IFB259: All About Taxes and Different Vehicles You Can Use to Help Reduce Your Taxes

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Dave

0:00

All right, folks, welcome to investing for beginners podcast today we have episode 259. And today, Andrew and I thought we would talk about taxes. Yes, Everybody's favorite subject taxes. By the time this goes live, it will probably be closer to the middle of February and people will start receiving their W fours W tos and sort of getting ready for tax filing season everybody's favorite season.

So we thought this might be an appropriate conversation to just give everybody an overview, and help you prepare a little bit for your favorite friend paying taxes. So I guess the first question would be why, why do we need to talk about taxes? So Andrew, do you want to tell our good Westerners why we want to think about this,

Andrew

0:42

unfortunately, when you invest, you're gonna pay taxes, if you make money. So there's gonna be two ways, they will hit you on this, they're gonna hit you on any money you make, that's called capital gains, and they'll also hit you on any income you receive. So if that's like a dividend, for example, you'll have to pay taxes on the dividends.

Now, if you're saving for retirement, the government's given lots of tax exceptions. And those are the things that we try to get people to become aware of, so that you can save layers of taxes when you invest. That's awesome. So

Dave

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let's talk about capital gains, what are capital gains? And how can you I guess, avoid paying them if you have to?

Andrew

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Yeah, so I mean, the simplest way to think about it, if you buy a stock, and it goes from 20, and you sell at 25, that difference that you made between 20 to 25, that's your capital gain, that's, that would be $5. And so they're gonna tax you on that. And that's something that's going to be reported through your broker. So if you know you have Merrill Edge, or you got fidelity, they're gonna print out a form at the end of the year, send it to you, and then it's on the the sent to the IRS, and send any monies along with that if you owe anything.

So couple of things about the capital gains, I mean, in this conversation, we'll try to avoid using specific numbers and percentages. Because these things change over the years, even, you know, new presidents or Congress comes in, they might tweak these things. And also, if you're doing this stuff yourself, I think you owe it to yourself to double check your sources and not just go on the first thing you hear.

So with capital gains, if you hold a stock for less than a year, it's called a short term capital gain. And if you hold it for more than a year, it's a long term capital gain. And so the long term capital gain can be a lot less than the short term. And so if you can, it's better to hold stocks for at least a year, in order to get a better tax rate on the capital gains.

Dave

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So in essence, they use your your $5 analogy, but if you buy Company A for $20, and you sell it for 25, within a calendar year, you will pay a higher rate on that $5 than if you held it for 366 days as opposed to 364 days. So if I held that for, let's say three years, and I made $15, then I would pay a different rate, even though it's the same company, and I sold it three years later, I would pay a different rate on that $15 that I earned on the difference over the three year period. Yep,

Andrew

3:28

that's exactly it. Okay. Okay. That's,

Dave

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I think that's fairly straightforward. Alright. So I guess, what are some ways are there some vehicles that we could use to help us reduce the amount of taxes that we could owe by investing?

Andrew

3:42

There certainly are. So I will push it back to you which one would be your favorite and one that you think most people should use? If they can,

Dave

3:51

I think we're probably both bigger fans of retirement accounts. And when we talk about retirement accounts, we're we're in essence, referring to the two main ones. There are different kinds of retirement accounts depending on what your tax situation is, and who you work for, and how that all rolls in together.

But the main two, I guess, would be the Roth IRA, and the traditional IRA. And these are individual retirement accounts that you can use in again, the amounts that you can use to help you reduce taxes will change from year to year, the IRS does update them annually. Sometimes they do it every year, sometimes they do it every other year, just kind of depends. So it would be a good idea to every year to look and see what your allowed amounts are depending on your marriage situation and your employment situation. But the basic gist of them to make it easy for people to understand is a Roth IRA.

You pay your taxes now, so when I get my paycheck, I pay my taxes, and then when I invest that money, then I don't owe money on those taxes. I don't owe taxes on that money. At the end of my retirement, traditional, I don't pay the taxes now. And then I invest that money. And then when I start taking distributions or money out of that account at some point in the future, then I will owe Uncle Sam taxes on that money at that time.

That's the easiest way for me to think about them. But I know you have specific reasons why you like the Roth IRA. And we've talked about that before, but maybe you could refresh people's memories on that.

Andrew

5:27

Sure. Before I do break down the traditional IRA again, because it's it's very similar to people's 401k accounts. Yeah. So I mean, to me, when I used to be a W two worker for somebody else, I remember seeing how the 401k would affect my paycheck. So give us an example of like, how the 401k affects taxes. When you say pay taxes later, what does that mean? Exactly?

Dave

5:50

Yeah. All right, perfect. So I think the easiest way to think about that is, when you use a traditional IRA, you get a tax benefit on your paycheck every two weeks, or every week or a month, or however you get paid. And it works the same with the 401k. And what that means in numbers wise, just to make it easy, let's say that you earn $30,000 a year, and you set aside $5,000 a year to be taken directly from your paycheck into your traditional IRA.

That means that it reduces the amount of taxable income that you would have to pay taxes on for that calendar year. So instead of having to pay taxes on $30,000, you would pay taxes on $25,000, which, depending on what your tax bracket is, could save you quite a bit of money. And so that money is considered tax deferred. And so that $5,000, you've taken and put it into your traditional IRA, you have not paid taxes on that, because those taxes were not withdrawn from the $5,000 initially. And so the government is basically putting an IOU on that $5,000, at some point in the future, you will have to pay taxes on that.

Now, the trick is, is that the $5,000 that you set aside, it will grow in value, hopefully, and over time, you will have to pay taxes on that. But the tax bracket that you pay will be based on your retirement, not what it was when you earned it when you were 24 years old. So there could be a big difference, hopefully, in what your tax bracket is. So that it is something you have to I guess, to consider and think about. And whenever we're talking about taxes, I always like to say, Andrew and I are just giving you some guidance, and maybe some general information.

But if you really, really need to dive into this stuff, talk to a tax professional, because they're the people that will know this inside and out and can help you conclusively figure out what would be the best way to put it.

So I think does that help kind of explain the traditional, I guess maybe you could talk a little bit more about the the Roth IRA?

Andrew

7:57

Yep. So like you've said earlier, the, with the traditional, or traditional 401k, or traditional IRA, you're paying taxes later tax deferred the Roth IRA, you're paying taxes. Now, with the benefit there being when you take out in retirement, you don't have to pay taxes on that. And so that could give you a level of freedom, depending on how much money you've accumulated. So if you feel more comfortable in your, you know, financial situation, you don't feel like you want to take taxes. Now, that's definitely a way to go. It's kind of like a delay gratification thing.

But you know, there's arguments for doing one or the other, the main point is to do at least one of those, because those are serious tax savings that the government is offering to encourage people to take care of themselves. And it makes no sense to not take advantage of those. Nobody knows what the tax rates are going to be in 10 years, 20 years, 40 years, but shielding yourself from one layer of tax is going to leave you more money than if you don't use any tax shields at all. And this is all legal. This is all just above the board like things that the government wants us to take advantage of. So you might as well do it.

Dave

9:11

Exactly. That's why they put these different retirement accounts into place was to help encourage people to start investing for their retirement. One thing I wanted to kind of touch on a little bit and because you're the dividend King, can we talk a little bit about dividends and how they're treated tax wise with a Roth versus a traditional?

Andrew

9:29

Yep. So when they lump in that tax deferred idea, it's going to be any taxes on capital gains and dividends. So kind of like you're saying the IOU concept. If you're in a Roth IRA, remember you pay taxes on your income, you pay taxes first, you did not get to reduce the amount of taxes paid and reduce your taxable income. So the taxes on any dividends for the Roth you won't have any big As you've already paid taxes on the money you put into it,

Dave

10:02

in particular buying companies that pay dividends, which, obviously, we like, it would be more beneficial to hold it in a Roth IRA

Andrew

10:10

than a traditional, just as a general rule, not specifics as a general rule, but in my opinion, that's kind of like splitting hairs a little bit when you start to get into that situation. Because another thing about the Roth and the traditional is you have to pick one from year to year, you can't say I'm gonna put three grand in a traditional IRA and three grand in a Roth, you have to pick one or the other for that year.

And so you can't necessarily like, say, I'm gonna put my non dividend paying stocks here, my dividend paying stocks there, you can if you're talking about like a regular account that has no tax shield, but when it comes to the retirement accounts, it can get kind of tricky, but that's it.

Dave

10:53

I know that when you open a brokerage account, this is one of the first questions that they ask you is what kind of account you want to set up, whether it would be a traditional brokerage account, or whether it'd be one of the retirement accounts. And we strongly encourage you to learn more about these accounts and use either traditional Roth whichever works better for your retirement situation and tax situation, as opposed to just opening a brokerage account without any sort of other tax consequences or implications, that would probably not be the best choice. Initially,

Andrew

11:27

there's also an HSA? And I'll talk about that.

Dave

11:31

No, you could talk about that, because you know more about them than I do.

Andrew

11:36

Yeah, our buddy, Andy is a huge fan of HSAs. It is a way to pay for medical expenses, and also save money, tax deferred as well. So an HSA works similarly, where it can reduce the amount of taxable income. Going back to example, I can't remember what the numbers were was like 30, and 25. Yeah. So let's say you made 30 grand, and you were allowed to put five grand, and they just say, that will reduce your tax bracket down to the 25 Grand. And so it can be a great way, at the end of the year, if you're trying to reduce your taxes, you could put some extra Christmas bonus in your HSA.

And that reduces your tax liability, a few things that it's similar to retirement accounts where there's an early penalty if you take out early, so you want to familiarize yourself with those rules, whatever they are at the time you're trying to make a move. And also you have to have a very specific type of insurance in order to contribute to an HSA. So you have to have a high deductible insurance, whether that's through your work, or if you're self employed, it has to have a high deductible, and that definition changes. So you are taking a little bit of risk.

Rather than just having full coverage. Now you're adding like a high deductible, whether there's cheaper, and you are able to like why HSA actually invest in the stock market, just the same as all my other accounts. So you can make that grow pretty nicely. But there is a little bit of a risk that if something happens to you, now you have a high deductible, and you're having to pay that medical expense out of the pocket.

Dave

13:16

Yep, exactly. I use an HSA as well, I have one to pay my medical bills. And the nice thing about it is those are bills, I was already going to pay, I have to pay. And so by using an HSA, it helps me reduce my taxable income the same as it would as a traditional IRA. And so that's one of the nice benefits as well.

And if you're in a situation where you do have regular medical bills, that could be another easy way to reduce your taxable income, that, again, all government sanctioned, and it's very easy to use, you can get your own debit card, that's what I have me, I have mine through fidelity. And then they give me a specific debit card. And then that's what I use to pay my bills online.

And it makes it really easy. I just transfer the money into the HSA, and then I use the card to pay and while ah, you know, I get a tax break. So it works out slick. And I think I don't have a traditional but I do have a Roth

IRA and you can contribute to both During the same year. So I'm not sure about a traditional I don't know how that would work

Andrew

14:17

a traditional IRA. Yeah, yeah, for my understanding, it's like, HSA is a completely separate thing. So nice as a cool benefit. Yeah,

Dave

14:25

yeah, that is awesome. If you're getting older as the older person in the room, medical bills, unfortunately, are going to be something that we may all have to pay. And this might be a nice way to set yourself up because you can contribute every year to them. And I think the maximum amount right now is $7,000 or 7500. I don't remember specifically, but I mean, that could be a nice, that could be a nice chunk of change to set aside if you're anticipate having to pay those in the future. And it grows on the stock market. It does and it's nice. Alright, so we've talked about accounts we talked about why can we talk we can we Talking about some deductions, how can we utilize those to help reduce our taxable amount we owe for taxes?

Andrew

15:07

Yeah. So I guess, kind of going off that same assumption, I think that we're doing this whole episode of maybe you've never had to deal with paying taxes, or you're just not all that familiar. Hopefully, this clears up by really breaking down the basics. But the way you can do taxes is you can take a standard deduction, or you can itemize, which means you're taking your own individual deductions.

So just to use an example, the standard deduction is $12,000, let's say, and let's say you have 8000. In itemized deductions, you take the greater of the two. So we can talk about all the different itemized deductions and you basically just add it all up. And you see if did my itemized deductions exceed the standard deduction or not. So the biggest one probably is mortgage interest.

And the interest you pay on your mortgage can be itemized. So going back to that example, if I paid 20, grand and mortgage interest that's higher than the standard deduction, so I can deduct 20 grand of my taxable income, based on an itemized deduction.

Dave

16:19

Yeah, that's awesome. So these are things that it's obviously the more complicated your financial situation becomes, the more you'll probably have to track those things where if you're 24, and just out of school and don't have a lot of assets and things like that, then the standard deduction probably is the easier route to go, depending on what your financial situation is.

Andrew

16:41

I guess the next big one, especially with for investors is capital loss deductions. And it kind of goes to that whole tax harvesting idea. So do you want to explain tax harvesting?

Dave

16:55

Yeah, I'm not an expert on tax harvesting. But my understanding of the idea is that you sell your losers before the end of the year, so that you can report losses on your investments, which you can use as deductions when you file your taxes on an annual basis.

And there are, I think some of the robo advisors are really big into this, where they really try to, I guess, in essence, manipulate your portfolio to try to take advantage of potential losses to use to your gain to help you reduce your taxable income. And high income earners probably rely on us a lot as well, normal peasants, like myself, probably not so much. It's not really my area of expertise in investing. But especially after last year, not being the greatest year in the stock market.

This could be something that you can consider when you're thinking about whether you want to do a standard deduction or itemized depending on what your how bad your portfolio performed during the year and how much this could benefit you in the I guess, deduction department. Does that kind of cover it?

Andrew

18:02

Yeah, I actually, now that we say it out loud, I think you might be able to do a capital loss. And maybe it's not itemized. I'm not 100% Sure, don't quote me on it. But bottom line that's like one of those deductions you can take. I'm personally like, super against the idea of tax loss harvesting, when you talk about like solely doing it

to save taxes. Because if I bought apple, for example, and it just happened didn't happen to go my way this year.

Just because it's a loss doesn't mean I'm gonna sell it, you know, right, just to take the tax cut, like that makes no sense at all, because that's sure you might save on taxes, but that's still money that comes out of your pocket. So you know what I like $1 Bill to save the 25 cents, I could have been tax deduction, like that's the kind of the way I look at it,

Dave

18:49

picking up pennies in front of a steamroller kind of idea.

Andrew

18:52

But you know, there is a time and a place, I think, for tax loss harvesting. For example, I think we heard a couple of horror stories of people who made like millions of dollars in cryptocurrency, and then oops, I forgot to set aside some for taxes. And then all of a sudden, you have a huge tax liability. So you know, if you have investments in the stock market, rather than take on credit card debt, you could liquidate some of those, with the added benefit of saving a little bit on taxes, if those investments are down, and you didn't want them anyway.

So there is some benefit there. But I would caution, like, don't start making portfolio decisions based off of that, because there are rules, too. You can't just like sell a stock, take the deduction and then go back and that's also against the rules. So you don't want to use it as like an excuse to sell out if you're losers, but it can be a benefit depending on your personal situation at the time.

Dave

19:50

Were there any other deductions that we wanted to cover? Yeah, if

Andrew

19:53

you give to charity that can be itemized. So let's say you're like at 10 grand for your or mortgage interest, you could add another four grand, or three grand or something together over, let's say if it was a 12 grand, so you could add a little bit for charity or churches, and that will get you over the standard deduction.

Dave

20:14

Okay. Yeah, that sounds great. And you know, giving a course is amazing thing to do if you have the resources to do it for sure. Alright, so we've talked about retirement accounts, we've talked about why we've talked about maybe some of the deductions, what is the number one best way to avoid paying taxes or reduce your taxable impact on your investments?

Andrew

20:36

I mean, the egotists gotta go the OG, Warren Buffett himself, he says, The best way to not pay taxes is just buy and hold. So you know, we talked about capital gains taxes, you only have to pay those, if you sell the stock, if you continue to hold it, you're not paying capital gains every year, at least at the time of this recording, there's wisdom in it, but by not selling the stock, you're letting the value of it compound.

And that's compounding. And you're not having to pay taxes as that grows. And so that's a very powerful way to compound your wealth.

Dave

21:11

And that's really been the biggest way he has compounded his wealth is by investing in a company like Coca Cola back in the 60s, and holding it all these years and letting that just compound and compound and compound and it's you know, grown in value exponentially over that period of time, which kind of goes back to what you were talking about, where if you are trying to tax a harvest from part of your portfolio, you're also interrupting the potential compounding of that portfolio as well.

So for a Coca Cola, for example, or even using your example of Apple, you know, if you sell some of that, a portion of the apple to try to benefit in the short term on your taxes, you could be impacting the returns that you earn, and your overall wealth in the long term, because you just reduce that amount that is available to compound. Yep, yep. So buy and hold is probably would you say that's probably one of the best ways to reduce your taxable income or reduce the taxes you would pay on investments?

Andrew

22:11

Yeah, I mean, if there's one takeaway, I would say it's not one that's a type timeless, timeless concept.

Dave

22:18

Yep, it is. And that's what we've been trying to preach for five plus years now. So all right, so we've talked about all these now, how do you file? How do you file taxes?

Andrew

22:28

I guess you could kind of take two approaches. One thing, which I've always liked to do is just find somebody to do it for me. So you can usually find an accountant. And they can ask you the right questions and get the right statements and all that because I can't keep track of all the different forms that comes in my mailbox.

So you can easily hire somebody for like 150 bucks or 200 bucks or something, and they can do it for you. That's a really easy way to do it. I think even if you do do it, though, you still need to be aware of these basic concepts, because you do have to act accordingly. If you have 10, grand and dividends, make sure you're setting some money aside for taxes, and your accountant might not, you know, isn't behind your ear making sure you do that every time we get a dividend.

Dave

23:18

Yeah, exactly. My the way that I have done it previously, when I had a much simpler life was using TurboTax worked great for me, it was fairly easy to do. And it didn't require a lot of heavy lifting. And mentally for me, when your life becomes a little more complicated than it really depends on how much in control, you want to be the rates that they charge, I think were between around $30 to about $200 Depending on the complexity, and what exactly you want from them.

And it takes about it took me about an hour, hour and a half, I think the last time I filed with them. So it's not super, super long. And it's very easy to use. And they walk you through the differences between the standard deductions and the itemized deductions. And as long as you have all your paperwork, it's fairly simple. And again, if your life is pretty simple, where you basically work, and maybe you rent and maybe you don't have a

mortgage payment, maybe you don't have student loans, hopefully then and just your investment portfolio, it can be fairly easy walkthrough to do.

But when you start having kids, and you start having houses and other kinds of assets, it can get a little more complicated. And that's when I started using personal people because it just makes it easier. But really, it just depends on your tax situation. But I'm a big fan of TurboTax personally.

Andrew

24:39

So when you say TurboTax they walk you through what you're talking about. It's a software. It's a software. Yep, questions. Yeah, yep,

Dave

24:45

yep, exactly. And the other nice thing about it too, is that it depending on the level that you pay for, they also have assistance that you can get, whether it's either through their AI or whether it's actual people, so they will put you in touch with via chat or a phone call, and you can work with people while you're in the program doing stuff. And I've actually had to do that a couple times, because I had specific questions about what I needed to do with my daughter and getting divorced and whatnot.

ou know, I had somebody call me and they walked me through exactly what I needed to do. So it was kind of slick. But you know, it just depends on what your tax situation is. And again, how involved you want to be some people don't want to be that involved. And some people want to be uber involved. So it just depends.

Okay. All right, well, with that, then we will go ahead and wrap up our conversation on taxes and how to prepare yourself for tax filing season, and thinking about your investments. And this is just a basic overview. If you have specific questions again, please reach out to a tax professional. If you have more general questions, check out our website investing for beginners.com you will find articles about the different taxable accounts that you can use HSAs, Roth, IRAs, traditionals, and things of that nature that can help give you a basic overview of information you need to start your filing taxes. Unfortunately, it's something we all have to do.

And it's part of our civic responsibility as Americans to pay our taxes. So none of us like it, of course, but it is something we got to do. And hopefully this can help you a little bit. So without any further ado, go out there

and invest with a margin of safety, emphasis on the safety and have a great week and we'll talk to you all next week.

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