Principle 8: Minimize Taxes

[Applause]

Jim Dahle: Thank you Alan. Now the moment you've all been waiting for. It's my last introduction today. Mike Piper is the secretary of the Bogle Center. He is a licensed accountant in Colorado. He's not licensed to do anything in Chicago so no asking personal questions to him afterward. He is the creator of an extremely successful investing blog and that was actually the inspiration, one of the Inspirations for my blog. He's been doing that for a long time--decade and a half or more.

He is also the creator of the best Social Security tool on the web. He's the author of--did I get this right--is it 11 financial books. He doesn't know even. That's how many, he's lost track.

He's a top-rated speaker at conferences. He's been the top-rated speaker in my conference before, and he has over 4,000 posts on the Bogleheads forum. And the truth is, despite being the smartest person on the stage today, he is also the most humble person. So Mike Piper, come on up.

[Applause]

Mike Piper: If I start wandering, because that's my natural inclination, please somebody in the front row just tell me to come back to the mic, please.

So today I get to talk to you about minimizing taxes, and there are a ton of things you can do to try to minimize your taxes, of course. But since we have a limited time we're going to talk about the two most important things you can do that are investing related. And those are to max out your retirement accounts if you have enough cash flow to do that every year. And when you're investing in taxable accounts--so when you're investing outside of a retirement account, make sure to use tax efficient mutual funds.

So starting with the first one, the idea here is basically every year make the maximum contribution to a Roth IRA if your income is such that you are allowed to contribute to your Roth IRA. If your income is too high then look into the backdoor method for making Roth IRA contributions. And if your employer offers, say 401-k,

403-b etc., to generally make the maximum contribution to that plan as well if you have enough cash flow to do that.

Now why is this a good idea? Why did this make it onto the list of Bogleheads principles? It's because taxable accounts--so things that aren't retirement accounts they incur tax drag every year. Meaning that you have to pay tax on the interest that you earn; you have to pay tax on the dividends that you earn; and you have to pay tax when you sell something for a capital gain. So the net result is that taxable accounts have a lower rate of return. They compound more slowly than retirement accounts.

And as we know from talking about mutual fund expense ratios, even a small difference in the annual rate of return makes a huge difference in the ending value when you compound that return over many, many years.

So the idea here, you just max out retirement accounts because they don't have tax drag. They grow more quickly because you get to actually receive the full rate of return every year that your Investments are providing.

And a question that often comes up is what about people who are planning to retire before 59 and a half, right. If you're planning on retiring before 59 and a half, people often ask should I still be contributing to my retirement accounts because there's that rule where you might have to pay a 10% penalty if you take money out early.

And the answer, overwhelmingly, and almost every case that I've looked at is yes, it still makes sense to max out those accounts. And there's two reasons. Reason number one is that if you're planning on retiring early you have to save a lot of money every year, right. If you're planning on retiring at, let's say age 50, well the earlier you retire the longer your retirement is going to be, obviously. And so that means you need to accumulate a larger sum. And the earlier you retire the fewer the number of years that you have to accumulate that sum. So really, the only way to do it is by saving a whole lot every year, and in most cases it actually means saving more than the contribution limits.

So you're saving enough to max out a Roth IRA, max out your 401-k and then still

invest more in a taxable account. So you're maxing out those retirement accounts and still accumulating some money in a taxable account that you'll have access to before age 59 and a half, without having to jump through any hoops.

And the second reason that it still makes sense to max out retirement accounts is that money in retirement accounts isn't as inaccessible as people often think that it is before 59 and a half. Because number one, with Roth IRAs any money that you put right into the account, any contributions that you make to the account, you can take that money back out tax-free and penalty free at any time. Somebody who's 24 could contribute to a Roth IRA. Three months later need the money. They can take it out no tax, no penalty.

Similarly with the Roth 401-k after you separate from service. So after you leave that employer you can roll that money into a Roth IRA and then anything that you had contributed to the Roth 401-k now basically counts as a Roth IRA contribution so you're allowed to take it back out tax-free and penalty free even if you're younger than 59.

And then we have the age 55 rule. This is the way this works--is if you leave an employer in a year in which you turn 55 or older. Then from that point forward you can take money out of the 401-k or 403-b with that employer without having to pay the 10% penalty. So basically instead of 59 and a half, now it's age 55. So you can access the money penalty free a little bit sooner.

And then we also have the series of substantially equal periodic payments rule--which is a mouthful--so people often just call the 72t rule because that's the part of our tax code that it comes from.

And the way that rule works is it basically says that if you take money out of a retirement account and it's a certain percentage that's based on your life expectancy and you keep taking these distributions for a certain length of time, then they won't be subject to the 10% tax even though you're younger than 59 and a half. And there's some complicated rules that go along with that so you know if you're considering using that, make sure to do your research or work with a tax professional. But the point is it's another way that you can access this money before 59 and a half without paying a 10% penalty and without needing something bad to happen to you. You don't have to become disabled.

So thing number one that you can do to minimize your taxes is to max out those retirement accounts. The second thing you can do is when you're investing in taxable accounts make sure to use tax efficient mutual funds. The idea here is after you have decided your asset allocation-- then so you've decided, you know for instance, you want this much in US stocks and this much in international stocks and this much in bonds---then take some time to think about what should go where, right.

Which funds should go in which accounts and we call that asset location as opposed to asset allocation. And the idea, very briefly, is just to make sure to use tax efficient funds in taxable accounts.

And there's a number of things that you can look for that would make a mutual fund tax efficient. Number one is you can look for low portfolio turnover.Portfolio turnover is exactly what it sounds like. It's just turnover within the mutual fund's portfolio. So when the mutual fund buys and sells stuff that's portfolio turnover. And the reason that's relevant from a tax point of view is that if you own shares of a mutual fund in a taxable brokerage account and the mutual fund sells something from the portfolio and it sells it for a gain you have to pay tax on your share of that gain. So even though you didn't sell anything you're still paying a capital gains tax.

So it's the turnover, it's creating what we call capital gain distributions that you have to pay tax on. And the higher the rate of turnover the more capital gains distributions you're going to have to pay tax on. And a higher rate of turnover also generally means that it's more likely that the capital gains will be short-term capital gains because the fund held whatever it is that it sold, it held it for one year or less. Which means it's a short-term gain which has a higher tax rate. So high turnover creates high tax costs.

So examples. Here's something that's very tax efficient--- s a total stock market index fund, right. Because that's a strategy where the whole idea is just buy everything and hold it. So it doesn't take hardly any selling at all so there's very little turnover and that makes it tax efficient.

And at the tax inefficient end of the spectrum we have actively managed funds with really high rates of turnover. It's going to create a lot of capital gains that you have to pay tax on.

Now when we move to the bond side of the portfolio the general rule is that safer bonds have lower yields, which means there's less tax, that makes it more tax efficient. That's just multiplication, right. The less income something pays the less tax you have to pay. So safer bonds lower yield, more tax efficient.

And so when we talk about duration, shorter term bonds are generally more tax efficient than longer term bonds because they pay a shorter term balance. Being safer, pay a lower rate of interest, so that generally makes them more tax efficient. And when we talk about credit quality bonds with better credit ratings pay lower yields and that makes them more tax efficient as well. So junk bonds, high yield bonds, they're tax inefficient because they pay a lot of income and it's fully taxable as ordinary income.

And on the tax efficient end of the spectrum with regard to bonds we've got treasury bonds which are particularly tax efficient because they're high credit rating means they have relatively low yields, so low tax costs. And the other thing that's applicable with treasury bonds is that they're exempt from state income tax. And so if you live in a state with income tax, or especially one with a high tax rate, that makes treasury bonds even more tax efficient.

And then lastly we have muni bonds, which are bonds issued by state and local government entities. And they are completely exempt from federal income tax and in many cases they're exempt from state income tax as well if you buy muni bonds from within your own state. That's why you see state-specific tax exempt bond funds. That's the idea you can buy bonds that are then going to be exempt from state and federal income tax.

Now when we're choosing between owning stocks or bonds in a taxable brokerage account we have to figure out which one's more tax efficient. One relevant point is that qualified dividends and long-term capital gains are taxed at lower tax rates than ordinary bond interest income. So that's a point in favor of stocks being more tax efficient.

But we also have to think about how much income something pays in the first place, right, because even if you have to pay a high tax rate, if there's very little income there's not going to be much tax.

So the lower that interest rates are relative to-- sorry relative to bond yields--- the more tax efficient bonds become relative to stocks, so it's something that shifts over time.

So just to summarize. On the tax efficient end of the spectrum we have things like total stock market index funds they're tax efficient because they have very little turnover. Treasury bonds are tax efficient because they're high credit rating means that they have relatively lower yields which means less taxes and they're exempt from state income tax. Muni bonds are exempt from federal income tax and in some cases state income tax if you buy ones from within your own state. And shorter term bonds are more tax efficient than longer term bonds because they're safer and therefore usually have a lower yield.

And then on the tax inefficient end we've got actively managed stock funds that high rate of turnover means more capital gains distributions that you have to pay tax on. High yield bonds are extremely tax inefficient. They pay a high level of income and that income is fully taxable at ordinary income tax rates. So high yield bonds, junk bonds, they are tax inefficient.

And lastly we have all-in-one funds, that's things like Target date funds and LifeStrategy funds--and we haven't talked about that yet because that's actually our next topic.

So the two most important things you can do to minimize taxes when it comes to investing is simply max out your retirement accounts if you have enough cash flow to do that every year, and when you're investing in a taxable account, make sure to use tax efficient mutual funds.