THE REAL IMPACT OF TAXES ON RETIREMENT SAVINGS

IT'S MORE TAXING THAN YOU THINK

Investors face a tax challenge. The tax bite from retirement savings could leave them coming up short in retirement—or in leaving a legacy for loved ones. As the tax environment evolves, it's critical to understand the landscape—and tax-efficient strategies.

IT'S NOT "IF TAXES GO UP," BUT "WHEN"

Above the entrance of the Internal Revenue Service building in Washington, DC is the following quote: "Taxes are what we pay for a civilized society." There's no getting around taxes—we have to pay them. But by being more tax aware, investors can use techniques and strategies that could lower the tax bite on their retirement savings.

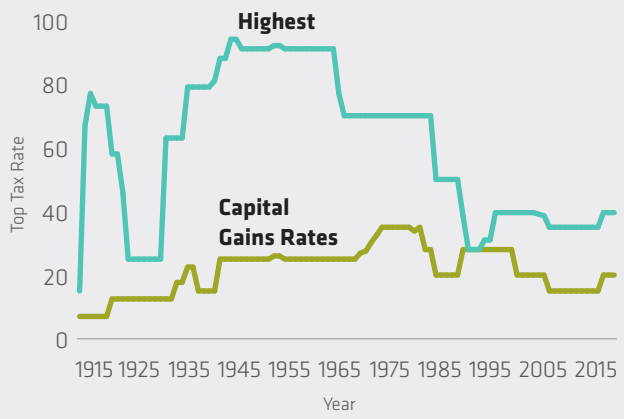
Taxes may seem high today, but they've only been lower than this three other times in the past 100 years—and at times they've been twice as high as today's rates (*Display*)! In relative terms, we're in a low-tax-rate environment, but the chances of taxes staying the same seem pretty slim. National debt is at an all-time high and is expected to reach US$22.6 trillion by 2020, according to the Congressional Budget Office. At the same time, the Old-Age and Survivors Insurance (OASI) Trust Fund, which is responsible for making Social Security payments, is on track for bankruptcy by the year 2035.

Obviously, something needs to change. We've already seen notable tax increases recently: the tax rates for the top two income brackets have increased by 6% and 13% percentage points, respectively; the long-term capital-gains tax rate for top earners has increased by 33%; and the Social Security tax rate has increased by 50% for everyone.

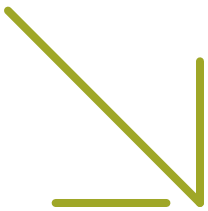
It's not a question of will taxes go up, but when.

TAXES ARE RELATIVELY LOW...BUT WILL THEY STAY THAT WAY?

US Federal Income Tax Rates



Source: Internal Revenue Service



NOTABLE TAX CHANGES

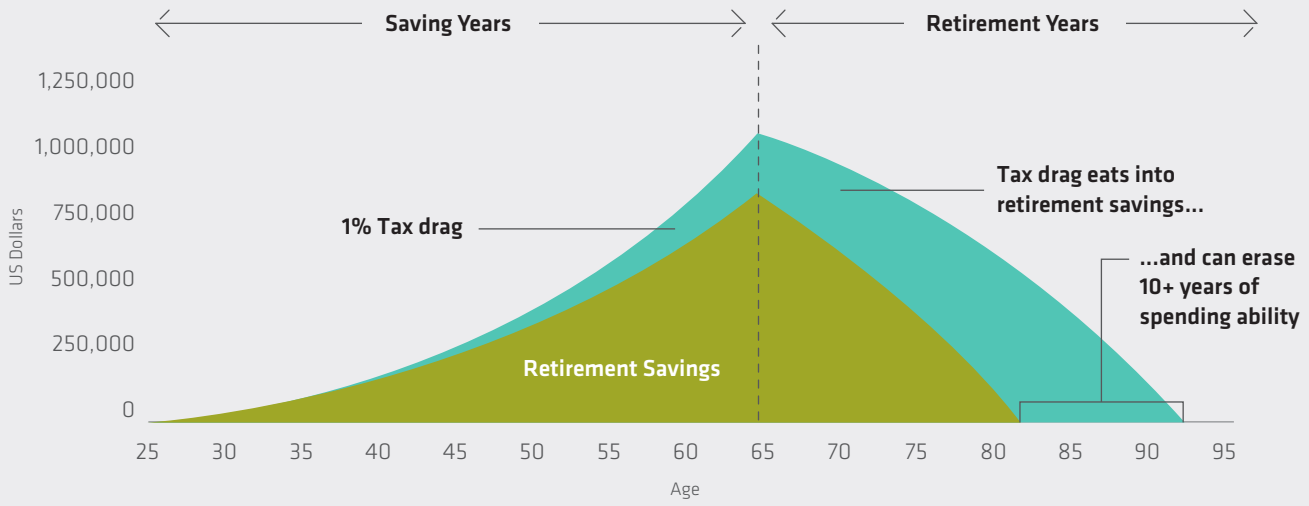
+ The US passed three revenue acts that raised taxes to fund World War I
+ To fund the New Deal between 1933 and 1938, the highest tax bracket was raised to a staggering 76%
+ 1981's Economic Recovery Tax Act included tax cuts to help stimulate the economy
+ The 2001 Bush tax cuts implemented reductions that expired in 2010

WHY IT'S IMPORTANT TO BE TAX EFFICIENT

Why are we talking about taxes more often today, especially when it comes to investing? It's all about tax drag—investment returns lost to taxes create a drag on wealth building. Reducing that tax drag can help in the short term…*and* the long run.

Decreasing the tax drag by just 1% a year could create 10 extra years of spending down the road in retirement (*Display, below*). *Now* is the time for investors to think about tax strategies, while they're saving and planning for retirement. Leaving tax planning in the hands of accountants isn't the answer anymore. Investors need to take the initiative and deploy tax-efficient investment strategies.

TAX DRAG CAN IMPAIR LONG-TERM SPENDING ABILITY



The example shown is hypothetical, is for illustrative purposes only and does not represent the performance of any specific investment, including any AB product.

The savings phase simulates a defined contribution participant salary of US$45,000 at age 25, linearly increasing to US$85,000 by age 65, making yearly contributions of 6% of salary at age 25, increasing by 0.5% per year to a maximum 10%, with a 50% company-matching contribution up to the first 6% of salary. In the spending phase, US$63,750 (75% of final salary) is deducted at the beginning of each year. A yearly investment return of 9% is assumed at age 25, linearly decreasing to 6% at age 80 and remaining constant thereafter. In the 1%-more-return scenario, a yearly investment return of 10% is assumed at age 25, linearly decreasing to 7% at age 85 and remaining constant thereafter. Inflation is assumed to be a constant 3%, and dollar values are expressed in real purchasing-power terms.

Source: AB

FOR MANY PEOPLE, TAX DRAG CAN TAKE A BITE OUT OF THEIR LONG-TERM SAVINGS ABILITY.

REDUCING TAX DRAG IN SAVING AND INVESTING

Taxes can take a bite out of investment growth, the ability to save and, ultimately, how much is left to spend in retirement. Losing just 1% from the growth of an investment account can eat away 10 years of spending in retirement. To put it more bluntly, a 1% tax drag could cause investors to run out of money *10 years sooner*.

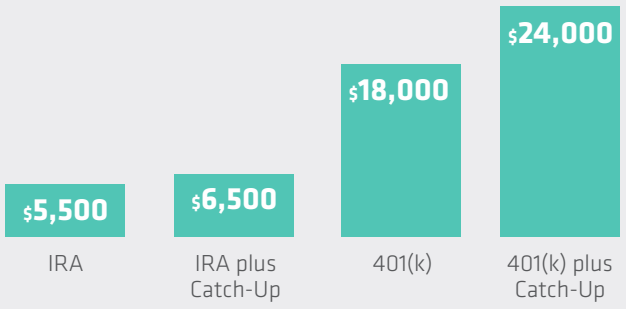
Luckily, there are strategies that can delay taxes, manage current taxes and lower the future tax liability. All of them rely on effectively positioning both pretax money and after-tax money.

DELAYING TAXES: MORE MONEY PUT TO WORK NOW

Certain investing options help delay taxes investors would normally pay on current earnings. Tax-advantaged accounts—usually retirement plans—allow contributions on a pretax basis. Pretax money is taken out of investors' salaries before they pay any taxes on it. This is also known as "qualified money."

This approach puts off taxes until later, when it's time to withdraw—it allows more money to be put to work now. This is especially useful when saving for retirement; investment returns won't suffer tax drag while savings are growing. Investors will also likely be in a lower tax bracket once it's time to start withdrawing money and pay taxes. Contributions can be made to retirement plans on a pretax basis up to annual limits (*Display, below left*).

2016 RETIREMENT PLAN CONTRIBUTION LIMITS (USD)



Source: Internal Revenue Service

MANAGING CURRENT TAXES: IT'S ABOUT THE VEHICLES

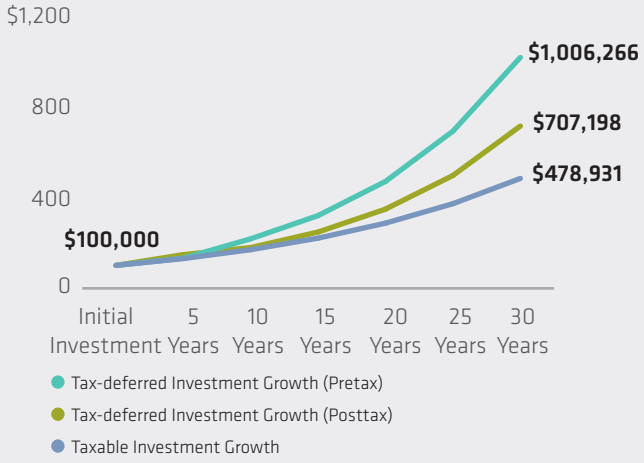
Because investors can't delay all their taxes until later, it's important to use strategies that minimize the taxes they pay on current investments. In most cases, this will include after-tax money that's invested. After-tax income is the amount of money left over after all federal, state and withholding taxes have been deducted. It's also known as nonqualified money.

Instead of getting a 1099 tax form each year that's used to calculate investment tax liability, investors can choose tax-efficient investment vehicles that grow tax-free— so there's no tax drag. Eliminating tax drag can increase savings power compared with a traditional account (*Display, below right*).

The only other way for investors to continue contributing to a tax-deferred account above the limits imposed by 401(k)s, IRAs and other retirement plans is by using a variable annuity. Annuities also allow for tax-free investment changes and 1035 exchanges, which enable investors to switch an existing variable annuity contract for a new contract without paying taxes.

ELIMINATING TAX DRAG MAY INCREASE SAVINGS POWER

Account Balance (USD Thousands)



Based on a US$100,000 investment compounding at 8% annually at a federal tax rate of 33%. No assumption was made for state taxes in this hypothetical scenario. Assumes lump-sum withdrawal or distribution.
Source: AB

IRS FORM 1099 is used to report income you receive that isn't from a wage-paying job. The income reported on form 1099 includes the yearly gains in many investment accounts.

LOWERING FUTURE TAX BILLS

Another strategy is to reduce future tax liabilities or reduce the impact of tax bills when investors are ready to access their money. Certain investments and accounts— including municipal bonds, 529 education plans and Roth IRAs—allow investors tax-free access to their money, as long as they follow certain rules and guidelines.

For example, withdrawals from a 529 plan can be made on a tax-free basis as long as the money is used for education costs for children, grandchildren or other qualifying students.

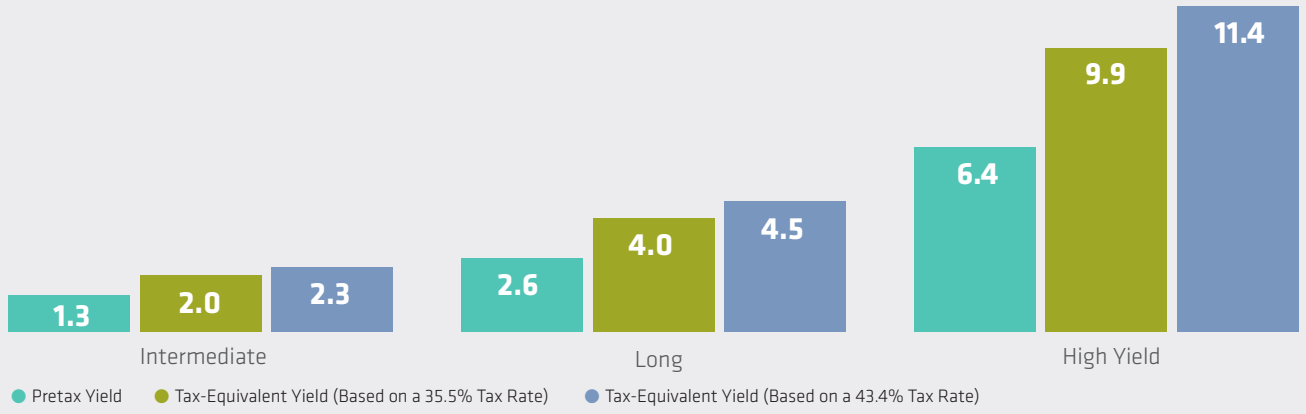
Roth IRAs are funded with after-tax dollars; they're designed to provide tax-free income as long as investors are at least 59½ years old and the earnings have been left untouched for five years. Roth accounts have certain income limits, which investors should consider before using them.

Municipal bonds can be an effective strategy for those looking for tax-free income, especially when investors are in a higher tax bracket. Muni bonds are issued by states, municipalities, counties and other local agencies; their income is exempt from federal taxes, and often state and local taxes. Munis' tax-equivalent yield—an apples-to-apples comparison with taxable bonds—can be more attractive (*Display below*).

The bottom line: taxes aren't going away. Investors will have to deal with the impact of taxes both when they're building wealth and in their retirement years. It's important to start early, using tax-efficient strategies that can help lessen the bite of taxes on investments and savings.

MUNICIPAL BOND YIELDS ARE ATTRACTIVE AFTER ADJUSTING FOR TAX ADVANTAGES

Municipal Yields: Pretax and Taxable Equivalent



Historical analysis does not guarantee future results.
As of May 31, 2016
Intermediate is represented by the Bloomberg Barclays Municipal 1-10 Year Blend Index; long is represented by the Bloomberg Barclays Municipal Long Bond (22+) Index; high yield is represented by the Bloomberg Barclays Municipal High Yield Index.
Source: Bloomberg Barclays and AB

TAX REFERENCE GUIDE

HERE ARE SOME KEY TERMS AND TAX RATES TO HELP INVESTORS UNDERSTAND TODAY'S TAX ENVIRONMENT.

2016 INCOME TAX RATES

Tax Rate	Single	Married	Long-Term Capital Gains	Short-Term Capital Gains
10%	$0–$9,275	$0–$18,550	0%	10%
15	$9,275–$37,650	$18,550–$75,300	0	15
25	$37,650–$91,150	$75,300–$151,900	15	25
28	$91,150–$190,150	$151,900–$231,450	15	28
33	$190,150–$413,350	$231,450–$413,350	15	33
35	$413,350–$415,050	$413,350–$466,950	15	35
39.60	$415,050+	$466,950+	20	39.60

ORDINARY INCOME

Income from wages, salaries, tips, commissions, bonuses and other types of employment compensation, interest, and dividends. Ordinary income is taxed at a rate ranging from 10%-39.6%, depending on an individual's total income (*Display, above*).

ADJUSTED GROSS INCOME (AGI)

Remaining income after subtracting all deductions.

MARGINAL VERSUS EFFECTIVE TAX RATE

The bracket taxpayers fall into based on their annual income. Someone making US$400,000 would have a **marginal tax rate** of 33% (*Display, above*). But not all income is taxed at that rate. The US has a progressive tax system, so taxpayers face a series of higher marginal tax rates that apply to all income above the relevant dollar amount. There are also available tax exemptions, deductions and credits (See AGI above). When all is said and done, the total dollar amount of federal income taxes paid divided by total income results in a percentage called the **effective tax rate.**

CAPITAL GAINS: LONG TERM VERSUS SHORT TERM

Investments are taxed when they're sold; tax is paid on the gain (the price an investment was sold for minus the price it was purchased at). The tax rate investors pay depends on how long they owned an investment. A **short-term capital gain**, when an investment held for less than a year is sold, is taxed at the same rate as ordinary income. A **long-term capital gain**, for a holding period greater than one year, is taxed at a lower rate. For example, a married couple making US$300,000 a year, will pay 33% on a short-term asset gain but less than half that rate on a long-term asset gain (*Display, above*).

STANDARD DEDUCTIONS VERSUS ITEMIZED DEDUCTIONS

The **standard tax deduction** is a fixed dollar amount that reduces the amount of taxable income; that deduction varies according to a taxpayer's filing status. About two-thirds of tax returns claim the standard deduction. In 2016, the standard deduction for a single taxpayer is US$6,300; for a married couple, it's US$12,600. **Itemized deductions** also reduce taxable income, but tax filers have to list each deduction. Itemizing may help if there are large, uninsured medical and dental expenses, nonreimbursable expenses as an employee, or large contributions to qualified charities.

EXEMPTIONS

Exemptions reduce or possibly eliminate the tax obligation. Common tax exemptions include charitable donations, medical expenses and interest paid on a mortgage.

EXTRA TAXES THAT AREN'T IN THE TAX CODE

+ 0.09% tax on all income over US$250,000, under the Affordable Care Act ("Obamacare")
+ 0.9% Medicare surtax on every dollar of income over US$250,000
+ 3.8% additional Medicare surtax, known as the Net Investment Income Tax, on investment income for those who earn over US$250,000 per year

LEARN MORE

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