The Truth About The Taxes You Pay

Scott A. T.: Broadcasting from One Dallas Tower, Scott Alan Turner, the financial rockstar and high priest of the church of the financial truth. Here to help you get out of debt faster, save more money and retire rich. With me is producer Katie, wants a deep breathe so she can buy a half a cow at a time moo! On the show today I'll be answering your questions about money, business and life. You have a question you'd like answered on the show visit goaskscott.com.

In the year 1696, the English government passed a law that required the subjects to pay a tax based on the amount of windows in their home. People said, "This is silly to be taxed on something, we're just going to reduce the number of windows in our home. We're going to cover them up." There was less light, less ventilation, a lot of health problems were introduced. Not a particularly bright tax, get it. Follow that up and since the year 1789 the English government outlawed making your own candles to illuminate your home unless you paid a tax on that as well. Most people decided, "No, I'm not going to pay that tax, we just won't have candles in our house." It became a very dark time in England.

Years later the government realized, "Hey, we're stupid let's repeal these taxes." In order to understand the opportunities to avoid paying taxes, we first got to cover what are the different types of taxes that we are paying? What are the different groups? How do we pay taxes? Who pays them? Then from there we can get into, "All right, let's look at the different opportunities available." You got income taxes that's if you earn income, you can get deductions, tax credits and you don't pay any income taxes if you are under a certain income threshold.

We've got property taxes, those are collected by the state, you can have taxes on your automobiles, on a boat, if you own a boat, trailers, you have a trailer, little landscape trailer, you got to pay taxes on that. Those amounts can presented just in very wildly from state to state, lots and lots of variances in property taxes. One for example, agriculture exemptions, here in Texas let's say I own five acres of land and I put some bees on the land, I can get an agriculture exemption and pay lower property taxes, that's pretty cool?

Way cheaper than buying land and putting a cow on it because cows are very expensive, bees cheap. What about consumptive taxes? These are the taxes on the sale of stuff you consume, consumpt. Your refrigerator if you buy a new fridge, cellphone, fishing licence if you like to fish, gas tax when you pay at the pump. Toll roads, we've got a lot of those around here. We've got the sin taxes, taxes on cigarettes, alcohol ... Please not intending to anger you, they're slumped under what's called the sin taxes.

These are how the imperial federal government gets you to curb your behavior without outlawing the underlying product that's being sold. Many states have sales tax holidays for consumptive taxes usually around going back to school so you can get clothes and shoes and pencils and books sometimes laptops for little Johnny, little Susie, not pay taxes on those.

What about my favorite buying on the internet to save taxes? I love this one, you might think you can save money by not paying taxes when you are buying or selling something on the internet. However, those sales are subject to sales tax usually. You and I and the vast majority people are big tax evaders on this issues. This is from the Texas website it says, "What should you do if the out of state seller does not collect Texas use tax?"

If the seller did not collect Texas use tax then you can report it directly to the comptroller's office. You don't have a sales tax permit, you can file an occasional use tax return, "Reporting use tax that is due helps put out of state vendors on an equal footing with Texas vendors." Even though when you order something on the internet and you may not have to pay sales tax on it, normally the state in their literature, laws, whatever want you to pay taxes on that but they just have no way to legally enforce it.

Here's one I found interesting, Texas garage sales and Texas sales tax, you probably got these in your state as well. If you have one or two sales of taxable items regardless of price during any twelve month period or sales totaling up to three thousand dollars and account a year of items that were originally acquired for personal use by the person or family member of the person selling the item; for example in the same calendar year you have a garage sale of your family's personal items and are at a thousand dollars.

You sell a used bicycle on Craigslist for two hundred dollars and you sell a child ... "Oh, I'll sell my Star Wars toys." Sell my Star Wars toys on eBay for five hundred bucks. Then I or you have made more than two sales in a twelve month period, the exemption does not apply. I've got to go fill out some forms reporting that, "Oh, I sold some stuff and I've got to pay sales taxes on it." None of that goes on. You must obtain a sales tax permit and start collecting tax on all future sales of taxable items beginning with the first sale after the limit is reached.

I can't have two garage sales a year without getting a sales tax permit, I'm paying taxes on stuff. Can't sell anything on eBay if I sold more than a few items a year. Nobody does this, nobody, meaning reporting unpaid sales taxes on internet purchases, sales on state income tax. According to the Israelis you post three things on Craigslist over a twelve month period or a Facebook group, you've got to collect the sales tax on it. Everybody is a tax evader on this issue, consider yourself a criminal, at this point you have been notified. I bet you didn't know this.

Moving on, capital gains taxes, those are taxes on investments that appreciated: stocks, bonds, real estate, you can lose some money on those too and you can write off the loses. When Warren Buffet is talking about how he pays less in income taxes than his secretary he's talking about capital gains because most of his money comes from his investments which have lower tax rate than ordinary income or employees. Mitt Romney same thing, back when he was running for the presidency, he said, "I don't pay any income tax or much on income taxes." It's because money comes from investments and businesses that he owns.

We've got inheritance in estate taxes called POD, Payable on Death, the amount an individual can leave to their heirs without having to pay federal estate tax. Roughly two out of every a thousand people owe some type of estate taxes. You have to die with more than 5.5 million dollars. Currently when the imperial federal government gets desperate in the future you can pretty much assure that amount is going to come down because they're going to take it from the dead people because you know what? Dead people they don't vote.

How about business taxes? We've got corporate taxes, if you're a business owner, how you structure your business if you own one or are considering owning one. Vastly different tax consequences. Here is an example I pulled it off nolo.com, it says, "Sole proprietors just report their income on their personal tax return form 1040, you pay social security, medicare taxes on your own." Said, "If you work for an employer would cover half those costs as payroll taxes. S Corp they've got more tax benefits, you pay payroll taxes minus social security and medicare. You can pay yourself a salary and pay yourself a dividend, you pay zero social security and medicare taxes, on the dividends. You're going to save roughly fifteen percent there in taxes.

There are rules though you just can't pay the dividend and not take the salary to avoid the taxes. You have to have your reasonable salary, we've had to go through this in our businesses before. Again we're explaining all these that we can build on them. You've got to know the different types of taxes that we can figure out how to avoid paying them. The next example, in one year the corporation has profits of seventy thousand dollars, it pays thirty five thousand dollars in employee's' salary and thirty five thousand dollars as a corporate distribution. The salary, the thirty five grand subject to a social security medicare, the distribution is not as a result Mel pays five thousand three hundred and fifty five dollars less than if you had been a sole proprietor and the entire seventy grand was subject to taxes.

If you were a sole proprietor, you'd pay fifteen percent on the full seventy grand or ten thousand seven hundred in taxes. There's a catch though S Corps cost more to run: you've got yearly registration fees, you got to pay more for accountants, depending on your state. Here in Texas we have a yearly franchise fee just for being in business, doesn't matter if you're a franchise, they just call it the franchise fee. You don't have to have a franchise you still pay it. Payroll taxes, you don't have a whole lot of on these, 12.4% for social security, 2.9% for medicare employers. If you're an employee they usually pick up half of each all they do, they pick up half of each of those.

The imperial federal government loves that you don't know about this, whatever your salary is eight percent of it, that's money you don't get. It's just factored into every hiring decision, a forty thousand dollar hire if that's your salary being offered to you, that is going to cost an employer somewhere between fifty and sixty grand between the taxes and benefits. That's what they have to account for if they're going out to hire somebody. If I'm looking to hire an entry level person from college to work for me I've got to occur about fifty or sixty grand just to be able to pay them forty grand with all the benefits and the taxes that I've got to cover.

Steve writes, I want to let you know we're working very hard to personally cut it since we first refinanced every spare dollar has gone on that payment. Which brings me to my question,

Steve: "We received the statement and all the extra money we put on the loan so far has not gone to principle, it went to interest. How do I get the bank to put the extra money on the principle?" The first place I'd look is your loan documentation, from whenever you took out the car loan. Go in there, there should be a section on prepayment, paying in advance, something like that. You'll see what specifically it says about that and if you want to prepay the steps in order to do that should say that on there in plain and simple language.

Scott A. T.: Based on that, that might give you some direction as to what your next step should be. If it's not clear call up the loan holder and say, "Hey, we sent in a bunch of extra money can you apply that towards the principle?" See what they have to say then. With the mortgage if you're prepaying a mortgage typically you'd mail and check and you put in the memo, "Extra money towards the principle." Then they would see that and take care of it or if you did it electronically you could put that in the memo is there as well. Car payments should be very similar it's going to depend on that language that they put in the original loan document though. Check that there fast, quick read, quick phone call, should get it straightened out for you. You figure out what you need to do, keep crushing it Steve way to go, get rid of the car debt.

Brian asks if there is a good time to close credit card accounts. Says,

Brian: "I'm sure you're familiar with the idea of getting a mortgage with no credit score and having no open credit card accounts whatsoever. Is closing all credit card accounts really the best way to get into a mortgage when you're ready to buy a home?" No and there's a couple of reasons for that: Number one, when you close an account, your score drops a little bit temporarily.

It's just a fact, it's how it works, don't ask me why, I don't know, it just does. You were thinking it could be the opposite because, "Oh, I have less opportunity to rack up debt but if I close scores they just don't work that way." Closing a credit card account it lowers the average age of your accounts and it's one of the smaller factors in your credit history. The big one though, the big kicker is thirty percent of your credit score is call from the credit utilization ratio.

Scott A. T.: Let's explain with example, if you have thirty thousand dollars in available credit if you show a balance of ten thousand dollars or less, FICO likes that. thirty percent of your score is based on the ratio and they like to see a ratio of thirty percent or less, it's the double thirty percent. If you have zero balances on all your accounts that's great you're not utilizing any of your credit which is awesome. If you close an account you can increase your utilization rate if you have a balance.

For example if instead of a thirty thousand dollar open line of credit you have a twenty thousand dollar open line of credit. You close one of your cards that had about a maximum credit charge limit of ten thousand dollars, you go from thirty to twenty and you still got ten grand in the balance, your utilization is now fifty percent. You're using fifty percent of your available credit, that's bad because you want to keep it at thirty percent or less.

Not your situation because you're not using your credit cards, this doesn't apply to you but it does to many people who have a balance on their cards. Your next question, "If someone already has good credit would you recommend waiting until after purchasing a home to close credit card accounts?" Yes, I'd absolutely wait till after the closing if you have a good credit score. As I mentioned, people think closing the card is going to increase your credit score but it often goes down for those reasons I just mentioned. Just sit tight, wait till the closing then shut them down. "Is there ever a good time to close credit card accounts or should we just live with them being open for the rest of our lives even if we don't intend to use them?"

After you get your mortgage, yeah you can close your accounts. You'll have a credit score probably one to two years until after your mortgage is paid out. Let's pick a number and let's say you're going to take fifteen years to pay off your mortgage, that mortgage payment is going to show up as a loan on your credit report. You're going to have a credit score for the duration of the mortgage until it all gets paid off then the mortgage is going to be closed. It'll show us, "Closed, paid in full." On your credit report then usually one to two years after that if you didn't have any other credit lines open then your credit score will start to go down. Because you're not charging stuff which is silly, it's just how it works but a good credit score matters for things beyond mortgages and loans.

Insurance companies look at it, they'll see a different score. It's still a factor in your insurance rates. There is an argument for, you should use an insurance agency or company that doesn't use a credit score. That limits your options for the best rates, if there's only company I'd pick from you can't shop around. Utility companies use credit scores, you pay a higher deposit for those services when you don't have a credit score. I'm just trying to think through your situation Brian, "When you pay off your mortgage what are you going to need a credit score for?"

You just have to ask yourself that question years and years down the road. You can use a free service like creditkarma.com and they'll check your credit score or either you can check your credit score. Just check it a couple times a year if you see that it starts dipping, if your life situation changes or something is going to go up where you need a credit score. Maybe years down the road when you pay off your mortgage in full, however long that takes: seven, ten, fifteen, twenty years, whatever your goal is maybe by then they'll be this less emphasis on having a credit score for stuff that is just kind of silly.

If you get a million dollars in the bank I don't want to give you a pretty good rate on car insurance. The car insurance companies would rather go look at your credit scores so you can pay your bills on time. I don't know, that's the world we live in. Bottom line, close your accounts after you get the mortgage done. Then once your mortgage is getting ready to be paid off, at whatever point that is, note that your credit score is going to start to go down at that point. You need to start considering what you might need a good credit score for. Then maybe you want a gas credit card, charge your gas and pay it off once a month, just to keep you out of credit card debt craziness. Thanks Brian for the question.

Quick break, back in less time than you can skip this commercial you're listening to Scott Alan Turner. Hey nation, this is Scott Alan Turner here. Now, for those of you that are my long time listeners, you know I'm not one of those guys in the radio who announce every product that shows up on their desk. You're never going to hear me trying to get you to buy pencils because who needs to learn how to write anymore? Or recommending you listen to Yani to pump you up on your workouts. No, I have a name to appall to you, the Rock Star Nation. If I were, if I were to recommend something to you I would tell you about sweet potato skin cleanser. Never will your skin look so fresh and smell so scenty. It's illegal in nine countries, it's made with bits of real sweet potato, you know it's good.

They've done studies and sixty percent of the time it works every time, available nowhere, tell them Scott Alan Turner sent you. Saying that he can already picture them calling him up at all hours and feeding him their sad sex stories to try to win his sympathy, thirty seven year old local man Sean Duiz told reporters Tuesday that he knows exactly which of his relatives will cause problems for him if he ever came into some serious amount of money.

"If I ever hit it big, I'd guarantee my brother Danny he will be the first one scratching at my door. That pain in the butt is always mooching off me and asking to use my car." Said Duiz. We're marketing that if you were to score that kind of cash there would be no way to keep it secret not in this family. "My aunt and uncle, my cousin Ed who can't hold down a job. Jeez, the whole side of the family would probably just camp out here looking for a little piece even though they've never done a thing for me."

"Then there's my ex-girlfriend Carol, she's not family but she'd come sniffing around too, probably acting all nice to me for a change, basically everyone's going to want a piece of what's mine." He added that while he would of course be willing to help out in the event of a family emergency, he wouldn't just hand out any of his hypothetical riches to help anyone, "Open a restaurant or anything dumb like that." That was from The Onion, the satire website, the article was, "Area man knows exactly which relatives would be a problem if he ever came into money."

It's an appropriate story because for some of us if you're in a position where you've never had money, you come into money or you turn your financial life around; then you suddenly start improving your life and get money and accumulate money. You have stuff, you have a good life, you have no money worries, out of the woodwork, the people who have done nothing with their lives that are in your circle related here they come. What do you do sir? What do you do?
Danny asks,

Danny: “Why wouldn't you invest in exchange trade funds, ETFs over mutual funds, like an index fund.” An ETF is a type of fund that tracks an index like the S&P 500. It doesn't try to outperform it, it's just trying to replicate the performance. Trying to be the market not beat the market, talk a lot about index funds on the show. ETFs are a little bit different because they trade like a stock, you can buy and sell them during the day whereas buying index funds they're bought and sold at the end of the day. ETFs you can also buy and trade them on Margin, which is a bad idea. It's like buying stocks with credit that you don't have. Difference between an index fund, index fund again are priced at the end of the day ETFs, their prices fluctuate during the day like a stock. It's irrelevant if you're just in the market and trying to be in there.

Scott A. T.: It's important if you're buying and selling stocks all day long, you have something that you pay attention to. Not want to teach, we're going to skip that. An ETF is like an index fund, it has the goal of getting the return of the benchmark it's following. Say you're trying to get the ten percent that the S&P500 is getting you can do that at minimum cost. Passive individual investors, they don't need a brokerage account or a deposit with index funds whereas if you want to buy and sell ETFs you've got to have something set up at a place like ETrade or TradeKing, one of those type of accounts. You can buy an index fund without incurring transaction costs, you just pay the yearly management fee, whatever that happens to be. When you're buying and selling ETFs you're paying brokerage commissions.

If it's ten dollars a trade, five dollars a trade, each time you buy and sell one of those you're paying five and ten bucks. Now, not all ETFs are created equal, look for ones from low cost leaders like Vanguard has ETFs and they'll mimic the index fund they develop. If you're a passive investor who has the buy and hold mentality, the smart type investor, I try to teach people about it all comes down to cost between these two. The transaction cost is usually the biggest factor in determining whether ETFs are right for you or not.

I got a little factoid here according to the Journal of Portfolio Management it shows that the cost favors index funds as the choice for most passive retail investors as opposed to institutional investors. Let's say if you're looking at one year time period, you'd have to have over sixty thousand dollars of an ETF for the management of the in taxation savings to offset the transaction costs. With a longer-term horizon of ten years your break even would be about thirteen thousand dollars.

You're doing dollar cost averaging, a great way to build wealth, ETFs are much more expensive because of the commission costs you pay each month when you're buying and selling those transactions. Makes it in practical index funds are much better for dollar cost averaging. We got to put our math hats on for a minute not that that wasn't confusing enough when I caved more down into the weeds. Some ETFs you're going to see that they come with no transaction costs and no commissions, it is free right? It's free.

No, it's not free, there's no such thing as a free lunch. When you see an ETF it doesn't have a transaction cost, it doesn't have a commission, you have to pay what is called the bid-ask spread. Deer in headlights, let's break it down, it's the same thing you pay when you buy and sell a stock if you're buying and selling an individual stock. Here's my example for you, let's say I'm selling exotic coffee beans imported from Peru, I have to stock market.

Now with most things there's two prices, if you want my coffee you have to pay what is called the asking price. If I'm trying to sell my coffee I have to sell it at the bidding price. The bid price is what people are looking to pay for my coffee. Let's say if you want to buy the coffee, you might bid nineteen dollars and eighty cents a pound. It's good coffee but the asking price is what I'm looking to get for my coffee.

Twenty dollars and twenty cents a pound, there's a difference between those two prices. The bid-ask spread is the difference between my asking price and the bidding price of the forty cents. Where does the forty cents go?

Goes to the guys that are doing the negotiation in wall street. That's what the market makers get paid for the transaction, it's how they make money. That's the sale, that's the deal between us, they make their forty cents.

You buy a pound of coffee for twenty dollars and twenty cents but forty cents is the cost of the transaction. I get paid nineteen dollars and eighty cents for the sale, that is what I make. You now have a pound of coffee worth nineteen dollars and eighty cents even though you paid twenty dollars and twenty cents of pound for it because you paid forty cents to buy that coffee. If you turn around and sell it immediately in a nanosecond, sell the coffee to somebody else, same thing.

They're going to pay twenty dollars and twenty cents, you'll get nineteen dollars and eighty cents, the market makers make another forty cents, that next person has a pound of coffee worth nineteen dollars and eighty cents. That's why you wouldn't buy and sell stocks or ETFs immediately, it gets very expensive. The ETFs and stocks they work the same way, when you buy and sell ETFs you might lose a penny per share because of that bid-ask spread. Adds up to a lot of money when you're buying and selling hundreds of thousands of shares over time.

Even if you see ETFs with no transaction fees, no commissions you still pay the bid-ask spread, you still pay it. Probably this clears mud, I know we had to get into the weeds a little, show you how there's no such thing as a free lunch, no such thing as free coffee. Bottom line there are costs with ETFs that don't show up in your research, you're not going to see a dollar amount in there when you're researching what this bid-ask spread is going to be because it just depends.

It changes second to second in the stock market each day unlike a mutual fund it just got the management costs, it's right there in the paper, you can figure out what it is. I'm going to include a link in the show notes outlining the differences between ETFs and mutual funds, you can go over that. You can listen to this explanation a hundred times and still probably get confused at it but the differences comes down to cost. If you were to dollar cost averaging index funds are the better play in the long-term. Thanks Danny for the question.

Rafael from New York writes,

Rafael: "I heard about DFAs, stands for Dimensional Fund Advisors, can you explain what they are? I read somewhere that if you have more than a hundred thousand dollars you should consider this type of investment over index funds, what are your thoughts?" The foundation of DFA funds is Nobel prize Winning research which is a little too heavy to cover on this show. Also I'm not an economist, a mathematician or a Nobel prize winner I don't think I can explain it very well. Anyway when we talk about the Vanguard S&P 500 Index that is based on the S&P 500 Index. DFA they use custom indexes based on their Nobel prize winning research. It's still a passive investment strategy depending on what research you read and for what time period. You can find that DFA their index funds do better than other index funds or ETFs.

Scott A. T.: Vanguard probably familiar with them they're a giant mutual fund company and they're very well known for their passive investing philosophy and their index funds. That's how they keep their costs low, they don't pay big expenses to people actively trying to manage their funds. DFA also low cost because they use passive investing strategies. What they do a little bit differently is they emphasize different kinds of investments, small cap and value investing. Again it's based on their research that they've done also the history of their funds.

The thing is DFA is not for short-term traders, you got to have a buy and hold mentality. If you try to get in and out of the market they'll probably kick you out of their funds. That's one of the reasons their funds are so low is because they maintain those low costs through not allowing people in that are going to be in and out all the time. People that freak out when the market goes up and freak out ... You don't freak out when it goes up, people freak out when the market goes down. It's another way they keep their expenses low.

You cannot get into DFA funds unless you work with a financial advisor that has that investment philosophy. That advisor is going to make sure you have that investment philosophy because it's for the long-term. To become an advisor who even has access to those funds, you've got to go through a rigorous process. They're located in Austin, Texas, you have to fly down there, you've got to spend a couple of days, they're going to get you, they're not going to let every advisor in. Picky because again they want people who are buying into their philosophy and they're in it for the long-term. You can get into DFAs through some 529 plans, the state of Utah for example has access to them. Some 401k plans and through some fee only advisors. When you start comparing Vanguard index funds and DFA's funds, it gets a little interesting, I don't think I'd worry about comparing them too much as just make sure you're in index funds.

If you're a do-it-yourselfer, you can't get into them: Vanguard is fine, Betterment fine, Fidelity Index Funds fine, Index funds or your 401k fine. They're all better than actively managing mutual funds. If you work with a fee only financial player, that can get you into DFA funds, you can meet their requirements, you're a passive investor, in it for the long-term, they might do a little bit better than Vanguard overtime, time will tell. I'm in DFA funds through TD Ameritrade, that's my advisor brokerage company. Before that I was in the same funds through SHRAB and before that index funds at Fidelity and before that I had index funds at Vanguard. They were all were the right choices at the time, all better than actively managed funds. Thanks Rafael for the question.

The reason you have shade from trees is because of the seeds or the acorns somebody planted fifty years ago. The reason you'll be able to have shade from the umbrella or the cabana on the beach during your retirement is from the dollars you start investing today. Those are the words please share the love, text the link getfr.com, getfr.com to the three people you know who you think would like the show or three people you don't like just to annoy them. Your thirty dollar donation helps keep the show on the air. That's it for this episode, I'm your host Scott Alan Turner, rock star Katie is my producer. All the links mentioned in the show are going to the show notes on scottalanturner.com. If you have a question you would like answered in the show visit goaskscott.com. Thank you so much for listening.