



**Tax Free Compounding:  
The Most Powerful Force in Investing and How to Achieve It**  
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# Three Physicists Lead the Way for Us



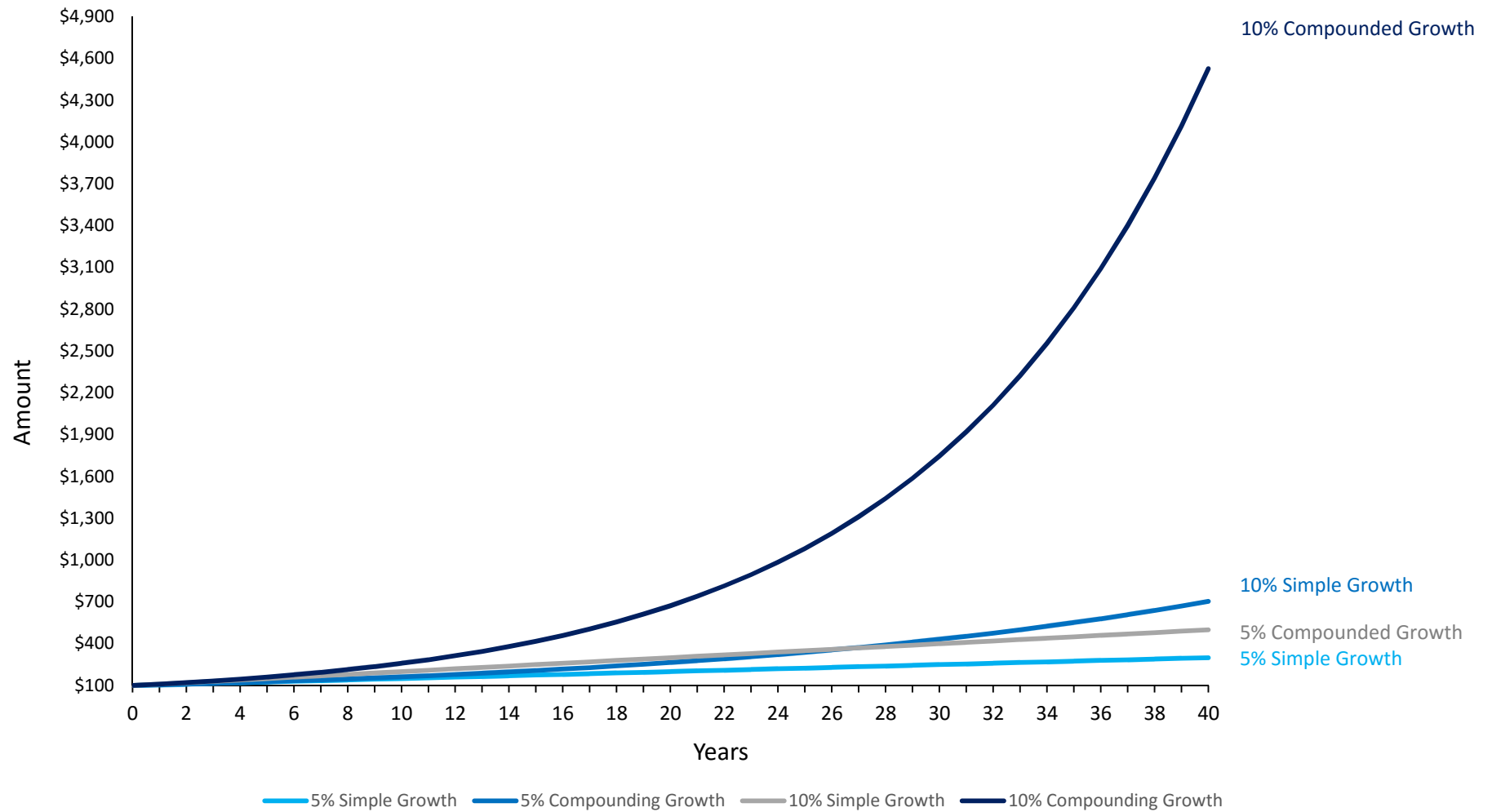
- Albert Einstein
  - $E = MC^2$  ...What?
  - “Compound interest is the eighth wonder of the world.”
  - “The hardest thing in the world to understand is the income tax.”
- Blattmachr’s corollary: Tax Free Compounding is the most important aspect of successful investing.

# Is the Corollary True?

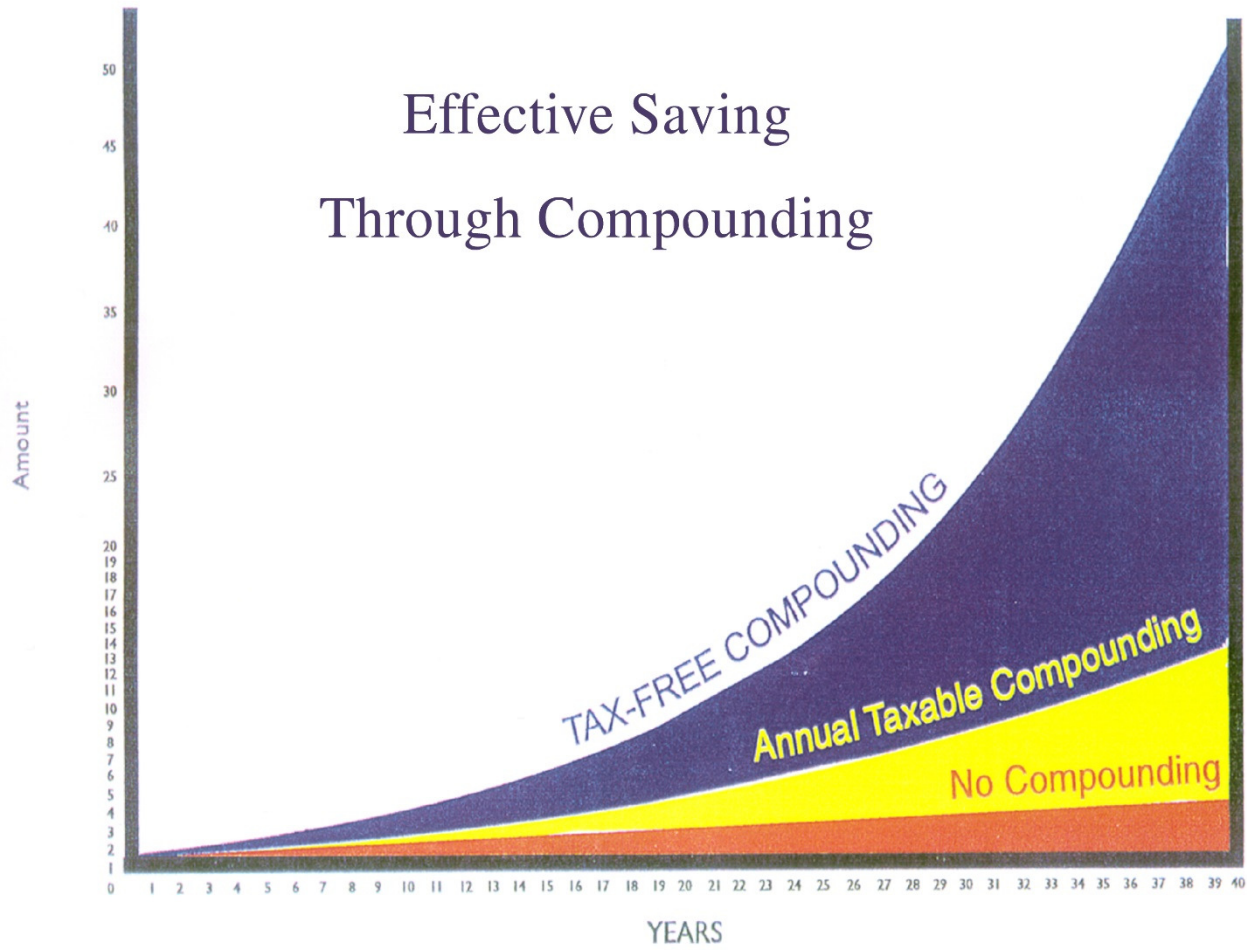


- Do we understand investments?
- Many religions and societies (from Plato to Moses to Jesus to Muhammad to Buddha) prohibited charging interest on money lent
- Before 1900, the concept of compounding of interest as not prevalent
- How important is the compounding? You cannot exaggerate it
- \$100, which earns 5% a year **without compounding**, grows to \$150 in 10 years and to \$300 in 40 years
- \$100, which earns 5% a year **with compounding**, grows to \$162 in 10 years and to \$704 in 40 years or **2.3 times more**
- \$100, which earns 10% a year **without compounding**, grows to \$200 in 10 years and to \$500 in 40 years
- \$100, which earns 10% a year **with compounding**, grows to \$259 in 10 years and \$4,500 in 40 years or **nine times more**
- Lessons Derived:
  - (1) **The longer the term, the greater the effect of compounding**
  - (2) **The higher the interest rate, the greater the relative increase in wealth with compounding**

## Simple vs. Compounded Return



# Effective Saving Through Compounding



# Public Markets for Company Equity



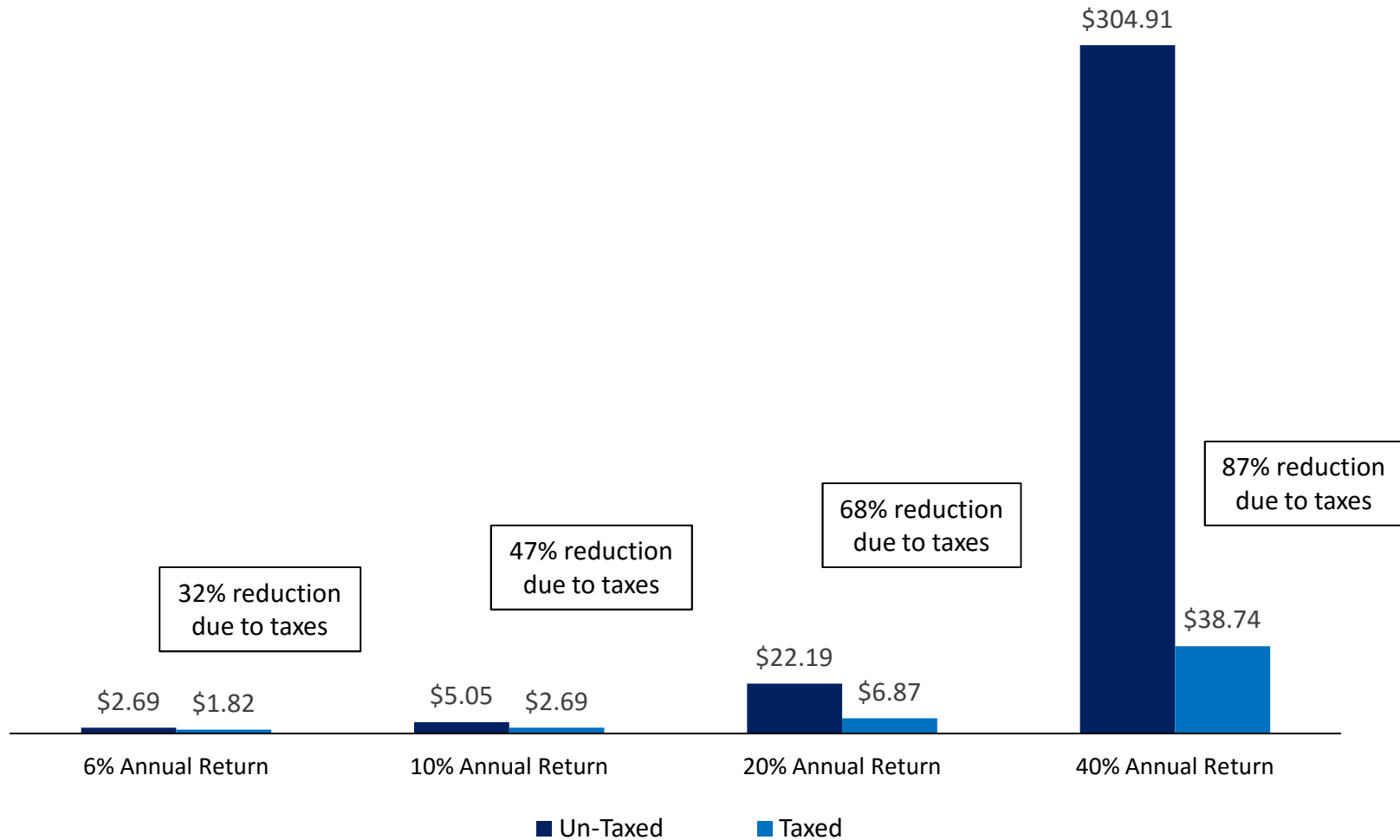
- Probably begun by the Dutch in the 1600s
- New York Stock Exchange: Begun around 1792
- Do we really hold sophisticated notions of investments?
- Distinction between equity and debt is...?
- What would the holders of General Motors bonds say?
- The tax lawyer's practice: Debt if you are the issuers; equity if you are the investor
- And that is on account of differences in tax treatment from the "returns"
- The incorrect beliefs of some lawyers:
  - (1) Equity and debt returns are the same
  - (2) Value of equity is determined by price earnings ratio and underlying value of the company's assets

- 17 years of compounded investment:
  - At 6% annually, each dollar grows to \$2.69 (or \$1.82 with a 40% annual income tax or a 32% reduction)
  - At 10% annually, each dollar grows to \$5.05 (or \$2.69 with a 40% annual income tax or a 47% reduction)
  - At 20% annually, each dollar grows to \$22.19 (or \$6.87 with a 40% annual income tax or a 68% reduction)
  - At 40% annually, each dollar grows to \$304.91 (or \$38.74 with a 40% annual income tax or a 87% reduction)
- Moral: **The higher the return, the more the return is eroded by current income taxation**

# Returns and Taxation – What the Numbers Tell Us



## The Effects of Taxation on Compounded Returns After 17 Years





# How Do We Reduce the Impact of Income Tax



- Buy and hold (limitations and tradeoffs) and wait for the “step up” at death
- Municipal bonds?
- IRAs (Qualified Plans):
  - Deferral only and time limited
  - No avoidance of estate tax (a great “eroder” of wealth)
- Roth IRAs
  - Is it worthwhile?
    - Erosion of base
    - Higher/lower tax rate?
    - Does it matter?
    - Estate tax advantage
- The wise old accountant’s adage: A Tax Dollar Delayed May Never Be Paid Up

# Other Ways?



- Charitable Remainder Trust
  - Description
  - Is the PV of the retained interest > after tax return?
  - Is 90% > 80%?
  - Comparison is not perfect (type of income, inflexibility)
- Charitable Lead Trust
  - Only if a “grantor trust”
  - Trade current deduction for a term of taxable income, unless...
  - Funded with a tax exempt investment
    - Municipal bonds—yield too low
    - Roth IRA—Cannot do lifetime transfer
    - Life insurance
      - Section 170(f)(10) doomsday provision
      - Non-MEC and borrow
      - Multi-life PPLI

- The most misunderstood financial product
- The structure: NAAR plus investment component
- “I don’t believe in life insurance”
- Its best attribute: Tax Free Compounding
- Why isn’t it used by everyone?
  - Cost (NAAR cost, fees and taxes)
  - Complexity
  - Limitations
  - Lack of understanding
- The solution for some: private placement life insurance

# Private Placement Life Insurance



- Life Insurance and SEC Regulation
- Wholesale NAAR and Flexibility of Investments (code limitations and rules)
- Capacity and complexities
- Is the cost worth the effort?
- Blattmachr's Formula: **Anticipated Annual Cost** (in BPs) divided by **Anticipated Annual Income Tax Rate** (in BPs) **must** be greater than the **Anticipated Annual Return** on the investment
  - Example: Anticipated Annual Cost (e.g., 100 BPs) divided by the Anticipated Annual Income Tax Rate (e.g., 40 BPs) equals the minimum threshold (e.g., 2.5 or rate of anticipated annual return should be higher than 2.5%)
  - Example: Hedge Fund Anticipated Annual Return: 9%. Anticipated Annual Income Tax: 45%. Net after tax return: 4.95%.
  - Earned Inside a Private Placement Policy with an Annual Cost of 1% (100 BPs), the net annual return is 8%.
  - The difference is having \$1.62 for each dollar invested outside the policy vs. \$2.16 inside the policy, after ten years
  - Another Example: Fund's Anticipated Annual Return: 30%. Anticipated income tax: 45%.
  - The difference is having \$4.61 for each dollar invested outside the policy vs. \$12.76 inside the policy, after ten years
- Moral: **The higher the return and/or the higher the tax rate, the more powerful the private placement chassis becomes**
- How to learn more...

**Ask Your Investment Advisor This Question:**



**“How much more could you earn for me if I were tax exempt?”**

# That Elusive 40% Return



- Is a 40% annual return the impossible dream?
- Is determining the movement of heavenly bodies possible?
- Our second physics genius: Sir Isaac Newton...a new mathematics: calculus
- No analogy is perfect but...
  - Computer scientist and physics guru Jeff Glickman's method
- Beat the dealer (when card counting was allowed)
- Beat the market (when market inefficiencies prevailed)
- Beat the market (when the market is efficient)—it is about machine intelligence

# Conclusion



- Tax free compounding is probably the most important factor in investing
- The higher the return the more important compounding is
- The higher the return the greater the drag current income taxation is on yield
- Tax free compounding is available with PPLI but the details are complicated (divide the anticipated annual cost by the anticipated annual tax rate to start the comparison—and the enhanced yield by investing in a tax free environment may reduce or eliminate the annual cost)
- It might be possible to achieve a 40% annual return on average which will make tax avoidance even more important