Hidden Taxes: What Is Your True Cost?

We are pretty well aware of the taxes we must pay as U.S. citizens; income taxes, payroll taxes, sales taxes, property taxes, and gift and estate taxes, to name a few. We can easily see these taxes on our pay stubs, tax bills, and sales receipts. But there are other taxes imposed on us that you may not be aware of. They are "hidden taxes." And when you add them together with visible taxes, you may be surprised about how high your taxes really are. Here's the rundown on hidden taxes.

How taxes are hidden

Taxes are hidden in many ways. For example, you see the payroll taxes that are deducted from your payroll check each pay period. What you do not see are the taxes that your employer pays. For example, in addition to income tax, your employer pays half of the Social Security tax as well as unemployment tax on your wages. Like all costs paid by your employer, these taxes get passed on to you as an employee (as a factor in compensation paid), as well as to shareholders and to clients and customers. And if you're receiving dividends from a corporation, keep in mind that taxes have already been paid on that income.

But most hidden taxes are paid by consumers. Sometimes these taxes are disguised as fees, surcharges, tariffs, duties, assessments, dues, excises, levies, licenses, and tolls, among others. And sometimes they're simply rolled into the price of goods and services and are either completely undisclosed or they appear somewhere in the fine print, which is often left unread by the consumer.

Planes, trains, and automobiles

Many hidden taxes are associated with travel. For example, when you pull up to the pump, you can clearly see the price for the gas, but the "taxes included" disclosure is usually posted somewhere else. How much of what you pay goes to tax revenue? Well, it varies by each state and its tax policy at the time, but it can range from 8¢ per gallon (Alaska) to 47.7¢ per gallon (California). (Source: Tax Foundation, Tax Data, February 25, 2011)

Taxes associated with traveling by air can include ticket excise tax, flight segment tax, arrival and departure fees, September 11 security fees, passenger facility fees, and--if your travel is international--agricultural inspection, customs, and immigration user fees. There are 16 or more fees that can add up to $61 (or 20% of your total cost) or more. (Source: Airlines for America, www.airlines.org, 2012) And those are just the U.S. taxes; there can be foreign taxes as well.

Car rental, hotel, and meal taxes can also add up. The GBTA Foundation, the education and research foundation of the Global Business Travel Association (GBTA), reported from its 2011 annual study of the top 50 U.S. travel destination cities that the travel taxes and fees imposed on travel-related services increased the traveler's cost an average of 56% over and above any general sales taxes paid, and that taxes for a single night at the national average room rate of $95.61 were $13.12. The combined lodging taxes levied by state, county, and city averaged 13.73%. (Source: News Release, July 21, 2011, www.gbta.org).

Sin taxes

A seemingly favorite way for government to tax is with the so-called "sin" taxes. Ostensibly, these taxes are imposed to reduce behavior that society considers unhealthy, immoral, or just undesirable in some way. That is why there is a tax on soda, alcohol, tobacco, gambling, and ammunition and firearms. According to the Alcohol and Tobacco Tax and Trade Bureau, revenue collected in 2011 for just some of the above-referenced items totaled approximately $26 billion. (Source: Statistical Release, December 1, 2011, www.TTB.gov)

Why are taxes hidden?

Not surprisingly, hidden taxes largely go unnoticed. The result may be that this can make it difficult for us to choose wisely the goods and services that we purchase, or to have a true accounting of our total tax burdens.

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How to Raise a Saver

Earmarking savings

To help your child learn how to manage money, encourage a 50-25-25 rule (or some variation) that earmarks 50% for immediate spending needs, 25% for the purchase of big-ticket items, and 25% for long-term savings.

As parents, we naturally want what's best for our kids. We want them to be polite, respectful, healthy, curious, and smart. And we hope that someday, they will grow into successful adults with independent, fulfilling lives. How best to accomplish this? Well, along with teaching the ABCs, 123s, and right from wrong, teaching your child the basics of financial literacy can help you raise a saver and lay the foundation for your child's bright financial future.

The early years, 3 to 7

Children this age may think that money magically appears from special machines whenever Mom or Dad pushes a few buttons, but there is one money concept they can understand. They know people need money to buy things--chances are they've tagged along with you to the grocery store a few times and watched you fill up your cart. Young children often model the behavior of their parents, so on these shopping trips, when you think your child is receptive, you might say things like "I can't buy this right now, I have to save more money and buy it next time" or "That's great these apples are a really good price today--I can buy more." These types of comments sink in and hopefully will get your child thinking about money and spending.

Once children can identify coins and dollar bills, give them a piggy bank or clear plastic jar to keep any money they earn or receive as gifts. Tell them they can buy something they want once they save a certain amount (make sure the item/price is appropriate and within short-term financial reach). Taping a picture of the item on the bank can provide a visual goal. Of course, children need a way to earn some money. Consider giving your child a weekly allowance and/or payment for small jobs around the house. Some parents tie an allowance to chores; others expect chores as part of everyday family life, but pay extra for "super" chores. The overall goal is to get your child excited about seeing the coins and dollar bills pile up.

The middle years, 8 to 12

These years are the sweet spot to lay a solid financial foundation. Children this age are more financially and materially aware--they have a general idea of what things cost (at least the things they want), they see (and covet) the possessions their friends have, they're bombarded by advertising, they get asked what they'd like for their birthday, and they often have a say in the new clothes and school supplies they get every year. And they aren't shy about pointing out the other items they want--electronics, sports equipment, room decor. It's enough to make any parent shudder.

The first thing to do? Explain the difference between "needs" and "wants." Continue to give your child an allowance, and encourage a 50-25-25 rule (or some variation) that earmarks 50% for immediate spending needs, 25% for the purchase of big-ticket items, and 25% for long-term savings. Consider matching a portion of that last 25% so your child is more motivated to save. Open a bank savings account for your child's long-term savings, and explain how interest and compounding works.

Help your child set financial goals, both short-term (a skateboard or sweatshirt) and long-term (a laptop). When it comes to spending, explain--and model--the concepts of delayed gratification, prioritizing purchases, and making tradeoffs. Help your child learn to get the most value for his or her money by selecting quality merchandise, comparison shopping, waiting for sales, and discouraging impulse buying. Let your child see that you, too, can't buy everything you want all the time.

Introduce the concept of budgeting by explaining how your family's budget works. Without going into detailed numbers, explain how income you receive from your job must be used to pay for needs like food, housing, utilities, and clothing, and how any money left over is set aside for emergency savings, long-term savings, and for "wants" like trips to the movies, restaurants, and new toys and gadgets.

The teen years

Children this age often seem to be ever-growing financial sinkholes--$10 here, $20 there, a laptop, sports equipment, an instrument, school trips, gas for the car, not to mention looming college expenses. Build on the saving, goal-setting, and budgeting lessons from earlier years. Be more specific about what things cost in your family's budget, and explain that in addition to paying day-to-day expenses and saving for college, you're saving for your own retirement.

When your child is old enough, encourage him or her to get a job to help pay for some typical high-school expenses and to start building a nest egg. Teach your child how to use an ATM/debit card, balance a checkbook, and wisely manage credit--skills they'll need in college. Finally, you can introduce your child to more advanced financial concepts, such as stocks, bonds, IRAs, and diversifying investments, by looking at teen-oriented investing books and financial websites.

Pay Down Debt or Save and Invest?

Should you pay off debt or should you save and invest? To find out, compare what rate of return you can earn on your investments versus the interest rate on the debt. There may be other factors that you should consider as well.

There are certainly a variety of strategies for paying off debt, many of which can reduce how long it will take to pay off the debt and the total interest paid. But should you pay off the debt? Or should you save and invest? To find out, compare what rate of return you can earn on your investments versus the interest rate on the debt. There may be other factors that you should consider as well.

Rate of return on investments versus interest rate on debt

Probably the most common factor used to decide whether to pay off debt or to make investments is to consider whether you could earn a higher after-tax rate of return on the investments than the after-tax interest rate on the debt if you were to invest your money instead of using it to pay off the debt.

For example, say you have a credit card with a $10,000 balance on which you pay nondeductible interest of 18%. You would generally need to earn an after-tax rate of return greater than 18% to consider making an investment rather than paying off the debt. So, if you have $10,000 available to invest or pay off debt and the outlook for earning an after-tax rate of return greater than 18% isn't good, it may be better to pay off the debt than to make an investment.

On the other hand, say you have a mortgage with a $10,000 balance on which you pay deductible interest of 6%. If your income tax rate is 28%, your after-tax cost for the mortgage is only 4.32% (6% x (1 - 28%)). You would generally need to earn an after-tax rate of return greater than 4.32% to consider making an investment rather than paying off the debt. So, if you have $10,000 available to invest or pay off debt and the outlook for earning an after-tax rate of return greater than 4.32% is good, it may be better to invest the $10,000 rather than using it to pay off the debt.

Of course, it isn't an all-or-nothing choice. It may be useful to apply a strategy of paying off debts with high interest rates first, and then investing when you have a good opportunity to make investments that may earn a higher after-tax rate of return than the after-tax interest rate on the debts remaining.

Say, for example, you have a credit card with a $10,000 balance on which you pay 18% nondeductible interest. You also have a mortgage with a $10,000 balance on which you pay deductible interest of 6%, and your tax rate is 28%. So, if you have $20,000 available to invest or pay off debt, it may make sense to pay off the credit card with $10,000 and invest the remaining $10,000.

When investing, keep in mind that, in general, the higher the rate of return, the greater the risk, which can include the loss of principal. If you make investments rather than pay off debt and your investments incur losses, you may still have debts to pay, but will you have the money needed to pay them?

Some other considerations

When deciding whether to pay down debt or to save and invest, you might also consider the following.

- What are the terms of your debt? Are there any penalties for prepayment?
- Do you actually have money that you could invest? Most debts have minimum payments that must be paid each month. Failure to make the minimum payment can result in penalties, increased interest rates, and default. Are your funds needed to make those payments?
- How much debt do you have? Is it a problem? How do you feel about debt? Is it something you can easily live with or does it make you uncomfortable?
- If you say you will save the money, will you really invest it or will you spend it? If you pay off the debt, you will have assured instant savings by eliminating the need to come up with the money needed to pay the interest on the debt.
- Would you be able to borrow an additional amount, if needed, and at what interest rate, if you paid off current debt? Do you have an emergency fund, or other source of funds, that could be used if you lose your job or have a medical emergency, or would you have to borrow?
- If your employer matches your contributions in a 401(k) plan, you should generally invest in the 401(k) to get the matching contribution. For example, if your employer matches 50% of your contributions up to 6% in a 401(k) plan, getting the 50% match is like getting an instant 50% return on your contribution. In addition, there are tax advantages to investing in a 401(k) plan.

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Can I convert my traditional IRA to a Roth IRA in 2012?

It may be an excellent time to consider converting your traditional IRA to a Roth IRA. As a result of market volatility, some investors have seen a reduction in the value of their traditional IRAs, meaning that the tax cost of converting may have dropped significantly. Also, federal income tax rates are scheduled to increase in 2013, so converting this year may be "cheaper" than converting next year.

Anyone can convert a traditional IRA to a Roth IRA in 2012. There are no longer any income limits, or restrictions based on your tax filing status. You generally have to include the amount you convert in your gross income for the year of conversion, but any nondeductible contributions you've made to your traditional IRA won't be taxed when you convert. (You can also convert SEP IRAs, and SIMPLE IRAs that are at least two years old, to Roth IRAs.)

Converting is easy. You simply notify your existing IRA provider that you want to convert all or part of your traditional IRA to a Roth IRA, and they'll provide you with the necessary paperwork to complete. You can also transfer or roll your traditional IRA assets over to a new IRA provider, and complete the conversion there.

If a conversion ends up not making sense (for example, the value of your Roth IRA declines after the conversion), you'll have until October 15, 2013, to "recharacterize" (i.e., undo) the conversion. You'll be treated for federal income tax purposes as if the conversion never occurred, and you'll avoid paying taxes on the value of IRA assets that no longer exist.

The conversion rules can also be used to allow you to contribute to a Roth IRA in 2012 if you wouldn't otherwise be able to make a regular annual contribution because of the income limits. (In 2012, you can't contribute to a Roth IRA if you earn $183,000 or more and are married filing jointly, or if you're single and earn $125,000 or more.) You can simply make a nondeductible contribution to a traditional IRA, and then convert that traditional IRA to a Roth IRA. (Keep in mind, however, that you'll need to aggregate the value of all your traditional IRAs when you calculate the tax on the conversion.) You can contribute up to $5,000 to an IRA in 2012, $6,000 if you're 50 or older.

Can I undo my Roth IRA conversion?

When you convert a traditional IRA to a Roth IRA, you include the value of your traditional IRA, reduced by any nondeductible contributions you've made, in income for federal tax purposes in the year of the conversion. But what happens if the value of your Roth IRA subsequently declines, making the conversion a bad deal from a tax perspective? No problem. The IRS lets you recharacterize (undo) a conversion, if you act in a timely fashion.

For example, assume you convert a fully taxable traditional IRA worth $50,000 to a Roth IRA in 2012. You include $50,000 in income on your 2012 federal income tax return. But shortly after the conversion, the value of your Roth IRA declines to $25,000. Now you're suddenly faced with the proposition of paying taxes on $50,000, while your Roth IRA is worth only $25,000.

All is not lost--because of the recharacterization rules, you have until your tax return due date (including extensions) to undo all or part of a conversion if it no longer makes good financial sense. So in this example, you have until October 15, 2013, to recharacterize. (Similarly, if your conversion occurred in 2011, you have until October 15, 2012, to undo the conversion.)

When you recharacterize, you need to withdraw the amount you originally converted, plus any earnings, out of the Roth IRA and transfer it back to a traditional IRA. To simplify the calculation of earnings if you decide to recharacterize, you should consider using a new Roth IRA for each conversion. You might also consider using a different Roth IRA for each separate investment, or class of investments, you plan to make--this way, if one investment goes down but another goes up, you can recharacterize only the Roth IRA that declined in value (you don't need to aggregate your Roth IRAs for this purpose). If you wish, you can always combine Roth IRAs later after the recharacterization deadline passes.

If you convert a traditional IRA to a Roth IRA in 2012 and then recharacterize, you'll have to wait until January 1, 2013, to reconvert those same dollars (and any earnings) to a Roth (or, if later, the 31st day following the recharacterization). However, any other traditional IRA dollars you have can be converted to a Roth IRA without restriction.