WEALTH CREATION STRATEGIES

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"There is no art which one government sooner learns of another than that of draining money from the pockets of the people."
Adam Smith, The Wealth of Nations (1776)

"When we own portions of outstanding businesses with outstanding managements, our favorite holding period is forever."
Warren Buffett, 1988 Berkshire Hathaway shareholder letter

California's Billionaire Tax: Billions Lost Before a Dime Collected

California has discovered a remarkable new way to raise taxes: threaten to confiscate a portion of people's wealth, watch them move elsewhere, and then wonder why tax revenues fall short of expectations.

Proposition 40, the proposed California Billionaire Tax Act, would impose a "supposedly" one-time 5% tax on the net worth of California billionaires. Its supporters estimate it could raise approximately $100 billion, principally to help fund "healthcare" programs facing reductions in federal support.

The proposal sounds politically irresistible. California has roughly 200 billionaires, depending on whose count we use. Tax them, collect a fortune, and spare everyone else.

What could possibly go wrong?

Quite a lot, as it turns out. And some of the damage has already begun.

Billionaires Aren't Sticking Around

The most remarkable aspect of this proposal is that the tax has not yet been approved by voters, but the people expected to pay it have already started to change their behavior. This is precisely what Econ 101 teaches.

Prominent entrepreneurs and investors identified in reports of departures, relocations, or substantially reduced California ties include Google co-founders Larry Page and Sergey Brin, PayPal co-founder and venture capitalist Peter Thiel, technology investor and co-founder of Craft Ventures David Sacks, and Uber co-founder Travis Kalanick.

Venture capitalist Chamath Palihapitiya claimed in January that approximately $1 trillion in billionaire wealth had already left California.

A more detailed analysis by Jared Walczak for the California Tax Foundation, published in April, estimated approximately $777 billion in reported departures, with a potential total exodus of $1.23 trillion.

The Tax That Will Almost Assuredly Cost More Than It Collects

California's personal income tax is extraordinarily "progressive." The top 1% of earners generally accounts for roughly 40% or more of personal income tax collections. That concentration makes state revenues particularly vulnerable to changes in the fortunes (and residences) of a relatively small group of taxpayers.

Consider what happens when a billionaire leaves.

California loses future income taxes on investment gains, business income, and other income no longer sourced to the state. It will also lose associated business activity, employment, charitable spending, and investment. It risks losing entire business enterprises.

Suppose a California billionaire realizes a $2 billion gain on investments that would be taxable if the individual remained a California resident. At the state's 13.3% top marginal income tax rate, that gain would generate nearly $266 million in California income tax. California also reduces certain otherwise allowable itemized deductions once adjusted gross income exceeds specified thresholds: for 2025, $504,411 for joint filers, $252,203 for single filers, and $378,310 for heads of household. The effective marginal rate can reach 14.1% as deductions are reduced.

That's from one transaction by one taxpayer. Multiply the possibilities across numerous billionaires, over decades.

Economic Incentives

Walczak estimates that the migration prompted by the proposal could reduce California's annual tax revenues by approximately $3.53 billion to $4.49 billion, primarily through lost income tax collections.

At $4 billion annually, twenty-five years of foregone revenue would total $100 billion before considering

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investment returns, discounting, and reductions in overall economic activity.

The Tax Foundation's analysis concludes that the present value of projected ongoing losses could easily exceed the proposed tax's one-time proceeds. Given those incentives, I suspect the actual losses will be substantially greater.

Five Percent of What?

The proposed tax has another problem. The advertised 5% rate may substantially understate what some taxpayers would owe.

Billionaires' wealth generally consists largely of business ownership, stocks, venture investments, intellectual property, and other assets whose value may be difficult to establish, and even more difficult to convert into cash.

A founder might own a relatively small economic interest in a corporation while retaining substantial voting control through special classes of shares.

Under the proposal, certain ownership interests could be valued using voting-control percentages rather than the founder's actual economic ownership.

Walczak highlights the example of DoorDash founder Tony Xu, whose reported economic ownership was approximately 2.6%, while his voting control was approximately 57.6%.

Walczak estimates that Xu could face approximately $4.17 billion in tax on an economic ownership interest worth approximately $2.41 billion.

Say what?!

A purported 5% tax could, under this interpretation, exceed the value of the taxpayer's actual economic interest.

That is not a typo. It is the consequence identified in the Tax Foundation's analysis of the proposal's valuation provisions.

Other provisions raise concerns about valuations of private businesses, penalties for valuation disagreements, family transfers, and deferrals that could leave taxpayers owing tax on wealth that subsequently evaporates.

Courts will ultimately resolve some of the ambiguities. But uncertainty has costs. People contemplating billions of dollars in possible liability have powerful incentives to avoid being test cases. And where there are disputes, imagine the cost of both compliance and of policing collections. You thought regular income tax audits were intrusive? A wealth tax brings this to a new level.

Wealth Isn't Cash

Let's suppose the tax amounts to exactly 5% of a billionaire's net worth.

Someone worth $10 billion would owe $500 million. Is that $500 million just sitting around?

Of course not.

The wealth might consist primarily of shares in a business the individual founded. Paying the tax could require selling stock, borrowing against it, or surrendering part of the ownership interest.

Selling appreciated stock could itself generate capital gains taxes. Borrowing creates interest expense and financial risk. Selling a large block of shares can also affect market prices and, in some circumstances, control of the company. A tax on estimated wealth creates a cash obligation whether or not the wealth produces cash.

This is different from taxing income when it is realized.

When a tax forces an owner to sell assets, it diverts resources that could have supported private investment into government spending. I expect that diversion, compounded by government's generally much lower efficiency in allocating resources, will mean less future investment, lower living standards, and a smaller future tax base.

This brings us to a lesson economists have understood for generations.

The Seen and the Unseen

The great nineteenth-century French economist Frédéric Bastiat explained that economic decisions must be judged not merely by their immediately visible consequences, but also by activities and actions those decisions discourage.

In the case of California's proposed wealth tax, the visible benefit would be the money collected and spent on "healthcare" and other designated programs.

The unseen consequences might include a business never founded, a research project never funded, a company expansion in Texas or Florida or Tennessee rather than California, or an entrepreneur who decides that building the next great technology company is more attractive somewhere else. (Consider my 2014 article, "Go East, Young Man," in which I encouraged young entrepreneurs to start in places other than California. I was already warning about its increasingly anti-entrepreneurial policies more than a decade ago!)

Businesses never started. Jobs never created.

Not that every dollar collected in taxes disappears. Government expenditures pay employees, purchase services, and provide "benefits." But with far less efficiency. I once asked a state government employee what percent of the employees in her bureaucracy could be fired without preventing the remaining staff from getting the job done. There was no hesitation: "half."

Even the Governor Opposes It

Even Governor Gavin Newsom opposes the proposal, recognizing the risk of driving away the taxpayers on whom California's budget depends.

And the state's own nonpartisan Legislative Analyst has warned that the measure would likely reduce existing income tax revenues by hundreds of millions of dollars or more annually.

That is a remarkable admission. Even if the wealth tax brings in substantial one-time revenue, it could

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simultaneously weaken the revenue streams supporting California's ordinary budget.

I think it will destroy those streams over time.

The proposed tax also raises a broader question: Will it remain a one-time tax, and will it be on just billionaires once the billionaires have all left the state?

Governments have a long history of expanding taxes initially directed at a narrow group to far broader groups.

The federal income tax began in 1913 with a top rate of 7%, applying only to exceptionally high incomes. Within a few years, wartime legislation had dramatically broadened and increased it (77% during WWI). California's statewide combined sales tax rate was 5% in the early 1970s. Today, the combined rate exceeds 10% in many communities and averages about 9% statewide.

Social Security provides another example. In 1937, employees and employers each paid 1% on the first $3,000 of annual wages, a combined 2%. That earnings ceiling is roughly $70,000 in today's purchasing power. In 2026, the combined tax is 12.4% on the first $184,500: more than six times the original rate on an inflation-adjusted earnings ceiling more than two and a half times as high. Originally excluded were the self-employed, farm and household workers, government employees, and nonprofit employees. Congress subsequently brought many into the system, beginning with most nonfarm self-employed workers in 1951. These figures exclude Medicare taxes.

If you think the 'billionaire' tax won't eventually be ratcheted down to directly affect you, I've got a bridge to sell you.

The January 1 Trap

Proposition 40 also contains another particularly troubling feature: its proposed residency test looks back to January 1, 2026, even though voters would not decide the measure until November.

Someone who was a California resident at the beginning of the year could be subject to a retroactive tax increase.

The constitutionality and enforceability of that approach are likely to be (and should be) contested. But a legal challenge will take years and cost a fortune, for both sides.

California's dispute with inventor Gilbert Hyatt over his move to Nevada illustrates how intrusive and expensive residency battles can become. After nearly three decades of audits, appeals, and litigation, its demand (reportedly exceeding $55 million with penalties and interest) was largely overturned. By 2017, the state had reportedly spent more than $25 million pursuing the case and defending its investigators' conduct. Can you imagine the legal battles when billions are at stake?

For those with billions in net worth, litigation alone is a reason to leave early and document the departure thoroughly.

This creates a particularly perverse incentive: the more aggressively California threatens to tax accumulated wealth, the stronger the incentive to establish residency somewhere else before the rules take effect.

And once someone has moved, established new business relationships, and reorganized financial affairs as so many billionaires (and, likely, so many would-be billionaires) have already done, what is the incentive to return? The stagnation of Europe is arguably at least partly due to a "brain drain" of precisely the sort that could happen here, if it hasn't already happened.

The Billion Dollar Question

The issue isn't whether billionaires are sympathetic people (many are not), whether their fortunes are too large (I do not suffer from envy), or whether California could find useful ways to spend another $100 billion (it won't).

The issue is whether this proposal will improve the state's long-term financial position.

There is extreme irony here.

The proponents expect to collect money from approximately 200 people. But the costs of getting the policy wrong would not be confined to those 200 people.

They would be borne by the remaining taxpayers, businesses, employees, and beneficiaries of government largesse.

A tax can be enormously popular with people who will never write the check. That doesn't mean they won't eventually pay the price.

California's billionaire tax may turn out to be a spectacularly expensive way to collect money from people who no longer live here.

And even if voters reject it, the state may already have lost something far more valuable than the proposed one-time revenue: a portion of its future tax base, and the confidence of wealth builders that the fortunes they create will not become targets of confiscatory taxation by an increasingly voracious government.

The Trump Account: An Innovative Program to Give Young People an Ownership Stake

I don't believe government belongs in the business of giving people money. Its proper function is to protect "negative rights," preventing others from interfering with your actions and protecting life, liberty and property, and not to create "positive rights" to "benefits" financed by compulsory payments from others. Trump Accounts therefore aren't something I would have designed. I appreciate the sentiment: give young people a stake and perhaps increase their support

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for property rights and capitalism, but this mechanism isn't rooted in property rights and, because the means often predetermine the ends, such methods have a way of backfiring. Still, Trump Accounts are now the law, and financial planning is about dealing with the law as it exists, not as we wish it existed.

I've long given similar advice about Social Security. Even the most ardent libertarian should collect the benefits to which he is legally entitled. Refusing them won't shrink government or return the money to taxpayers. Likewise, if Washington is offering your newborn $1,000, take it.

But taking the money doesn't mean applauding Congress for adding yet another tax-favored account to an already absurdly complicated system.*

Take the free $1,000. Then consider funding the account, but have a plan for what happens at age 18.

What Is a Trump Account?

Trump Accounts are essentially IRAs for children under 18, with no work-related income requirement. Under a pilot program, qualifying U.S.-citizen children born in 2025–2028 can receive a one-time $1,000 federal contribution. Children born before 2025 can still have a Trump Account if otherwise eligible, but they don't get the $1,000.

Eligible children will generally be automatically enrolled in Trump Accounts without their parents first applying. Automatic enrollment does not mean automatic receipt of the $1,000 federal contribution. A parent or guardian must elect it, and families must claim their accounts to manage them and make additional contributions.

Family members can contribute after-tax dollars and employers may contribute under a separate tax-favored provision. (Under proposed IRS regulations, employers may also establish written programs permitting qualifying employee-funded contributions through cafeteria plans, potentially providing additional tax advantages.) The annual contribution limit per recipient is generally $5,000 in the aggregate from family members, employers, and other ordinary contributors, indexed for inflation after 2027. The IRS has also provided a gift-tax safe harbor that generally allows parents, grandparents, and others to make qualifying Trump Account contributions within the annual gift-tax exclusion without having to file a gift-tax return. States, other governmental entities, and qualifying charities may also make equal contributions to broad classes of children such as all eligible Trump Account beneficiaries in a particular state or born in particular years. Michael and Susan Dell, Elon Musk, and Ray Dalio are among those promising to make such contributions. Qualifying contributions under these broad-based programs do not count against the ordinary annual contribution limit.

After-tax family contributions create tax "basis," which is the part that cannot be taxed again when withdrawals are taken. Earnings grow tax-deferred but are ultimately taxable as ordinary income. Withdrawals are generally prorated between basis and taxable amounts.

Until January 1 of the year the child turns 18, withdrawals are prohibited, subject to limited exceptions. After that period, distributions before age 59½ incur a 10% additional tax on the taxable portion, unless an exception applies, such as for qualifying higher-education expenses or certain first-home costs.

Except for qualifying donated stock, investments are restricted to broad, low-cost U.S. stock-market index funds. That restriction may be a virtue: it makes speculation with a child's account difficult.

For a beneficiary who qualifies for an Achieving a Better Life Experience (ABLE) account (a tax-favored account for people with disabilities) the entire Trump Account can be transferred tax-free, trustee-to-trustee, to the beneficiary's ABLE account during the calendar year the child turns 17. The transfer does not count against the usual ABLE contribution limit.

Beginning in the calendar year the beneficiary turns 18, part or all of the Trump Account can be converted to a Roth IRA. That can supercharge the account's long-term value.

Which Account Is Best for What?

Vehicle	Best features	Principal drawbacks
Trump Account	"Free" government/employer/charitable money; long compounding period; possible later Roth conversion; $1,000 federal contribution for qualifying 2025–2028 births.	Earnings are generally tax-deferred rather than tax-free; investments are restricted; the child ultimately controls the assets.
529 Plan	Qualified education withdrawals are tax-free; with restrictions, up to $35,000 can be rolled to a Roth IRA.	Non-qualified uses can trigger tax and penalty; best suited to education-oriented savings.
Roth IRA	Potentially decades of tax-free compound growth.	Child must have work-related compensation; contribution is limited by such income and the annual IRA limit; the child ultimately controls the assets.

Because qualified growth can be entirely tax-free, the Roth IRA is the likely long-term champion. But taxable compensation is required to contribute, so it isn't an alternative early in life unless a toddler or young child is in the Screen Actors Guild. Once a teenager starts working, parents or grandparents can provide the cash for a Roth contribution, subject to the child's work-related-income limit.

A Simple Example

Assume a newborn in 2026 receives the $1,000 seed contribution. The family contributes the Trump Account maximum through age 17. We assume the $5,000 limit remains $5,000 for 2026–27 and then rises 2.5% a year with inflation indexing, and investments grow 8% annually. These are illustrations, not predictions.

Under those assumptions, total family contributions are about $109,000 by age 18; the total value of the Trump Account is nearly $238,000. A 529 funded with the same dollars is about $234,000. The Trump Account's modestly

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higher balance reflects the government's initial $1,000 contribution and its growth, not any investment advantage. The important difference is taxation. Qualified 529 earnings, spent properly, are tax-free; Trump Account earnings generally are taxable.

The Roth becomes especially attractive once the child works. Three contributions at ages 15–17 totaling a little more than $21,700, compounded at 8% until age 65, grow to about $944,000 and, assuming the Roth rules are satisfied, that amount can be tax-free. Put those same dollars into the Trump Account instead and eventually tax the earnings at a hypothetical 24%, and the comparable after-tax value is about $723,000, a difference of roughly $221,000 from only three years of contributions.

What Happens at 18?

Beginning January 1 of the year the child turns 18, most of the special Trump Account rules end. The account remains a Trump Account, but it is thereafter governed largely by traditional-IRA rules. At that point the beneficiary may leave the account as is, take permitted distributions, transfer it to another traditional IRA (although traditional IRA balances can complicate future conversions, especially backdoor Roth conversion strategies), or convert some or all of it to a Roth IRA. A Roth conversion trades a current tax bill on the taxable portion for potentially decades of tax-free growth thereafter.

But don't convert automatically at 18. A taxable conversion can trigger the kiddie tax, under which some income may be taxed at the parents' marginal tax rate. The right strategy may be a series of partial conversions when the beneficiary is no longer subject to those rules or is otherwise in low tax brackets.

Keep Records of Contributions

Withdrawals and Roth conversions generally contain both taxable amounts and tax-free basis. Families should keep contribution records to establish that basis so after-tax contributions aren't taxed again.

For many beneficiaries, the greatest long-term wealth-creation opportunity may be using a Trump Account as a tax-deferred launching pad into a Roth IRA rather than spending it at 18.

How to Claim and Fund a Trump Account

1. Claim the account. The U.S. Treasury is automatically establishing Trump Accounts for eligible children. Parents or guardians must still claim the accounts to manage them and make additional contributions.

2. Elect the $1,000 contribution. For eligible children born in 2025–2028, a parent or guardian must separately elect the $1,000 federal contribution using Form 4547. The government will not deposit the money merely because an account has been established.

3. Activate the account. Follow the instructions provided through the official Trump Account program to activate and manage the account. Visit www.Trumpaccounts.gov for instructions.

We can prepare and file the required election for your child or grandchild with proper authorization, or the family can handle it directly. Our primary role is planning. Contact us to optimize your contribution and to coordinate the Trump Account with 529 plans, Roth IRAs, and other investments.

Beware of scams. The government will not ask for passwords or one-time authentication codes by email, text or telephone.

Doug's Rules for Trump Accounts

1. Take the $1,000 if the child qualifies.

2. Take employer and other "free" money.

3. Don't fund a Trump Account blindly when a 529 or Roth IRA may be better. For education, a 529 has a major advantage: qualified withdrawals are tax-free, while Trump Account withdrawals generally include taxable amounts.

4. Once the child begins earning income, consider a Roth IRA. Decades of genuinely tax-free compounding can overwhelm the after-tax value of tax-deferred growth.

5. Before converting to a Roth, calculate the actual tax cost, taking into account the kiddie tax. Be aware that part of a conversion may be taxed at one rate and other parts at other rates.

6. Remember whose money it is once the child reaches 18. If the 18-year-old is irresponsible (which is especially concerning when addiction runs in the family and the child inherits that disease), consider whether you want to retain total control over the funds. A 529 plan allows the account owner to retain that control; a Trump Account does not.

* A partial list of tax-favored accounts and plans includes traditional IRAs, Roth IRAs, SEP-IRAs, SIMPLE IRAs, 401(k)s, Roth 401(k)s, 403(b)s, 457 plans, profit-sharing plans, money purchase pension plans, defined-benefit pension plans, cash-balance plans, 529 plans, HSAs, Section 125 Cafeteria Plans, ABLE accounts and an array of specialized retirement plans.

Wealth Creation Depends Not Just on the Tax Rate but on When You Pay It

The next two articles examine related questions: how tax timing affects wealth, and how to choose among taxable, Roth, and traditional retirement accounts.

We spend considerable time helping clients reduce their taxes. One of the most powerful (and often overlooked) ways to do so is through the timing of those taxes. Postponing a

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tax for decades can dramatically increase wealth, even if the tax is eventually paid. And sometimes, under current law, the tax can be avoided altogether.

The effect of tax deferral is enormous because money that would otherwise have gone to the government remains invested, earning additional returns that themselves compound.

Consider an investment of $10,000 earning 8% annually for 50 years. For illustration, assume 1.5% of the return comes from qualified dividends and 6.5% from appreciation. Assume a 15% federal tax on qualified dividends and long-term capital gains, excluding any additional tax costs from income-based phaseouts such as increased taxation of Social Security income. Ignore state taxes and assume after-tax investment income is reinvested.

Same Investment, Different Results

Investment strategy	Value after 50 years
Taxable account: all gains realized annually	$268,264
Taxable account: gains realized every 5 years	$283,406
Taxable account: gains realized every 10 years	$300,207
Taxable account: gains realized every 20 years	$321,546
Taxable account: gains realized only at the end	$370,835
Taxable account: held until death with stepped-up basis	$422,573
Compare with a Roth IRA:	
Roth IRA, assuming qualified tax-free withdrawals	$469,016

The investment return is the same. The tax rate is the same. The only difference among the taxable accounts is when capital gains are realized and taxed, or whether those gains escape income taxation through the basis adjustment at death.

That difference alone produces more than $154,000 in additional wealth over 50 years.

Look at the extremes. Rounding, realizing gains annually leaves $268,000. Holding the appreciated investment until death leaves $423,000 for the heirs, assuming the investment qualifies for a stepped-up basis. An immediate sale at that value generally creates no capital gain.

That difference of more than $154,000 is generated without earning a penny more before taxes.

Notice, too, that the taxable investment held until death retains 90% of the Roth's value. It would be 100% except for the fact that qualified dividends are taxed annually.

A taxable account, then, can be an extraordinarily tax-efficient wealth-building vehicle if investments are bought and held.

What About Traditional IRAs?

The table above omits traditional IRAs because they require a different comparison.

A Roth IRA is funded with after-tax dollars. Qualified withdrawals are tax-free. A deductible traditional IRA generally gives you a deduction today, but withdrawals are taxable later.

If you put $10,000 into each, the Roth will appear superior when both earn the same return and the traditional IRA's distributions are taxed. But that ignores the traditional IRA's initial tax deduction.

Suppose your marginal tax rate is 24%. An illustrative $10,000 deductible traditional IRA contribution—ignoring annual contribution limits—saves $2,400 in current taxes at a 24% marginal rate.

Here's the surprising result: if the contribution and withdrawal tax rates are both 24%, Roth and traditional IRAs are mathematically equivalent when we compare equal after-tax investment costs and assume tax-free growth on the invested tax savings. If those savings are invested in a taxable account, however, taxes on their earnings can give the Roth an advantage.

If your tax rate is higher today than when you withdraw, the traditional IRA generally has the advantage. If your rate is higher when you withdraw, the Roth generally wins. A surprising number of retirees are subjected to higher effective tax rates during the withdrawal period, especially after a spouse dies.

Advertised tax brackets are far from the only consideration. Traditional IRA withdrawals can increase the taxation of Social Security income and trigger Medicare premium surcharges and other income-based costs. Qualified Roth distributions avoid those hidden taxes and costs.

The lesson is that the best retirement account depends on when the tax is paid, the applicable rates, and what you do with the money in the meantime.

What If the Money Goes to Your Children?

Under current law, appreciated investments held in a taxable account generally receive an increased "basis" when the owner dies. Decades of unrealized capital gains simply disappear for income-tax purposes. The basis step-up is particularly valuable for investments that have appreciated for many decades.

A traditional IRA receives no comparable adjustment eliminating its deferred ordinary-income tax liability. The beneficiary inherits that liability, and the inherited IRA distribution rules frequently require the money to be withdrawn within ten years. The beneficiary is often subject to higher effective tax rates on the withdrawals than is the decedent.

A Roth IRA passes to beneficiaries with qualified distributions income tax free so long as the usual rules are met.

Thus, the optimal strategy depends on numerous factors, including many unknowns and unknowables. And that strategy may be different for money you expect to spend during retirement versus money you expect to leave for your children. Plan. But understand that even the best plans may lie in ruins if too many variables change unexpectedly or if even one changes markedly.

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How Much More Must You Earn to Keep Up Without Tax Deferral?

A $10,000 investment growing tax-free at 8% annually for 50 years becomes approximately $469,000.

The same investment held in a taxable account with all gains realized annually must earn approximately 9.41% before taxes to produce the same ending value.

An extra 1.41 percentage points must be earned every year to overcome the tax cost. And that assumes only a 15% tax rate. At a combined federal and state income-tax rate of 30%, you'd need to earn 11.43% annually, an additional 3.43 percentage points. At 38%, a tax rate that can apply to substantial capital gains in high-tax states, you'd need to earn an astonishing 12.90% annually, a 61.25% higher return, just to keep up with an 8% Roth!

For a taxable investment whose gains are realized every ten years, the required return falls to 9.05%. If gains are deferred until final sale, it's 8.51%. If the investment qualifies for a stepped-up basis at death, the required return falls to 8.23%, reflecting principally the annual dividend tax.

This doesn't mean taxes should dictate every investment decision. Investments differ in risk, diversification, liquidity and expected returns. Nor should anyone hold an investment merely to avoid realizing a gain.

But the arithmetic demonstrates an important principle: before taking additional investment risk to earn another 1%, consider how much of a return you might gain by postponing the tax.

The Value of a Roth Compared with Non-Roth Accounts

We are often asked: if I have $10,000 to invest for decades, how much does the type of account, and how often I pay tax, really matter? In other words, which account should I invest in?

We routinely compare taxable, Roth, and pre-tax accounts when advising clients about retirement contributions.

The options include:

Roth IRA (or other Roth-style retirement account): the tax is paid before the money goes in; thereafter, assuming the rules are satisfied, there is no tax on interest, dividends, gains, or qualified withdrawals.

Traditional IRA (or other pre-tax retirement account): investment income grows tax-deferred, and distributions generally are taxable as ordinary income. To compare equal after-tax dollars invested, we must account separately for the tax savings on the traditional IRA's upfront deduction.

Taxable account holding long-term-growth assets: qualified dividends are taxed as earned, capital gains are taxed when stocks or other assets are sold, but unrealized appreciation remains deferred. If the owner dies holding the assets, the heir(s) get a stepped-up basis, which wipes out the tax on deferred gains.

A taxable account is not simply "taxable every year." A large portion of the tax can be deferred for decades and, potentially, eliminated due to the stepped-up basis at death.

An example

We'll reuse the preceding article's $10,000 investment and 8% return, this time bringing traditional IRAs into the comparison. Assume qualified dividends and long-term gains are taxed federally at 15%, ignore state taxes, and reinvest everything after tax. Calculations exclude transaction costs.

Assume a 24% eventual ordinary-income tax rate on traditional IRA distributions. We'll compare identical $10,000 starting balances.

Here's what $10,000 grows to:

After	Roth IRA	Traditional IRA after 24% withdrawal tax	Taxable: all gains realized annually	Taxable: gains every 10 years	Taxable: hold gains until end	Taxable: held until death/step-up
30 years	$100,627	$76,476	$71,968	$76,993	$83,924	$94,524
40 years	$217,245	$165,106	$138,947	$152,033	$176,049	$199,858
50 years	$469,016	$356,452	$268,264	$300,207	$370,835	$422,573

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The Roth IRA wins because the taxable account, with nothing sold, suffers an annual tax drag on dividends. But that taxable account has retained about 90% of the Roth's ultimate value: roughly $422,500 compared with $469,000.

That's remarkable.

Taxable is Not Necessarily Tax-Inefficient

If someone owns low-turnover growth assets, minimizes sales and ultimately leaves those assets to heirs, the taxable account can be enormously tax-efficient.

Compare with the investor who realizes all gains every year. After 50 years, the same taxable account has only about $268,000 instead of $422,500.

Same investment. Same 8% pretax return. Same 15% capital-gains rate.

The difference, roughly $154,000, is the result of paying taxes along the way rather than deferring them, potentially until they disappear at death.

Let’s Add State Income Taxes and Higher Federal Taxes

The first example assumed a 15% federal capital-gains tax and no state tax. Higher-income investors in high-tax states can face much higher rates. Let's assume a 23.8% federal tax on qualified dividends and long-term capital gains, plus 7.2% state income tax, for a combined 31%. For traditional IRA withdrawals, we'll assume 32% federal plus 7.2% state, or 39.2%.

Everything else stays the same: $10,000 invested at 8%, including 1.5% qualified dividends and 6.5% appreciation.

Investment strategy	30 years	40 years	50 years
Taxable: gains realized annually	$50,124	$85,781	$146,804
Taxable: gains realized every 5 years	$53,103	$92,645	$161,631
Taxable: gains realized every 10 years	$56,608	$100,888	$179,804
Taxable: gains realized only at the end	$67,441	$136,595	$279,590
Taxable: held until death with stepped-up basis	$88,409	$182,807	$378,000
Traditional IRA, after 39.2% withdrawal tax	$61,181	$132,085	$285,162
Roth IRA, qualified tax-free withdrawals	$100,627	$217,245	$469,016

At these higher tax rates, realizing gains annually leaves only about $147,000 after 50 years. Holding the investment until death, with a stepped-up basis, leaves $378,000.

That's a difference of more than $231,000, even though both investments earned the same 8% before taxes.

And consider the Roth comparison: to match an 8% Roth return, an investment whose entire return is taxed annually at 31% must earn 11.59% before taxes. That's an additional 3.59 percentage points every year, nearly 45% more than 8%, just to overcome taxation. That puts the taxable account at an enormous disadvantage compared with the Roth.

But We Haven't Been Fair to the Traditional IRA

In the first table, the approximately $356,500 traditional-IRA result started with the same $10,000 as the Roth. But a deductible $10,000 traditional-IRA contribution saves $2,400 in current taxes at a 24% marginal rate. Investing those savings in a side account outside the IRA makes the traditional IRA a much better deal than the comparison above suggests. Spend the savings instead, and the Roth retains its big advantage.

If tax rates are identical when the money goes in and when it comes out, Roth and traditional IRAs are mathematically equivalent when we compare equal after-tax investment costs and assume no taxes on earnings in that side account. But if those savings are invested in a taxable account, taxes on the earnings give the Roth an advantage.

The Roth’s advantage over a traditional IRA isn’t merely that the Roth is ‘tax-free.’ The comparison depends on the tax rates when contributions and withdrawals occur, including the effect of higher Medicare premiums and other income-related costs. If today’s marginal tax rate is higher than the eventual withdrawal rate, the traditional IRA generally has the advantage; if the future rate is higher, the Roth generally wins.

An Inheritance vs. Traditional IRA

A taxable appreciated asset gets a stepped-up basis to fair market value at death. Decades of unrealized capital gain disappear for income-tax purposes. Our most successful “millionaires next door” clients have done precisely that: buy and hold. It won't always work; the Dow Jones Industrials didn't regain their 1929 peak until 1954, although an investor reinvesting dividends would have recovered by approximately September 1945. But buying and holding quality investments has been an enormous wealth-building strategy for many of our clients.

A traditional IRA does not get that stepped-up basis. The beneficiary inherits the income-tax problem along with the account, and current inherited-IRA distribution rules generally require full distribution by the end of the tenth year for most non-spouse beneficiaries.

A Roth IRA generally gives heirs tax-free qualified distributions, although the ten-year withdrawal rule generally applies here, too.

What you expect to do with the money matters enormously. If you’ll spend it during retirement, compare the taxes on withdrawals or investment sales. If you’ll leave it to heirs, compare what they’ll receive after taxes, including their expected marginal rates on inherited retirement-account distributions. A taxable investment held until death may be far more attractive than one sold during your lifetime, while a traditional IRA’s balance overstates its spendable after-tax value.

The lesson: the tax rate matters enormously, but so does when you pay it, and whether you or your heirs will ever have to pay it at all.