Taxable Compound Interest

In many cases to compound interest in taxable accounts can cost some consumers more money than they make in the long-run. This is because, in the long-run, the combination of income taxes, lost opportunity costs on income taxes, inflation, and estate taxes can potentially erode most or all of the money that is in the compound taxable account. In order to help protect one's assets, one should design money strategies to help eliminate some or all of the costs when using a taxable compound interest strategy.

Here is a hypothetical example of how a taxable compound interest account can be eroded over the long-run:

Suppose a person deposits $50,000 into a Certificate of Deposit. The hypothetical assumption is that the CD is guaranteed and insured and will pay 6% compounded interest for as long as the money remains in the account. Let's examine how the account works over a 30-year term.

$50,000 compounded at 6% interest for 30 years = $287,175

Here are the basic costs associated with this event:

Original principal cost	= $ 50,000
Income taxes paid in a 32% marginal tax bracket	= $ 75,896
Inflation cost on the output over 30 years at 3%	= $168,863

As you can see above, the basic costs associated with creating $287,175 in a taxable compound interest account is a staggering $294,759.

But there are other problems with taxable compound interest accounts:

First, the income taxes were paid out-of-pocket. Therefore, there is also a loss of what those tax payments could have been worth in 30 years had they been invested. At a 5% net earnings rate, that costs the individual another $60,573. The compound interest account holder could potentially move into a higher tax bracket costing them even more money over the entire term period.

Second, if the client dies with the account, it may be included in his estate and subject to possible estate tax erosion.

Third, at anytime the taxable compound account could be subject to a creditor due to a lawsuit.

One must carefully assess the amount of time they will compound interest in any taxable accounts and consider the impact of taxation and inflation on these accounts in order to make appropriate financial decisions.