



HARRISON LAZARUS ADVISORS
GIVING LIFE TO YOUR FINANCES™

Chapter 3 – Tax Deferred Investing

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The road to financial success begins by learning from the past, living in the present, and planning for the future. By funding a tax deferred account, such as an individual retirement account (IRA), 401(k), 403(b), defined benefit, Keogh or other similar retirement account, you can accomplish those goals. Let me explain...

Learning from the past

If you knew what you know now, wouldn't you have invested early in Microsoft? If you had, you could be retired by now, but it's not so much what you invest in, rather than it's the power of compounding. Einstein once said the most powerful force in the universe is compounding. For example, if you start with 1 penny and double it every day for 30 days, you will have over 1 billion pennies (or \$10 million) by next month (see following chart).

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Power of Compounding

Day

Amount

1	\$0.02
2	\$0.04
3	\$0.08
4	\$0.16
5	\$0.32
6	\$0.64
7	\$1.28
8	\$2.56
9	\$5.12
10	\$10.24
11	\$20.48
12	\$40.96
13	\$81.92
14	\$163.84
15	\$327.68
16	\$655.36
17	\$1,310.72
18	\$2,621.44
19	\$5,242.88
20	\$10,485.76
21	\$20,971.52
22	\$41,943.04
23	\$83,886.08
24	\$167,772.16
25	\$335,544.32
26	\$671,088.64
27	\$1,342,177.28
28	\$2,684,354.56

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29	\$5,368,709.12
30	\$10,737,418.24

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However, based on market history, it is unrealistic to expect your money to double every day or even every year. History has shown, though, that with consistent and frequent contributions to an investment causes it to grow substantially over 10, 20, or 30 years, and what you can expect is to realistically accumulate substantial wealth.

Living in the present

By making consistent and frequent contributions, you also see a benefit in the present. Some of the benefits include:

1. Growing assets tax-free and in some cases, withdrawing the assets tax-free.
2. Reducing your taxable income.
3. Obtaining up to a \$2,000 tax credit for your contributions.
4. Worrying less about having more money when you turn 59 ½.

In regards to the first benefit, take a look at the following chart.

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Value of IRA Investing

<u>Year</u>	<u>Non-Taxable IRA Account Balance</u>	<u>Taxable Non-IRA Account Balance</u>	<u>Non-Taxable vs. Taxable Difference</u>
1	\$6,000.00	\$6,000.00	\$-
2	\$12,432.00	\$12,280.80	\$151.20
3	\$19,327.10	\$18,855.54	\$471.56
4	\$26,718.66	\$25,737.98	\$980.67
5	\$34,642.40	\$32,942.52	\$1,699.88
6	\$43,136.65	\$40,484.23	\$2,652.42
7	\$52,242.49	\$48,378.89	\$3,863.60
8	\$62,003.95	\$56,643.02	\$5,360.93
9	\$72,468.23	\$65,293.92	\$7,174.32
10	\$83,685.95	\$74,349.67	\$9,336.28
11	\$95,711.33	\$83,829.24	\$11,882.10
12	\$108,602.55	\$93,752.44	\$14,850.11
13	\$122,421.93	\$104,140.06	\$18,281.88
14	\$137,236.31	\$115,013.81	\$22,222.50
15	\$153,117.33	\$126,396.46	\$26,720.87
16	\$170,141.78	\$138,311.81	\$31,829.96
17	\$188,391.98	\$150,784.81	\$37,607.18
18	\$207,956.21	\$163,841.54	\$44,114.67
19	\$228,929.05	\$177,509.32	\$51,419.74
20	\$251,411.95	\$191,816.76	\$59,595.19
21	\$275,513.61	\$206,793.78	\$68,719.83
22	\$301,350.59	\$222,471.73	\$78,878.86
23	\$329,047.83	\$238,883.40	\$90,164.42
24	\$358,739.27	\$256,063.15	\$102,676.12
25	\$390,568.50	\$274,046.90	\$116,521.60
26	\$424,689.43	\$292,872.30	\$131,817.13
27	\$461,267.07	\$312,578.72	\$148,688.35
28	\$500,478.30	\$333,207.41	\$167,270.89
29	\$542,512.74	\$354,801.51	\$187,711.22
30	\$587,573.65	\$377,406.22	\$210,167.43

Assumptions:

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- 1 Contribution is \$4,000 per year
- 2 Rate of return 7.2% per year
- 3 Federal and state tax rate 20% per year

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This spreadsheet tracks the growth of \$6,000 per year contributions over 30 years, earning 7.2% per year. The difference between the non-taxable account and the taxable account is the federal and state tax rate of 20%. This level of tax quickly devours whatever gains your account has earned, but they are only applicable to the taxable account. At the beginning, it doesn't make much of a difference, but notice at the end of 30 years, the non-taxable account is worth almost \$600,000, and the taxable account is worth less than \$400,000. Taxes eat into over half of the taxable account. Which would you prefer?

The government allows you to deduct most contributions to a tax deferred account. This is where reducing your taxable income is useful. If you contribute \$6,000 to one of these plans, and your combined federal and state tax rate is 20%, then you can reduce your taxes by \$1,200. In other words, you only need to spend \$5,000 of your money to save \$6,000...now that's a good, good deal!

The third benefit offer you up to a \$2,000 "Saver's Credit", another government benefit, which encourages you to put money into a non-taxable account. This applies to those earning \$50,000 or less, and if that's you, this is a strong incentive to put money into your non-taxable account.

For the fourth and final benefit, non-taxable account assets are generally available for withdrawal (without penalty) when you

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turn 59 ½ years old. For some of the non-taxable accounts, assets can be withdrawn tax-free.

Planning for the future

Here's the difficult part - which non-taxable account to invest your money in. There are so many choices: 401(k)s, 403(b)s, 529s, Traditional IRA's, Roth IRA's, Educational IRA's, SEP-IRA's, Simple IRA's.

The answer is to invest in as many as you can; start with the ones that give you the most in return. Typically, these are the employer-based tax-deductible plans that match your contributions, 401(k)s or 403(b)s. After that, contribute to any other employer or self-employed plans that allow tax-deductible contributions, such as SEP or Simple IRA's. Then, consider non-deductible plans, like Roth IRA's, 529's and/or Educational IRA's.

An additional reason to contribute to a plan that gives you the most in return is the fact that these types of assets (401(k)s, 403(b)s and IRAs) are not considered an asset for college financial aid purposes¹. This could qualify you for substantially

¹ If you have a child applying for college, always complete the Free Application for Federal Student Aid (FAFSA). This is available at <http://www.fafsa.ed.gov/FOTWWebApp/complete013.jsp>
Don't assume that you don't qualify, it's worth the effort because not only may you qualify for needs-based financial aid, you may also qualify for access to beneficial loans that are not needs-based.

more financial aid than if your contributions are directed toward other taxable assets, described below.

If you still have money to invest after contributing to all of the above accounts, here are some other investments to continue your tax deferred investing:

1. Annuities: These are contracts backed by an insurance company that allow your investment dollars to compound without taxation. Annuities carry higher annual operating costs, so the lower returns have to be weighed against the tax savings.
2. Federal Money Market or Bond Funds: These can be appropriate if you're in a low federal tax bracket (28% or less) and a high state tax bracket (5% or more).
3. State Money Market or Bond Funds: These can be appropriate if you're in a high federal tax bracket (28% or more) and a high state tax bracket (5% or more).
4. Municipal Money Market or Bond Funds: These can be appropriate if you're in a high federal tax bracket (28% or more) and in low state tax bracket (5% or less) or a State Money Market Fund is not available for your state.
5. Real Estate: The simplest way to approach real estate is to buy your own home. Over your lifetime, owning your own home will be less expensive than renting a comparable home. However, unlike other investments, real estate is unique in many ways:

- Livability – You can live in this investment

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- Limits – The percentage of earth available is not increasing but as the population increases, the use of it is. This natural demand increases the value of your real estate daily.
- Leverage – It is common practice when buying real estate that 80-90% of the money used for your purchase is borrowed. Thus, with only 10-20% of your own money, you can buy and control a much larger investment. We'll talk more about using someone else's money to enhance your finances in the next chapter, debt leverage.

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