SENSIBLE STRATEGIES TO REDUCE YOUR TAXES

BEFORE, AT, AND DURING RETIREMENT

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Overview

Disclaimer: This article discusses topics at the nexus of investments and taxes, but does not provide and should not be construed as providing tax advice. Please contact your CPA or tax professional for guidance on tax-specific issues.

Chasing returns can be a double-edged sword

When I first started working in the investment profession 25 years ago, my first job focused exclusively on researching profitable stock-picking strategies. While chasing returns is generally more glamorous than financial and tax planning, it is also a double-edged sword.

More certainty and less risk

Fast forwarding two decades, my experience and due diligence have led me to the conclusion that financial and tax planning can generate just as much or more financial benefit, but with significantly more certainty and less downside risk. This is one of the reasons I wrote this guide.

In the following, I describe some of the strategies I leverage to help improve after-tax performance for my clients. I have tried to make this easy to read without too much jargon, but I do assume some basic familiarity with common investment and tax concepts.

Please note this is not a comprehensive treatise covering all tax strategies. Moreover, the strategies mentioned are interrelated. That is, employing one strategy may impact the effectiveness of others.

Executive Summary

- Retirement accounts can shift the timing of income AND shelter investments from taxes on interest, dividends, and capital gains.
- Using tax-deductible retirement accounts and paying income tax on distributions in retirement works out favorably for many, but is not necessarily optimal for everyone (e.g., high earners).
- Strategic use of Roth-based retirement accounts and conversions provides another degree of flexibility to optimize tax planning.
- Beneficiary designations can be tax-optimized for those with different types of accounts and multiple beneficiaries.
- Periods of low/no earnings in retirement are the golden years for tax planning (e.g., Roth conversions & loss/gain harvesting).
- Basic investment planning can significantly reduce investment-related taxes (e.g., taxes on interest, dividends, and capital gains).
- Tax deferral strategies with income annuities can be enhanced by leveraging the mechanics of exclusion ratios.
- Variable and index-based annuities may convert capital gains and potentially stepped-up cost basis into costly income taxes.
- Titling of real estate investments is a critical detail that is often overlooked for maximizing depreciation benefits.

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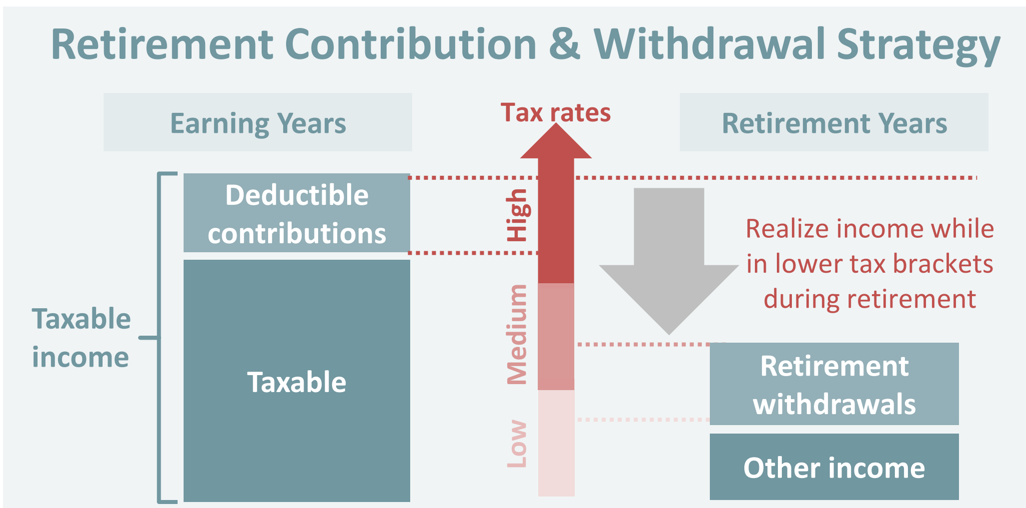
1. Income Tax & Retirement Accounts

1.1 Basics

Note: Section 1 focuses solely on the relationship between retirement accounts and <u>income</u> taxes. Section 2 discusses the additional benefits of retirement accounts in the context of <u>investment-related</u> taxes (i.e., sheltering from taxes on interest, dividends, capital gains, etc.).



If you are working and earning money, then you are likely paying income taxes. Moreover, our progressive tax system imposes higher tax rates as you earn more.

Retirement accounts can help you reduce taxes

Contributions to retirement accounts such as 401Ks, 403Bs, and traditional IRAs can reduce these taxes since they provide tax deductions in the year the contributions are made. In particular, these deductions temporarily shield earnings that would otherwise be taxed at your marginal rate.

Of course, these earnings will eventually be taxed when money is distributed out of the retirement account. However, one generally ends up in a lower tax bracket when they retire and are no longer earning. So this can reduce the tax rate they pay when those earnings are eventually taxed (i.e., when money is taken out of the retirement accounts).

1. Income Tax & Retirement Accounts

1.1 Basics (continued)

Married-filing-jointly (MFJ)

Another factor for married couples to consider is how taxes will likely increase after one spouse passes due to the loss of married-filing-jointly status. Of course, expenses may fall and offset that, but proper planning should consider this factor.

Control the timing of taxes

It is worth noting tax rates can change within brackets and many people (including me) expect tax rates to go up. However, my key point here is that **retirement accounts can be utilized to control the timing of taxes on some of your income**. In general, the goal is to shift the realization of income out of periods where it will be taxed at higher rates (e.g., peak earnings years).

THE 'TAX ON GROWTH' MYTH

Some people point out that it is bad to defer taxes since you end up paying tax on growth. However, this is mathematically inaccurate. Let us assume we earn $100, our tax rate is 20%, and that our investments double. If we pay tax upfront, then we end up with $80 and that will double to $160. If we defer taxes, then we invest the full $100 and it will double to $200. After we pay tax, we end up with the same $160. Readers interested in a more detailed discussion of this topic can read my Illustrating the Value of Retirement Accounts article.

1.2 Roth Accounts

Roth-based retirement accounts

Section 1.1 discussed deductible contributions to retirement accounts. You may also be able to make non-deductible contributions to Roth-based retirement accounts. Without the deduction, you will be paying income tax on those earnings in the same year. However, you will get the standard benefits of a retirement account (e.g., no taxes on the interest, dividends, or capital gains) and you will have required minimum distributions (RMDs). That is, the IRS will not force you to withdraw from this account during your lifetime and that money can grow 100% tax-free (unless you need to withdraw it).

1. Income Tax & Retirement Accounts

1.2 Roth Accounts (continued)

Given the previous discussion highlighting the benefits of deferring income tax, you may be wondering who would want to contribute to a Roth and pay taxes in the same year? There are two primary cases where this is often sensible.

- **Low earners:** The first case would be when you expect to be in a lower tax bracket. One example could be a young worker early in their career who expects to earn more down the road. Another example could be someone who was laid off or voluntarily choose to take time off within a given year. Regardless of the reason, anyone finding themselves in a lower than average tax bracket should consider Roth accounts.
- **High earners:** The second case is almost the opposite scenario. Some high earners may be trapped in higher tax brackets for their entire life. Thus, much of their income will be taxed at the highest marginal rate. If they expect tax rates to rise in the future, then paying tax on the income sooner via a Roth would allow them to lock in current tax rates. Moreover, the lack of RMDs could allow more of their money to grow tax-free for longer.

Roth conversions

Contributions are not the only way to get money into a Roth account. For example, traditional IRAs may be converted into Roth IRAs. That is, you can take money from an existing IRA and move it into a Roth IRA. Of course, the money taken from a pre-tax (i.e., income tax has not yet been paid) IRA account and placed in a post-tax Roth account is considered income and taxed accordingly. Thus, conversions provide us with another tool for financial planning.

1. Income Tax & Retirement Accounts

1.2 Roth Accounts (continued)

The golden period for financial planning

One key area where Roth conversions can be useful is for retirement planning. As highlighted earlier, many people will be in a lower tax bracket in retirement. So this is a ripe time to make Roth conversions since the income will likely be taxed at lower rates. I call this the golden period for financial planning.

Depending upon one's needs for income, they may have the option to delay Social Security (but receive higher payments down the road) and maintain the low/no income period for longer. However, we cannot control when RMDs must begin. Proper financial planning balances all of these factors to maximize the after-tax outcome.

$ High earner opportunity

Another key area where Roth conversions can be useful is for high earners. The IRS imposes limits which disqualify many higher earners from being able to contribute to Roth accounts. However, they may be able to use another strategy called the backdoor Roth conversion. This involves making non-deductible contributions to a traditional IRA, but then converting that contribution into a Roth.

There are important limits and considerations for this strategy. For example, if you already have existing IRA assets and you still want to employ a backdoor Roth strategy, then you must be careful not to violate the pro-rata rule. That is, the IRS demands that any such conversions proportionately convert deductible and non-deductible assets from your IRAs.

It is worth noting the IRS only looks at IRAs for this calculation. If one can transfer existing deductible IRA assets into an employer plan (e.g., 401K), then they may be able to leave only non-deductible contributions in the IRA and the pro-rata rule would no longer be relevant.

1. Income Tax & Retirement Accounts

1.3 Small Business Opportunities

One of the advantages of being a sole proprietor or small business owner is the ability to use alternative retirement plans. In particular, some plans allow for significantly higher contributions. That means you can take larger deductions and allow more money to grow with the tax benefits of retirements accounts (i.e., no taxes on interest, dividends, or capital gains which we address in Section 2).

Solo 401Ks and SEP IRAs

Solo 401Ks and SEP IRAs, for example, allow contributions in excess of $50,000 per year. This is a huge advantage relative to traditional IRAs where the limits are significantly lower (e.g., $6,000 per year as of 2020).

Defined benefit plans

Contribute more than $200,000 per year

Another tool, albeit more costly and tedious to administer, is a defined benefit plan. Having few, if any, employees is key for this plan since an employer must offer it to employees and fund their plans. The main benefit is the ability to contribute more than $200,000 per year. However, it can be combined with other plans like the Solo 401K or SEP IRA mentioned above. So this is one way to really turbo-charge your retirement accounts.

1.4 Beneficiary Designations

One easy way to reduce taxes is by strategically designating account beneficiaries (e.g., taxable brokerage, traditional IRA, or Roth IRA). For example, consider someone leaving behind a $500,000 IRA and $400,000 savings account to two children. Leaving the IRA (still to be taxed) to the lower earner could result in fewer taxes paid if they were in a lower tax bracket and the savings account would go to the higher earner tax-free. This would leave more money to the children and less to the IRS. For more precision (e.g., equalize after-tax inheritances), one could stipulate percentage designations within each of the accounts.

2.0 Investment-related Taxes

2. Investment-related Taxes

2.1 Basics

Note: For the purpose of this discussion, I assume investments are held in standard taxable accounts (not retirement accounts).

Capital gains

The first, and perhaps most obvious, investment-related tax is on capital gains. If you purchase an investment and sell it for more than you paid, then you will realize a capital gain and it will be taxed according to your tax bracket. It is worth noting capital gains tax rates are different than taxes on ordinary income. In particular, they are generally lower. However, capital gains on investment held for less than one year are considered short-term and taxed as ordinary income.

Qualified dividends

If investments generate income, that income will also be taxed. The three most common types of income are dividends from stocks, interest from bonds, and rent from real estate. Most stock dividends are qualified dividends. That is, they qualify for long term capital gains tax rates since they meet specific criteria set forth by the IRS.

Bond interest and rental income

Interest from bonds and rental income are both taxed as ordinary income. However, real estate depreciation can be used to offset the rental income as we discuss in Section 5.

A first line of defense against taxes could be to buy and hold for long periods as to avoid unnecessary capital gains taxes. We discuss other tools and tactics in the rest of this section.

2.2 Exchange Traded Funds (ETFs)

Unlike traditional mutual funds that pass on capital gains made inside the fund to their investors, exchange traded funds (ETFs) typically pass on little to no such gains to their investors. While many attribute this tax-efficiency to low-turnover in the indexes ETFs follow, there is another more important factor.

2. Investment-related Taxes

2.2 Exchange Traded Funds (continued)

In-kind ETF creation and redemption

While I do not go into the details of the actual mechanics here, shares of ETFs are primarily created and redeemed via in-kind exchanges that allow them to rebalance their portfolios without the usual buying and selling transactions that trigger capital gains inside of mutual funds. This mechanism makes ETFs significantly more tax-efficient relative to most mutual funds.

It is also worth noting that ETFs pass on income (e.g., dividends or interest) from their holdings to their shareholders. Just as with mutual funds, this income is taxable as if the investor held the stock or bond directly. Moreover, when one purchases an ETF and sells it for more, it will trigger a capital gain.

2.3 Tax-loss (+gain) Harvesting

Realizing investment losses to reduce taxes

One common strategy many portfolio managers employ to manage taxes is tax-loss harvesting. In a nutshell, this is the process of selling investments that are down to realize losses in order to net them against (current or future) investment gains or possibly up to $3,000 of non-investment income.

The investments that are sold are typically replaced with similar investments. So the transactions do not meaningfully change the economics of the overall portfolio.

These tactics are used by mutual funds – many of which carry a "tax aware" label. While some mutual funds have kept capital gains distributions low historically, one should monitor the embedded gains in their portfolios since they could trigger significant capital gains for their investors.

It can also be advantageous to harvest capital gains in a lower tax bracket. For example, one currently in the 0% long term capital gains bracket could convert some gains tax-free.

2. Investment-related Taxes

2.4 Minimizing Dividends

Tax tail might be wagging the dog

Some investors and investment managers avoid dividend-paying stocks for the specific purpose of avoiding the taxes on their dividends. I believe strategies like this are letting the tax tail wag the dog. For example, some of the best performing stocks in recent times pay dividends (Apple, Nike, Microsoft, Visa, etc.). Moreover, dividends indicate a certain degree of quality to the extent that many lower quality companies cannot afford to pay dividends.

This type of income-avoidance strategy does not apply to bonds. The IRS applies a more general rule that taxes interest whether it is paid out as income (interest) or accrued within the price of the bond. For example, zero-coupon bonds pay no interest. However, their accrued interest is reported as taxable income.

2.5 Asset Location

Asset location (not to be confused with asset allocation) is a very important strategy for those with different types of accounts (e.g., brokerage, IRA, or Roth IRA). For example, it is often sensible to hold bonds in retirement accounts since their interest is taxed as ordinary income (assuming it is not a tax-exempt municipal bond). If stocks were held in a traditional IRA, all of the growth would eventually be taxed as income. However, stocks held in a taxable account would only be taxed as capital gains or possibly avoid the tax on growth by receiving a step-up in basis upon death.

Rules of thumb and intuition will only get you so far as optimal asset location is a very nuanced topic. It depends on many moving parts that change through time – one of which is the tax code.

3.0 Annuities

3.1 Deferral

3.2 Level Taxation

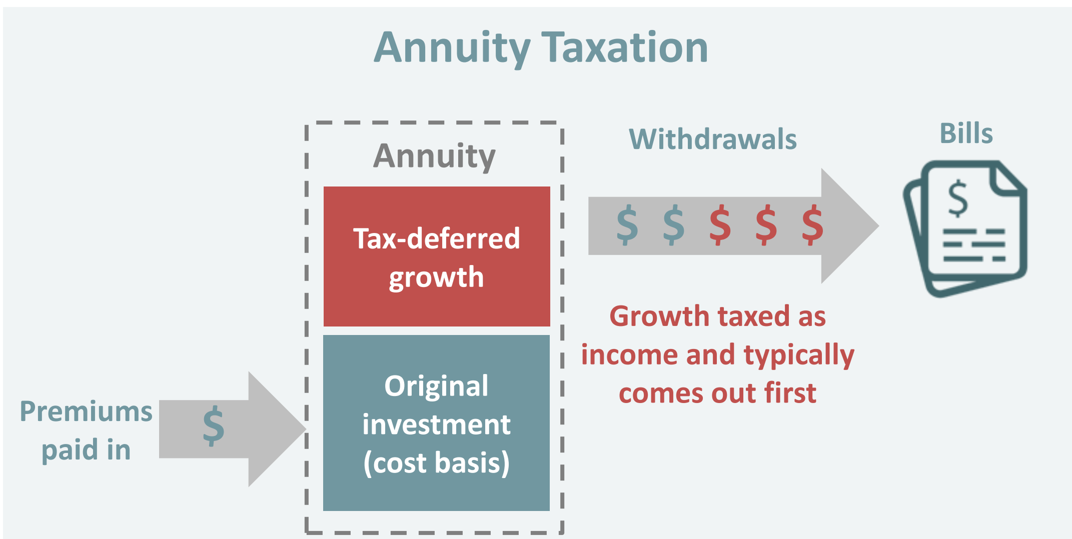
3.3 Retirement Accounts

3. Annuities

3.1 Deferral

Stigmas around annuities

Note: Stigmas exist around some annuity products for good reason. Indeed, many embed what I believe are egregiously high costs. My thoughts are very much aligned with other academic researchers as I generally only advocate the simpler and lower cost income annuity products. While I only discuss the tax mechanics here, all factors (costs, features, taxes, etc.) should be considered when purchasing an annuity.



Tax benefits are often advertised as a key advantage of using annuities. However, it is important to understand the mechanics of how they work. There are two tax factors that must be considered.

The first one is the ability to grow money on a tax-deferred basis inside of an annuity. This tax-deferral feature is an undeniable benefit.

The second factor relates to how withdrawals are taxed when money is eventually taken out. In particular, any growth within the annuity typically comes out first and is taxed as income. To be clear, investment growth is taxed as income and not capital gains.

3. Annuities

3.1 Deferral (continued)

Offsetting tax factors

As highlighted in the previous section on investment-related taxes, the IRS effectively taxes any growth in taxable bonds as income. So deferring those taxes within an annuity and then taxing the growth as income when it is withdrawn does not increase the tax levied on growth. However, the story is different for stocks.

Balancing Potentially Offsetting Tax Factors

Taxation of stock-based investments in annuities can be a net negative

If one holds stocks in a regular taxable account, then the growth is taxed as capital gains when sold or stepped up at death. Any dividends paid in the interim would also be taxed. In an annuity, dividends would not be taxed along the way, but the growth (including that from dividends) would be taxed as income upon withdrawal. Accordingly, one has to weigh the benefits of tax deferral inside of the annuity against potentially higher taxes on growth once money is withdrawn. To be clear, it is entirely possible for annuity taxation to have a net-negative impact for stock-based investments.

Deferred income and other fixed annuities

In the case of bonds and fixed income investments, however, the net tax impact is always positive. This is because there is a benefit from the tax deferral, but no additional cost from the growth being taxed as income (it already would have been). Accordingly, deferred income annuities (DIAs) and other fixed annuities can serve as tax-advantaged alternatives relative to holding bonds.

3. Annuities

3.2 Level Taxation

Decumulation or withdrawal phase

The deferral benefits I just discussed naturally relate to the accumulation phase (i.e., the period where one is saving and growing their nest egg). However, annuities offer additional tax advantages during the decumulation or withdrawal phase (e.g., retirement).

Given the potential issues with taxation of stock-based investments within annuities, I focus on income annuities to illustrate this point. That is, annuities that will pay out income for the rest of your life. In this case, taxes on the payments are calculated based on an exclusion ratio.

Exclusion ratio

Intuitively, the exclusion ratio indicates how much of each annuity payment is return of principal and thus excluded from taxation (only growth or returns are taxed). The formula is shown below. It involves an actuarial estimate of how much money will likely be paid out based on mortality tables and interest rates.

Exclusion Ratio Calculation

$$\text{Exclusion ratio} = \frac{\text{Total \$ invested}}{\text{Expected total \$ paid out}}$$

Level taxation

It is important to note that the exclusion ratio is calculated upfront and applies to all of the income annuity payments. In particular, the expected growth or return that will be taxed is uniformly distributed across the actuarially expected payments†. This level taxation creates a significant advantage relative to an equivalent portfolio of bonds where taxes are effectively front-loaded.

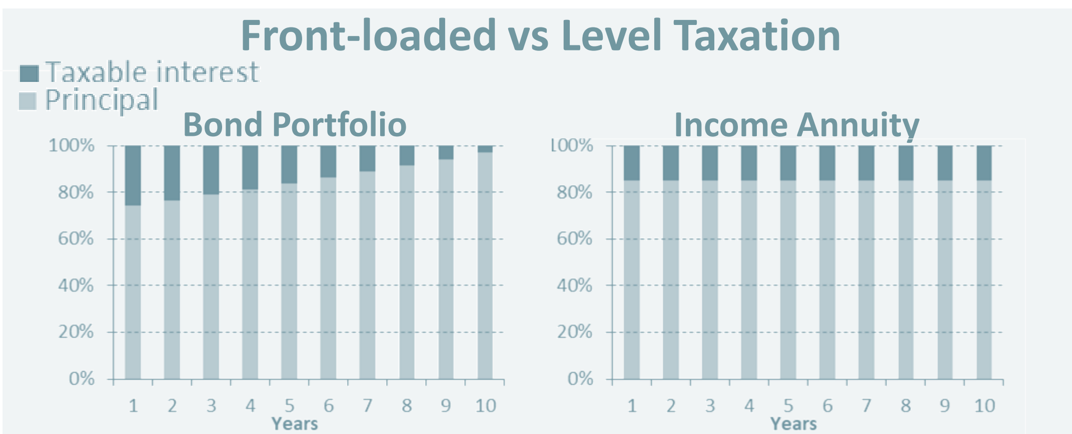
† If one lives beyond their expected age, then payments will become fully taxable as these payments are effectively additional return.

3. Annuities

3.2 Level Taxation (continued)

Front-loaded taxation with bond portfolios

To see this, consider a portfolio of bonds (or CDs) constructed so that the principal and interest amount to $10,000 for each of the next 10 years. This creates a stream of $10,000 cash flows that could be used to fund part of one's retirement. In year one, interest on each of the 10 bonds is taxed. However, in year two there are only nine bonds left. So there will be less interest and thus less tax due. This trend continues through year 10 when there is only interest on the last bond.



The bond portfolio generates significantly more interest in the early than later years. So the tax is effectively front-loaded. Accordingly, the level taxation resulting from the exclusion ratio with income annuities can provide tax benefits. For a more in-depth discussion on this topic, please read my research article on optimizing taxes with annuities.

3.3 Retirement Accounts

As highlighted in the earlier discussion of asset location, it is often sensible to place fixed income investments inside of retirements accounts. However, there are additional factors to consider when using annuities within retirement accounts. For example, retirement accounts already provide tax deferral. So this would make an annuity's tax deferral benefits redundant.

3. Annuities

3.3 Retirement Accounts (continued)

IRS treats income annuity payments as RMDs

Another factor to consider is the impact on RMDs. With standard investments, RMDs are calculated as a percentage of the account value each year. However, there is generally no account value reported for income annuities; they are simply contracts guaranteeing payments throughout one's life. For that reason, the IRS treats income annuity payments as RMDs.

This is relevant because annuity payments are generally larger than RMDs in the early years of retirement. For example, a single premium immediate annuity (SPIA) might payout 6% of the original investment whereas the RMD might only be 3% of account value. That is, the larger SPIA payments in the beginning effectively accelerate the realization of income.

Of course, this could be appealing if someone anticipated higher tax rates during their retirement. Furthermore, if someone is purchasing a SPIA, chances are they need the additional income and would be withdrawing more than their RMDs anyway.

More predictable taxes

SPIAs also make taxes more predictable than with standard RMDs. Given that the payments are fixed, one knows in advance precisely how much taxable income there will be each year. This is not the case with RMDs since they are a percentage of market value and this may fluctuate significantly.

Delaying RMDs to age 85

There is also an option to use deferred annuities within retirement accounts. In fact, one can use a special type called a qualified longevity annuity contract (QLAC) that allows one to delay RMDs beyond the standard starting age or 70 ½ (currently) to as late as age 85. This can serve as a valuable planning tool, but the IRS imposes strict limits on how much one can invest in QLACs within their retirement accounts.

5.0 Real Estate

6.1 Depreciation

6.2 Titling

6.3 1031 Exchanges

6.4 Renovations & Expenses

5. Real Estate

5.1 Depreciation

Many people like investing in real estate because it represents a tangible investment that typically generates income and increases in value. Fortunately for us, the IRS recognizes real estate (the physical structure – not the land) as a depreciating asset. In particular, the IRS allows us to depreciate investment and business properties over time.

Depreciation provides a tax advantage

This depreciation provides a tax advantage in that it allows us to record the depreciation as an expense. For example, it would be netted against rental income and reduce your tax liability.

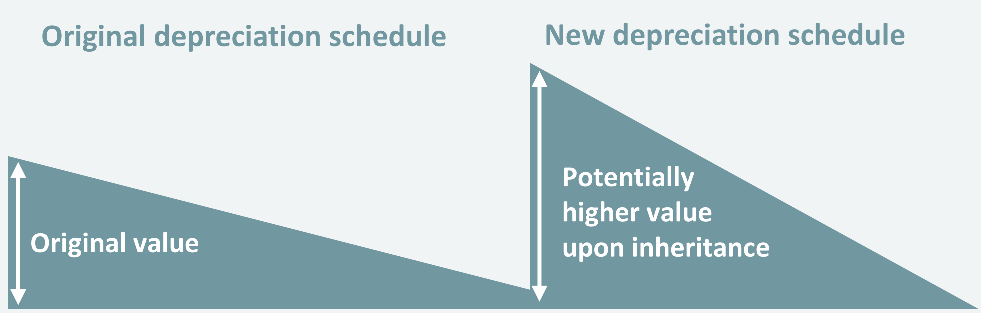
Like any other asset, you can only depreciate real estate down to zero. So this benefit will eventually run out. However, there is a potential opportunity for married couples to extend depreciation benefits. I discuss this in the next section.

5.2 Titling

Inherited real estate automatically receives a stepped up basis under current tax law and this can create opportunities for married couples to implement practical tax planning strategies. Unfortunately, this is one area I often see neglected.

Extend or increase depreciation

Step-up at Death May Allow for More Depreciation



5. Real Estate

5.2 Titling (continued)

For some married couples, age differences or health conditions make it likely that one spouse will pass before the other. In this case, it may be advantageous for the spouse with shorter life expectancy to own investments such as real estate.

Increase the value being depreciated

In the event the spouse owning the real estate passes away, then the surviving spouse will inherit the property and receive a step up in basis, and start depreciating it again. Not only could this extend the depreciation schedule, but it could also increase the amount of depreciation. That is, if the asset had appreciated, then it would be stepped up to a higher value. Accordingly, this would increase the value being depreciated going forward.

Note: The context here was depreciation, but similar logic applies to managing capital gains (i.e., it may be better to sell a property after a step-up in basis).

5.3 1031 Exchanges

Defer capital gains

Another advantage of real estate is the ability to defer capital gains through 1031 exchanges. A 1031 exchange basically allows one to sell an investment property and reinvest the proceeds into another without paying capital gains on the first property.

Possibly avoid capital gains

The IRS outlines specific protocols for real estate transactions to qualify, but the benefits can be significant. For example, if one uses 1031 exchanges throughout their life to defer capital gains, then those assets may receive a step-up in basis when inherited. In other words, capital gains would not just be deferred; they would be avoided.

1031 exchanges also provide an option for how depreciation is calculated going forward (one vs two schedules). This provides one more lever for financial planning and reducing taxes.

5. Real Estate

5.2 Renovation & Expenses

Timing expenses can be a useful planning tool

When you are thinking about improvements and renovations, taxes might be the last thing on your mind. However, the flexibility in timing expenses can be a useful planning tool. For example, let us say you are about to remodel the kitchen and bathrooms in an investment property. If you expect you will be in a higher tax bracket the following year (e.g., a new job or raise), then it could make sense to wait until then to make those upgrades. The expenses would then reduce income that would otherwise been taxed at a higher marginal rate.

Note: While this section on real estate generally focused on directly-held properties, many of these benefits also apply to other investments such as real estate investment trusts (REITs). Of course, direct ownership provides more control and this may be useful at times.

6.0 Conclusions

I hope this guide was helpful in highlighting some useful tax strategies. Financial and tax planning is a broad topic and always depends on the unique circumstances of the individuals being considered. So I tried to focus on some of the more common strategies in this guide. Some topics that did not make the cut were:

- Net unrealized appreciation (NUA) transactions
- Philanthropy and qualified charitable donations (QCDs)
- Gifting and estate taxes
- Advanced insurance planning (e.g., private placement life insurance)

As highlighted earlier, these strategies do not operate in independent vacuums. Implementing one strategy may have an impact on the ability to execute or the benefits from other strategies. As such, it is important to take a holistic approach to financial and tax planning.

It is also worth noting some strategies are easier to implement than others. Moreover, some are easier to change or reverse down the road while others are irreversible. When assessing each client's situation and presenting options, these are the types of variables I weigh against my numbers-based analyses.

Contact Me

Please get in touch if you have questions on these topics or about my low-cost and tax-efficient strategies for:

Saving & Investing
Grow your wealth and financial security while planning for longer-term goals.

Retirement & Income
Target robust and growing income with total costs around 0.10% per year

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