Tips for Teens

Understanding Taxes and Schedule B Income

By E. Dennis Zahrbock

Most likely, being a teen, you've not yet experienced Schedule B income. This article will teach you how to impress your grandparents (just like when you impress them on computers and electronic equipment!).

In the current Income Tax Code there are many forms of income. As a teen, your life may be limited to "earned income." Earned income is money you make by providing a service for an employer. When you receive a paycheck from your part time job that is earned income. You might, if you are lucky, also have some money in a savings account. When it earns interest it is known to the tax code as "unearned income"! Unearned income could also be dividend from some stock you might own. The good news is that unearned income arrives in your account at all times. It is better than "earned income" as you do not have to provide a service to receive the income. The catch, however, is that you need to have some money invested somewhere to receive the interest or dividend.

The government doesn't care if you have earned income or unearned income, as you must pay income tax on both. The two are added together to compute the tax you must pay. The trick to your future is to try to control your unearned income and thus, either avoid or defer unearned income (avoid is legal while evade is illegal). Schedule B of the tax return must be filed when you pay taxes, and this is the Schedule that can cause "bracket creep."

To explain bracket creep, let's use an example. Let's say Sue has \$30,000 of earned income and \$30,000 of unearned income. Her sister Mary has \$60,000 of earned income. Now let's pretend that tax brackets are 10% of the first \$30,000 you report and 20% of the next \$30,000. In our example both sisters have \$60,000 of total income, so both taxes are computed as follows: 10% of \$30,000 = \$3,000; plus 20% of \$30,000 = \$6,000 for total of \$9,000.

Even though Sue's earned income was taxed at 10%, all of her unearned income was taxed at 20%. Sue's unearned income caused her to creep into a higher tax bracket. Had Sue and Mary's other sister Sally had the unearned income that Sue had (\$30,000) then Sally would have paid \$3,000 (10%) instead of 20% like Sue.

The trick to your future "pay less taxes" goal is to find ways to legally defer or avoid Schedule B income. Always remember that no matter how little or how much Schedule B income may be, it will be taxed at the highest income bracket that you achieve. A second example would be if the next tax bracket was 30% of the next \$30,000 and the unearned income for our Mary example had been \$30,000 she would have paid 30% of \$30,000, or \$9,000. It's interesting that for Sally the tax would have been \$3,000, for Mary the tax would have been \$6,000 and for Sue it would have been \$9,000!

So how do you defer or avoid Schedule B income legally? Certainly the most common way is the IRA, 401(k), or 403(b) style of investing (and the government prefers these methods because as you defer the growth on your investment, the tax is deferred to the future – not avoided). No Schedule B income is ever created in these three accounts. Another very common choice is an annuity. Again, no Schedule B income is created. In some cases, tax-exempt government bonds can work to avoid Schedule B inclusion, but, sad to say, they can arrive to haunt you on the Alternative Minimum Tax schedule.

The two best ways to avoid (never pay Schedule B income tax – ever) are the Roth savings (Roth IRA, Roth 401(k) or Roth 403(b)) or high premium low death benefit life insurance (a policy that provides maximum cash value accumulation instead of maximum death benefit).

All three of the Roth options are great. All interest and dividends permanently avoid Schedule B taxation for your life and the life of your beneficiary – a very long tax avoidance. Some people don't

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choose Roth options, as the deposit is not deductible. A simple question to ask yourself is "would you rather pay taxes on the seeds or the harvest?" If you see the wisdom in picking the "seed" you should become a Roth saver.

High premium low death benefit accumulation oriented life insurance is the second best avoidance technique. It should be used when you are not eligible for a Roth or have exceeded the Roth max limits. I, for example, have employed this method most of my working life. I have accumulated significant cash values in two different accumulation methods, on one I am receiving between 4% and 5% growth and none is subject to Schedule B taxation. In the other I receive "market" returns...sometimes low and sometimes high; but, again, no Schedule B taxation. If I look back on my 40+ year career of helping clients, my happiest clients are those who own Roth's and Accumulation Oriented Life Insurance.

I meant what I said when I promised to help you impress your grandparents. Here are a couple of ways that you might start.

1. Ask them if they will need their RMD's (Required Minimum Distributions) from their IRA, 401(k) or 403(b), or if they'd prefer not being required to take it. We observe so many grandparents that live just fine on Social Security and Pensions that RMD's actually irritate them. They invest them in non-Roth accounts and start creating ever-increasing Schedule B income. These grandparents have two options; they can convert their IRA, 401(k) or 403(b) to a Roth and never have to take an RMD. But, sad to say, most won't as all the deferred tax is due at conversion. (Remember at the beginning of this article when I said government likes deferred accounts best too? This is why.) Their other option is to be stuck with the annual RMD's but at least avoid the future Schedule B income by using the RMD to acquire Accumulation Oriented Life Insurance.

2. Ask them if they already have increasing Schedule B income. If so, tell them to try to move their savings to Accumulation Oriented Life Insurance or use their savings principal to pay the taxes due to convert to Roth's. Once they investigate either of these strategies they'll be impressed with how you've help them.

Well, my pen is running dry so I hope I've provided you with what Schedule B can mean to you and your family – unfortunately most of it is not good news. I hope that the tax deferral or avoidance techniques I've outlined can help you, your parents and your grandparents enjoy a more prosperous financial future.

QUIZ

1. Tax evasion is a good way to reduce Schedule B income.

☐ **TRUE** ☐ **FALSE**

2. Tax creep never happens with Schedule B income.

☐ **TRUE** ☐ **FALSE**

3. Investing in an IRA avoids Schedule B income.

☐ **TRUE** ☐ **FALSE**

4. Investing in a Roth IRA avoids "tax on the harvest."

☐ **TRUE** ☐ **FALSE**

5. If you were in a 50% tax bracket, earning 5% in a Tax avoidance investment would be equivalent to earning which of the following in a Schedule B investment?

A. 6%
B. 8%
C. 10%
D. 12%

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