Record Government Spending Boosts Appeal of Tax-Free Income – Video Transcript

Federal and state governments have spent extraordinary sums in response to the economic toll inflicted by the coronavirus pandemic.

At some point it's likely that governments will look for ways to increase revenue to compensate for this spending, and one way for them to do this is to increase income taxes. That's why it might be a good time to think about ways to help reduce your taxable income.

Here are three potential sources of tax-free income.

Number one: Roth IRAs. Contributions to a Roth IRA are made with after-tax dollars and accumulate tax deferred, and contributions *plus* earnings may be received tax free in the future through qualified distributions. And this tax-free treatment of Roth IRAs is the gift that keeps on giving, because beneficiaries who may inherit your Roth IRA can also receive tax-free withdrawals.

There are income limits that restrict who can contribute to a Roth IRA, but you may be able to get around them by doing a Roth conversion with other retirement account assets.

Number two: Municipal bonds. Municipal bonds are issued by state and local governments to supplement tax revenues and to finance projects. Interest from municipal bonds is generally exempt from federal income tax and state and local income tax within the issuing state. However, state and local governments typically do tax the interest on bonds issued by other states.

And number three: health savings accounts. A health savings account, or H-S-A, lets you set aside tax-deductible or pre-tax dollars to pay for qualified medical costs that your insurance doesn't cover. Funds in a health savings account accumulate tax-deferred, and qualified withdrawals are tax-free.

While an HSA is intended to pay for current medical expenses, you don't necessarily have to seek reimbursement at the time the expense is incurred. You can hold your HSA until retirement and then reimburse yourself for all the medical expenses you paid over the years by taking tax-free HSA distributions — money you can then use any way you'd like. Just be sure to keep receipts for all your medical expenses. To be eligible to contribute to an HSA, you must also be enrolled in a high deductible health plan.

To qualify for the tax-free and penalty-free withdrawal of earnings, a Roth IRA must meet the five-year holding requirement and the distribution must take place after age 59½ or due to the owner's death, disability, or a first-time home purchase (up to a $10,000 lifetime maximum).

Nonqualified distributions are subject to regular income taxes and a 10% penalty tax, unless an exception applies.

Municipal bonds are subject to the uncertainties associated with any fixed income security, including interest rate risk, credit risk, and reinvestment risk. Bonds redeemed prior to maturity may be worth more or less than their original cost. Investments seeking to achieve higher yields also involve a higher degree of risk. Some municipal bond interest could be subject to the federal and state alternative minimum tax. Tax-exempt interest is included in determining if a portion of any Social Security benefit you receive is taxable. Because municipal bonds tend to have lower yields than other bonds, the tax benefits tend to accrue to individuals with the highest tax burdens.

HSA funds can be withdrawn free of federal income tax and penalties provided the money is spent on qualified health-care expenses. Depending on the state, HSA contributions and earnings may or may not be subject to state taxes. You cannot establish or contribute to an HSA unless you are enrolled in an HDHP.

All investing involves risk, including the possible loss of principal, and there is no guarantee that any investment strategy will be successful.