Financial Management Network, Inc.
Creating and Managing Wealth
26041 Acero, Mission Viejo, CA 92691
(949) 455-0300 Fax (949) 455-0303 www.fmncc.com

Pre-tax vs. After-tax Savings

You will often hear references in financial planning to pre-tax and after-tax savings. The basic differentiation is *when* you pay tax on money contributed to the account. Pre-tax accounts are retirement accounts that allow you to deduct the amount of the contribution from your taxes, either through a payroll deduction or through a deduction from your adjusted gross income on your taxes. In addition to a deduction on your taxes for the year of the contribution, the earnings on that contribution are tax-deferred until distribution. In contrast, an after-tax savings account (such as a bank savings account, CD, or an after-tax account at American Funds) will not be tax deductible, the earnings from interest and dividends will be taxed each year (you will receive a form 1099 with the amount of taxable earnings from the institution), and you will be taxed on capital gains upon distribution of the funds.

Benefits of pre-tax savings:

- Tax deferral allows you to build a larger savings for retirement.
- Deductions for pre-tax savings can help you qualify for tax credits.

Problems with pre-tax savings:

- Contribution limits apply.
- Distributions may be subject to higher tax rates based on tax levels at the time of distribution and your other income at the time of distribution.
- All income is taxed at income tax rates, even if it would normally be considered capital gains income.
- Distributions prior to age 59.5 are subject to penalties, if they are allowed at all.

Benefits of after-tax savings:

- There are no contribution limits.
- Withdrawals are subject only to the terms of the agreement with the financial institution, not to IRS regulations.
- Distributions are only taxed for capital gains, usually at lower rates than regular income tax.

Problems with after-tax savings:

- No tax deduction at the time of investment.
- Taxable income on interest and dividends for the life of the investment.
- Subject to capital gains taxes on distributions.

- Counted as assets when applying for financial aid for dependents.

Special after-tax accounts
A relatively new addition to the after-tax savings market are Roth retirement accounts, including the Roth IRA, and Roth 403(b). These are special after-tax accounts designed for retirement that enjoy substantial tax savings over traditional after-tax accounts, and in many cases will provide tax savings over traditional pre-tax accounts as well. These accounts have similar contribution limits to their traditional counterparts, but because contributions come from after-tax money, the entire distribution is tax free after age 59.5 or for a qualified event. Roth IRAs are also not subject to required minimum distributions and there is no age limit to when contributions can be made. For those who do not need the tax deduction of a pre-tax account, a Roth account is often the best choice for retirement.

Wycliffe Pre-Tax Options

- Lincoln 403(b)
- IRA

Wycliffe After-Tax Options

- American Funds after-tax account
- Lincoln non-qualified annuity
- Roth IRA
- Roth 403(b)