Trains, Tickets, and Taxes: All Aboard!

Imagine that there are four people in line to purchase tickets at the train station. One after the other, they each purchase one ticket of the same class, on the same train, bound for the same destination. As they board, they take their seats next to each other and after exchanging pleasantries they begin to compare the price of their tickets. They are shocked to discover that they had all paid a different price for what was essentially the same ticket, and none could have realized their own situation without having compared it to the others. Their tickets, all identical, each carried a different total cost to reach the same destination.

Prudence would dictate that you would want the lowest cost if available. However, I can guarantee you that the punch-line hits pretty hard for the person who paid the most for their ticket, and they won't be laughing. Neither will you if you are unfortunate enough to be caught in the same situation when it is time to pay the taxes that have accrued on your investment accounts.

Buying the Right Ticket

Most people are aware that their investment dollars will grow over time through the power of compound interest. They will either appreciate or depreciate and over time experience both. While attention to gains takes center stage the increasing tax liability on those gains often goes unnoticed. The way you choose to handle this tax liability can have a significant impact on the price of your ticket to be on the investment train. Your tax liability will determine one of the costs you will pay for your ticket. By the time you determine you paid too much it is usually to late.

Rolling earnings into the same taxable account increases the account value and the tax liability. Your partner the federal government is excited about your gains and looking forward to their share of your profits. There are three options to help reduce the tax tax liability on these type of accounts.

1. **Flat Tax Strategy: :** Move only the earnings. The problem is not the investment account but how the government taxes the account. Keep the principal in the taxable account, earn the interest, and pay the tax on the gain. Move the after tax gain to a tax favored account where those dollars can compound interest uninterrupted by taxes.
2. **Immediate Paydown Reducing tax strategy**: Move the entire taxable account to an account that compounds interest with not tax on the gains. While this option does have a positive impact on your tax liability it will probably impact your access to the money. You will need to weigh the benefits of each option before choosing this strategy.
3. **Reduce account over a period of years:** Take a portion of the principal and interest and move it into tax favored account over a period of years that best suits your financial circumstances. The taxable account decreases in value with every withdrawal and the tax favored account the dollars are deposited to continues to grow tax deferred and withdrawn tax free.

What is important to understand is that regardless of which method you choose, the account balance is going to be the same at the end. The only difference will be the cost associated with accumulating that balance along the way. As Benjamin Franklin once remarked: “In this world nothing can be said to be certain, except death and taxes.” We are all going to have to ride this train, but that doesn't mean we should pay more than we have to for the ticket. The issue is to determine which option best suits how you would like to solve the problem of compounding interest in taxable accounts.