Tax-Smart Planning Strategies

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Minimizing your annual income taxes requires a regular review of your overall financial position. With tax season underway, now is the perfect time to evaluate some effective strategies that could help reduce your current and future taxes. Tax planning should be a year-round activity, so it's wise to revisit these topics regularly in the context of your current financial situation.

Manage Your Retirement Savings Accounts

If you have the means, maximizing your annual contribution to a retirement account will give your savings strategy a healthy boost. But it's important to understand how the different types of available retirement accounts differ. The most common options include:

Employer-sponsored retirement plans. Employer-sponsored 401(k) plans allow your investments to grow with taxes deferred until you take money out through a withdrawal or distribution. Some employers offer both a traditional 401(k) plan and a Roth 401(k); if yours does, you should be aware of the different rules for taxes on contributions and distributions:

- With a **traditional 401(k) plan**, contributions are made with pretax dollars, thus reducing your current income and, possibly, your current-year taxes. Choosing this option may make sense if you want to reduce your income in the current year and/or expect to be in a lower tax bracket in retirement. Required minimum distributions from the account begin at age 72.

- With a **Roth 401(k) plan**, contributions are made with after-tax dollars, and the account's accumulated funds have the potential to be distributed tax-free and penalty-free in retirement, if certain IRS requirements are met. This could make sense if you're not looking for a current-year tax deduction and anticipate being in a higher tax bracket in retirement. Under circumstances known as "triggering events" (one example is termination of employment), Roth 401(k) funds could be rolled tax-free into a Roth IRA and eliminate the need to take required minimum distributions from those assets. Required minimum distributions begin at age 72 in Roth 401(k) accounts but are not required in Roth IRAs.

Retirement plans for the self-employed. If you run your own business, you can use an individual 401(k), SEP (Simplified Employee Pension), or SIMPLE (Savings Incentive Match Plan for Employees) plan to shelter income.

IRAs. If you qualify, you may also be able to make a contribution to an IRA. As of 2020, there is no age limit on making regular contributions to traditional or Roth IRAs. Different rules for taxes on contributions and distributions do apply:

- With a **traditional IRA**, contributions are generally made with pretax dollars, thus reducing your current income and, possibly, your current-year taxes. Eligibility for making tax deductible contributions to an IRA depends on your tax filing status, modified adjusted gross income (MAGI), and whether you're covered by an employer-sponsored retirement plan. Required minimum distributions begin at age 72.
- With a **Roth IRA**, contributions are made with after-tax dollars, and the account's accumulated funds have the potential for tax-free and penalty-free distribution in retirement. Eligibility for contributing to a Roth IRA is based on your tax filing status and MAGI. There is no requirement for minimum distributions when you reach a certain age.
- **Converting traditional IRA assets to a Roth IRA** is another strategy to consider. Generally, this move makes the most sense for those who anticipate being in a higher tax bracket in retirement than they are now. Eliminating the need to take required minimum distributions is a meaningful benefit.

Maximize Your Deductions
Some deductible items, such as medical expenses and charitable contributions, must meet a specific threshold before deductions can be taken. If you fall short of the minimum in a particular year, you might be able to time future discretionary expenses or charitable contributions such that you exceed the threshold one year but not the next.

Review Form 1040
Examining your 1040 could help you spot opportunities for making investments that provide greater after-tax savings. Pay special attention to the Taxable Interest, Tax-Exempt Income, and Dividend Income sections of the form.

Consider Tax-Advantaged Municipal Bonds
Municipal bonds are an excellent tax-advantaged investment, especially for people who are in a high income tax bracket or have moved into a higher tax bracket after a promotion or career change. Interest earned on municipal bonds is exempt from federal income taxes and, in most states, from state and local taxes for residents of the issuing states (although income on certain bonds for particular investors is often subject to the Alternative Minimum Tax).

Plan for Capital Gains and Losses
To determine when to recognize capital gains or losses, you will have to know whether you want to postpone tax liability (by postponing recognition of gains) or to recognize capital gains or losses during the current year. If the gains will be subject to a higher rate of tax next year (because of a change in tax bracket), or if you cannot use capital losses to offset capital gains, you could recognize capital gains this year.

Don't Forget Life Insurance
Life insurance can provide liquidity to pay estate taxes and could be an attractive solution to other liquidity problems, such as those family-owned businesses, large real estate holdings, and collectibles may face. Structured properly, life insurance proceeds can pass free of income and estate taxes.

Putting the Pieces Together
These are just a few of the most common tax planning strategies. We can work with you and your tax professional to assess your current situation and determine which options could be beneficial to you. Making proactive, tax-smart decisions throughout the year is an essential piece of overall financial planning.

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Municipal bonds are federally tax-free but may be subject to state and local taxes, and interest income may be subject to federal alternative minimum tax (AMT). Bonds are subject to availability and market conditions; some have call features that may affect income. Bond prices and yields are inversely related: when the price goes up, the yield goes down, and vice versa. Market risk is a consideration if sold or redeemed prior to maturity.

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