

The Power of Tax Deferral

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Do you know the difference between people who are wealthy and people who are not? Of course, the obvious answer is that one group has more money.

The well-off may have acquired their original stake in any number of ways: inheritance, marriage, talent or simply hard work. However, through compounding (that is, reinvesting earnings to accumulate even more earnings), an initial sum of money may blossom, especially when tax-deferred financial products are considered.

Conversely, people who are struggling financially often find their situation exacerbated because they are on the wrong side of compound interest. In many cases, these people have to borrow heavily to acquire what most of us consider necessities: a car, a house or an education. In other cases, the lure of credit cards is overwhelming. Once you start the cycle of paying high interest — and interest on interest (compounding in the negative sense) — it is hard to reverse the process. As a general rule, the interest is not tax-deductible. This, combined with the fact that income earned on many investments is taxed currently, makes accumulating wealth difficult.

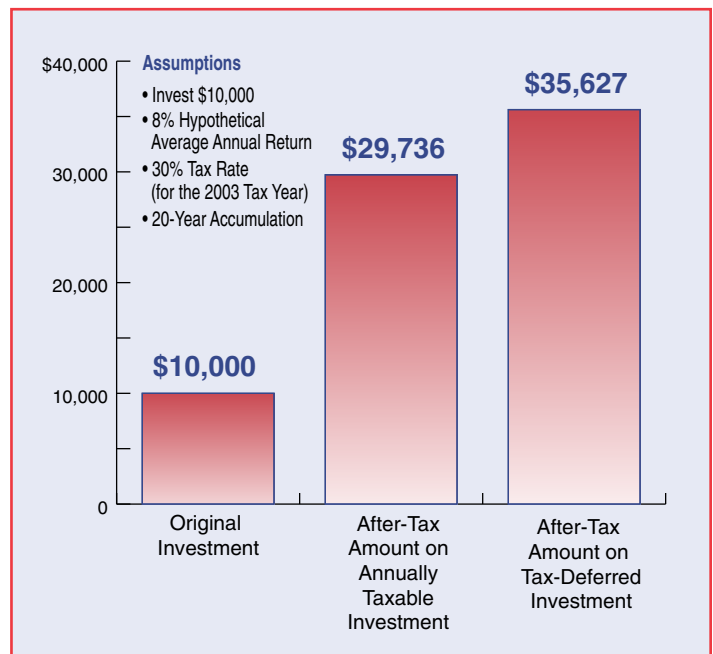
Let's focus for a minute on the idea of compounding in a tax-advantaged product. "Tax-deferred" means that money earned in a particular investment is not subject to income tax until it is withdrawn. Examples include IRAs, 401(k) retirement plans and deferred variable annuities. These products offer an excellent opportunity to help accumulate capital because they can cut your income tax liabilities today, so more of your money remains invested for tomorrow.

The accompanying chart demonstrates the advantages of compounding in a tax-deferred environment. Here, \$10,000 is set aside for 20 years earning a hypothetical 8% rate of return annually. In one investment, taxes are deferred until the money is withdrawn. In the other, taxes are paid annually based on a 30% income tax bracket.

Withdrawals of tax-deferred accumulations are subject to ordinary income tax. At the end of 20 years, even if all of the money was withdrawn from the tax-deferred product and taxed at the 30% tax rate, it would yield an additional \$5,891 or 30% more in earnings over the investment that was taxed annually in this illustration. That's the power of compounding in a product where taxes are deferred!

Of course, earnings withdrawn from tax-deferred products prior to age 59½ may be subject to a 10% federal tax penalty. Also, some tax-deferred vehicles (such as variable annuities) have insurance-related charges that taxable investments generally do not have.

Tax-free investments also may be important to your long-term financial strategy. "Tax-free" means that earnings from the financial product are exempt from federal, state and/or local income taxes. Municipal bonds and savings bonds are good examples of investments where earnings may be available to you on a tax-free basis.



Keep in mind that tax-free municipal bonds may be subject to the alternative minimum tax, and some tax-free investments are subject to state and local taxes.

Overall, you should develop a personal investment strategy that best suits your income tax bracket and investment goals. However, compounding, especially in a tax-advantaged investment, may help you reach those goals in a most effective way.

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