

**The Tax Free Trap:
How the Quest for Tax Free Income Can Deprive Injured Plaintiffs of the Highest and Safest Net After-Tax Results**

by Richard G. Halpern

FACT: The seductive appeal of the words “tax free income” leads many injured plaintiffs to overlook safer and higher-yielding money management strategies. FACT: The net after-tax income on a taxable investment will frequently be greater, often significantly greater, than the income from a tax-free investment.

The only reasonable and logical way to decide whether taxable or tax-free investments are best for an individual plaintiff is to compare the numbers. First and foremost, all funds received as the recovery for physical injury tort damages are tax exempt. The tax treatment of the income from this amount is greatly affected by what the income buys. Since the settlement is designed to cover damages arising out of a physical injury, much of the periodic income will typically be devoted to medical expenses and life care needs. These are tax deductible, so net taxable income is minimized. Assume a \$1,000,000 recovery, invested so as to produce a 10% annual return that is taxable as ordinary income. The resulting \$100,000 is then reduced by \$30,000 of deductions, leaving taxable income of \$70,000. At current rates, the tax on this would equal \$14,387...14.387% of the total income, for a final after-tax return on the investment of 8.5%. A tax-free investment of the \$1,000,000 would average between 5% and 7% return per year. No taxes on it, true; but it is less than the 8.5% after-tax returns with the taxable investment. This accounts for Federal income tax. State income tax can range from 0% to 12%, depending on the individual state and the amount of the income.. Using an average of 6%, net after tax return would still be 8% or higher. It is not a difficult choice. The contrast is even more striking with equities. Over the last 5 years, the average annual growth of the Standard and Poor’s 500 has been greater than 25% a year. As a long term capital gain, income from investments in the S&P 500 are taxed at a maximum rate of 20%. Even at this rate, the net after-tax return on investment is more than 20%, obviously far more lucrative than the best tax-free investment available. **In the vast majority of cases, tax-free investments of large amounts are simply not logical or financially sound, because they give away far more in income than they save in taxes.** This is why stockbrokers, portfolio managers, bank trust officers and professional money managers, who have a duty to seek the best possible net after-tax return to the investor, often use taxable investments. This is why those in the very highest tax brackets, people like Bill Gates, George Soros, Warren Buffet and Sandy Weil, still disdain tax-free investments for the higher yields of taxable returns. Seeking tax-free investments is a trap for the injured plaintiff, involving a large financial sacrifice for an imaginary financial gain.

There is only one wise way to invest a recovery: match the needs and risk tolerance level of the plaintiff to the type of investment, and seek the best possible after-tax investment return.