 401(k) that the rule falls under in the U.S. Internal Revenue Code or tax laws. Put in Money Vehicle terms, the account got its name from the rule that made it. A 401(k) is an employer sponsored, **DEFINED CONTRIBUTION**, personal pension account. Put in Money Vehicle terms, this account will be connected to your job or employer. While it is your account, you have access to it because you are an employee of a specific company. There is a defined contribution or set maximum amount you can put into the account each year, in 2023 that maximum amount is $22,500.

$22,500

401(K) MAXIMUM CONTRIBUTION FOR 2023

While your employer will be the 'Plan Sponsor' and owner of the account, typically they will hire a 'third-party administrator (TPA) to manage the accounts. These third parties will make sure all 401(k) rules are being followed and support each employee as they invest for their retirement. The fees for a 401(k) plan can be paid by your employer, by you, or by both. These third-party administrators will be governed by the Employee Benefits Security Administration within the US Department of Labor.

WHY ARE COMPANIES CLOSING PENSIONS AND OPENING 401(K) ACCOUNTS?

Why it is called a 'personal pension' is because back in Chapter 1 we discussed how the pension system was going away, well this is the new form of retirement planning that companies are moving toward. This also has to do with the lessons we learned in Chapter 6 around risk and diversification. With a pension plan, your company is responsible for every employee's retirement. Pensions are designed to be a fixed income for life, but what we learned in Chapter 6 is that investments are anything but fixed. Moving to the 401(k) account allows companies to offload the risk of your retirement from their responsibility onto your responsibility. You are driving Your Money Vehicle and this transition from pensions to 401(k) is a clear message that your company is not in the driver seat anymore.

CHAPTER 1 RULE:

YOU ARE DRIVING!

INDIVIDUAL RETIREMENT ACCOUNT (IRA):

The **INDIVIDUAL RETIREMENT ACCOUNT (IRA)** is intentionally named because it represents an individual's plan to retire. Unlike the 401(k) where you must be an employee of a company to participate, the IRA is available for anyone to open and use. It does act as a personal pension as the account holds investments targeted for an individual's eventual benefit in old age or retirement. Like the 401(k), the IRA is also a defined contribution or set maximum amount you can put into the account each year, in 2023 that maximum amount is $6,500.

There should not be many fees associated with opening this account, but some companies will charge a management or custodial fee. Since this account is not connected to your employer, there is only one real requirement, you must have an earned income. This allows for great flexibility in both what you invest in as well as this account staying with you no matter where you decide to work, many entrepreneurs begin their retirement planning with an IRA.

$6,500

IRA MAXIMUM CONTRIBUTION FOR 2023

ROTH IRA

WHAT IS THE DIFFERENCE BETWEEN 401(K) AND IRA?

ROTH IRAs are still IRAs, so all the requirements and contribution limits stay the same. The real difference is in how these two accounts are taxed and that is what we will discover as we progress through the rest of this chapter.

401 (K)	You work at a company and even though it is my account and money, the 401(k) is setup through your employer. The employer will control what you can invest in and who is managing the account. If you are to leave that company you would most likely need to transfer your funs to an IRA, called a **ROLLOVER IRA**.
IRA	You work for yourself or want an account that is not connected to your company. In an IRA there is no one telling you what to invest in or helping you manage the account, that is all on the 'Individual'.

THE MONEY TREE EXPO: TAX ADVANTAGED INVESTMENT ACCOUNTS CONTINUED:

How you treat the three trees can also explain how the three types of investment accounts will be taxed. Instead of the judge coming to measure the trees, you are measuring how well you U.S.E. your money, and instead of trimming the trees, you are trimming your income or paying taxes on your money.

Tree One (Taxable Account: Brokerage): The usual way to handle a tree and the first investment account format. With Tree 1, we trimmed the tree before we put it in the ground and then again before the judges measured it.

In a brokerage account, you will tax your earned income before you put it into the account and then down the road when you want to use the dollars, you will tax them again. First is income tax and later is capital gains tax.

Tree Two (Tax Deferred Account: 401(k) or IRA): With Tree 2, you wanted to see how big the tree could grow before you trimmed it, so you did not trim it at first, putting it straight into the ground. Then, as the tree grew larger, you had to trim even more when the judge came to measure.

In a **TAX DEFERRED** account you get to place your earned income directly into the account before it is taxed. This is why it is a **TAX ADVANGTAGED** account; you do not pay income taxes before you deposit the money. Then as the account grows and you want to use the dollars later in life, you will have to pay income taxes then. The idea is that your income tax bracket in retirement will be much lower than your income tax bracket today.

Tree Three (Tax Free Account: Roth): With Tree 3, you used the secret soil, trimming the tree and then putting it into this special Roth Soil. But then you did not have to trim the tree again when the judge came to measure.

In a **TAX FREE** account you contribute dollars after you pay income tax on them, but then as the account grows you will not be taxed on the growth of your dollars. This is why it is a tax advantaged account; you do not have to pay taxes on the growth of your money, no matter how big the account gets.

You quickly see that Tree One is not the biggest, because you are trimming it—or paying taxes on it—twice, and there is no advantage to that. You only had to trim Tree Two and Tree Three once, making them tax advantaged accounts. Which tree ends up being the biggest? We will find out in Section 10.2.

SECTION 10.1

RECAP

1. BROKERAGE ACCOUNTS ARE TAXABLE ACCOUNTS MEANING YOU ARE TAXED WHEN YOU PUT MONEY IN AND WHEN YOU TAKE MONEY OUT.

2. 401K/IRA ACCOUNTS ARE TAX DEFERRED ACCOUNTS MEANING YOU ARE NOT TAXED WHEN YOU PUT MONEY IN, INSTEAD YOU ARE TAXED LATER WHEN YOU TAKE MONEY OUT.

3. ROTH ACCOUNTS ARE TAX FREE ACCOUNTS MEANING YOU ARE TAXED WHEN YOU PUT MONEY IN BUT NEVER AGAIN.