How Proactive Tax Planning Improves Your Financial Plan

#1 – Tax planning can save you money.

Did you know that many tax-efficient planning strategies are also low cost? Here are just a few examples.

- Tax-efficient index funds are typically lower in cost than actively managed mutual funds.
- Municipal bonds can provide tax-free income to help diversify your portfolio.
- Paying attention to taxes when planning for retirement can increase your retirement savings. Consider a backdoor Roth strategy and/or after-tax contributions to your 401(k) if they make sense based on your personal financial situation.
- Staying on top of your tax withholdings can help you efficiently manage your year-end tax bill.

#2 – Tax planning can enhance your investment returns.

The following tax planning strategies can greatly impact your long-term investment returns.

Asset location — This strategy can help minimize portfolio taxes and enhance returns by dividing assets among taxable and non-taxable accounts according to each asset's tax characteristics. In other words, asset location allocates tax-efficient investments to taxable accounts and tax-inefficient investments to tax-advantaged accounts.

Investment returns play a critical role in asset location. The higher an investment's return, the more taxes you'll need to pay. That's why it's wise to place high-return investments in tax-advantaged accounts. Investments with lower return potential, such as U.S. government bonds and cash, can be placed in taxable accounts without incurring significant tax liability.

Tax-loss harvesting — Within an investment portfolio, investors are taxed on their net capital gains (capital gains minus capital losses). Realized losses reduce an investor's tax liability. Tax-loss harvesting is the process of looking for opportunities to realize losses to offset gains.

Tax-loss harvesting works by taking advantage of selling an investment that has declined in value in the short term — a common occurrence in a heavily weighted equity portfolio — and replacing the investment with a highly correlated alternative. If done correctly to avoid wash sale rules, the risk profile and expected return of your portfolio remains unchanged, but the temporary tax losses are extracted in the transaction.

By realizing the investment loss, a tax deduction is generated that can lower your taxes. You can then reinvest your tax savings to further grow the value of your portfolio.

If enough losses are harvested in a given tax year, you may benefit in two more ways:

- If capital losses offset all capital gains in a given tax year, up to $3,000 of the capital losses can offset ordinary income.
- If capital losses are not all used in a single tax year, those losses can be carried forward into future years to offset future gains.

Tax-efficient withdrawal strategies — It's important to develop a withdrawal strategy to help minimize taxes in retirement. The good news is if you've already implemented the asset location strategy noted above, you're likely invested in a variety of accounts with different tax characteristics. This can be an advantage when planning a tax-efficient withdrawal strategy.

There are two main withdrawal strategies to consider based on your specific goals, tax situation, and income needs.

- **Traditional approach** — Using this approach, you withdraw from one account at a time, typically beginning with taxable accounts, followed by tax-deferred accounts and, finally, tax-exempt accounts. This approach allows the tax-advantaged accounts to continue growing tax-deferred for a longer period of

time. The challenge, however, is that you will likely have more taxable income in some years than others.
- **Proportional approach** — With this withdrawal strategy, you establish a target percentage to withdraw from each account each year. The amount is based on the proportion of retirement savings in each account type. This can help ensure a more stable tax bill from year to year and can also help you save on taxes throughout your retirement.

#3 – Tax planning can boost your wealth accumulation potential.

This one is pretty straightforward — the more you save in taxes, the more money you have to save and invest in your future. Here are several ways proactive tax planning can help you build your nest egg:

- Begin saving in a Roth IRA early in your career when your taxable income is relatively low. As your income increases, you may reach an income threshold at which you're no longer eligible to contribute after-tax assets to a Roth, so it's wise to beef up this tax-free source of retirement income while your income allows.
- Roth conversations are a great income tax planning tool:
    - If your retirement assets are heavily skewed toward pre-tax sources, converting a portion of those pre-tax accounts to Roth accounts could reduce future required minimum distributions (RMDs) from your pre-tax accounts. Distributions from a Roth account aren't only tax-free — they're also not subject to RMDs.
    - For workers that have retired, aren't yet taking Social Security and are experiencing a period of low taxable income, a properly timed and executed Roth conversion could result in minimal taxation or taxation at a low tax bracket.

- Tax-efficient accounts, such as 529 college savings plans and health savings accounts (HSAs), can help maximize your savings available to cover these specific expenses.

#4 – Tax planning allows you to provide for the people and causes that matter most to you.

Tax planning helps maximize the amount you're able to pass along to your loved ones and favored charities. It's vital to incorporate tax planning strategies into your estate and charitable giving plans.

- Did you know you can give up to $16,000 in cash or assets (e.g., stocks, bonds, mutual funds, land, a new boat, etc.) in a single year to any one person without tax implications? For example, you can give $16,000 to each of your three children without paying taxes. And if you're married, you can give up to $32,000 per year, per recipient without triggering the gift tax. This can be a tax-efficient way to pass along assets to your loved ones during your lifetime.
- Tax-efficient charitable gifting strategies include donor-advised funds (DAFs), qualified charitable distributions (QCDs) and the direct transfer of appreciated stock. These strategies help lower your tax liability while providing more assets to your favorite charitable organizations. A win/win for sure!
- If you intend to gift to charity at your passing and have a mix of pre-tax and post-tax assets, consider opening a separate IRA and naming the charity as the only beneficiary. The charity wouldn't pay any income tax on the funds received from the IRA, and there's a better chance your heirs will receive more assets subject to less income tax.
- Incorporating tax planning into your estate planning process can have a significant impact on the amount your loved ones owe in taxes following your death. Work with your wealth manager to

implement tax-efficient wealth transfer strategies and make the most of the lifetime gift tax exclusion.

Need help with your tax planning strategy? Creative Planning is here for you. Our teams have experience navigating a wide range of tax and financial challenges, always aiming to help clients achieve their long-term goals. For help with your tax planning strategy, or with any other financial matter, please schedule a call.

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