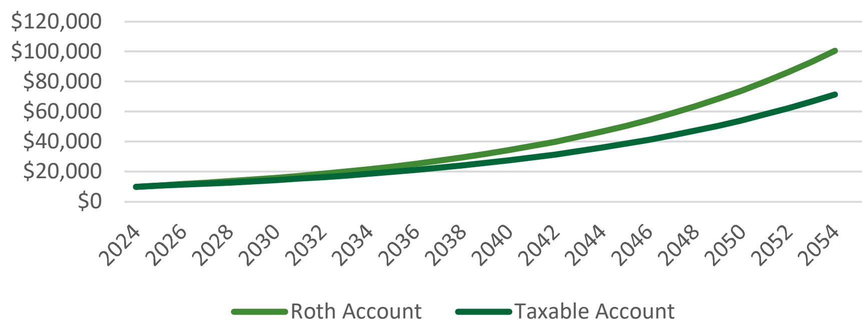
Thinking Ahead: Tax Strategy

The 4th quarter wrapped up with a combination of strong economic indicators and positive Federal Reserve guidance, boosting global equities. While short-term market movements are always unpredictable, we remain optimistic about the long-term outlook for global financial markets and our portfolios.

The new year is a time to reflect backwards and look forwards in both our personal and professional lives. Holiday cards, report cards, and performance bonuses are all reflections on last year's accomplishments; followed quickly by setting goals and resolutions for the new year. As tax season approaches, we have the opportunity to follow the same pattern in our financial lives. While the IRS forces us to look backwards and provide a summary of last year's finances in the form of our tax returns, we can also look forward and identify strategies that may be beneficial for future years.

Everyone's tax and financial situation is different, and many of the tax-planning scenarios we help clients with are complex and unique to a specific situation. Therefore, our goal this quarter is to highlight several of the more common tax situations and strategies that may be relevant as tax season approaches.

Transferring funds from taxable accounts into Roth's. This strategy is specific to money that is not in a qualified retirement account (IRA, 401k, 403b) but is meant for the long-term (typically checking/savings, CDs, brokerage, or trust/inheritance accounts). The goal is to avoid taxation on the growth earned in future years by shifting as much as possible into Roth-style accounts.



The previous chart shows the after-tax wealth generated by an initial $10,000 investment in a Roth vs Taxable account[1]. Despite identical investment returns, the Roth account provides 40% greater after-tax spendable wealth. In fact, Roth tax benefits are so valuable that the IRS limits the amount that can be contributed annually.

There are also income limits on making contributions, but for those over the threshold, there is an IRS-acknowledged loophole that avoids those limits called "backdoor Roth" contributions. There are additional rules depending on age, other accounts, and income levels so be sure to speak with us and/or your accountant before acting on this strategy.

Strategic Roth Conversions. The second strategy is for people with existing balances in pre-tax accounts (IRA, 401k, 403b), and expect to have a low taxable income for the upcoming year. This is most common early in retirement prior to taking social security (or RMDs) but could also result from life events like starting a new business, illness, divorce, or simply taking time between jobs. Regardless of the reason, the goal is to essentially pull future taxable income into lower current tax rates using an IRS provision called "Roth Conversions".

	No Action	Full Roth Conversion
Current Pre-Tax Balance	$25,000	$25,000
Other Taxable Income	$0	$0
Roth Conversion Taxation	N/A	$0
Expected 2034 Income	$100,000	$100,000
2034 Account Value	$50,000	$50,000
Taxes Owed on Distribution	$14,425	$0
Net Spendable Wealth[2]	**$35,575**	**$50,000**

As the table demonstrates, the Roth Conversion allows us to not only pull income forward from higher taxation in future years, but also eliminates taxation on future growth, increasing net spendable wealth by over 40%.

Front-loading charitable contributions with a Donor Advised Fund. Not all tax deductions are created equal. While several qualified expenses are always deductible (i.e. retirement contributions), many other *itemized* deductions (such as charitable donations) are only claimed to the extent that they exceed certain thresholds. While this has been true for decades, new tax rules in 2016 raised the threshold where itemizing becomes relevant (the *standard deduction*), in addition to limiting one of the most common *itemized* deductions (State & Local Taxes). This significantly reduced the number of taxpayers who itemize their tax returns and are therefore able to claim these deductions. The net result is that many people don't actually receive a federal tax benefit for donating to charity.

We often talk about *proactive* tax & financial planning, and this is a perfect example. The key dilemma in the scenario below is that a person's various deductible expenses add up to less than the standard deduction amount ($14,600 single, $29,200 married). For someone who plans to make annual charitable donations, the solution is to bundle multiple years of donations into a single calendar year in order to exceed these thresholds, thereby realizing the tax benefit. The tool that allows us to do this is a "Donor Advised Fund" (DAF).

	No Action	DAF
Annual Charitable Giving	$15,000	$0
Other Itemized Deductions	$14,000	$14,000
DAF Contribution	$0	$150,000
Standard Deduction	$29,200	$0
Itemized Deductions	$0	$134,800
Effective Tax Savings	**$0**	**$33,792**

In the above hypothetical, a married couple in the 32% federal tax bracket contributes $15,000/year to charity. By pre-funding 10 years of donations in a DAF in a single calendar year, they can save over $30,000 in federal taxes compared to simply making annual donations. The funds can remain invested to grow inside the DAF, which then makes the annual donations going forward.

Donating Appreciated Securities. Continuing the charitable giving theme, this strategy applies to someone planning to make charitable donations, and who also happens to own stocks (or other liquid assets) with unrealized gains. A quick refresher in capital gains taxation: when you purchase an asset like a stock and it gains value, that gain is considered *unrealized* and therefore not subject to taxation until the stock is sold (aka *realized)*. Once realized, the gains are subject to their own unique tax rates, separate from income tax brackets (typically between 15% - 23.8%).

In addition to being tax deductible, a separate provision in the tax code states that if an asset is donated to charity (rather than donating cash) any unrealized gains embedded in that asset avoid taxation. Because this provision is in addition to, not instead of, the tax deductibility of a charitable donation, this creates an opportunity to double-dip the tax benefits of charitable donations. Let's take another look at our previous example, this time donating an appreciated security instead of cash.

	No Action	DAF (Cash)	DAF (Asset)
Annual Charitable Donation	$15,000	$0	$0
Other Itemized Deductions	$14,000	$14,000	$14,000
Cost Basis of Donation	N/A	N/A	$50,000
DAF Donation Value	$0	$150,000	$150,000
Standard Deduction	$29,200	$0	$0
Itemized Deductions	$0	$164,000	$164,000
Capital Gains Tax Avoided	$0	$0	$23,800
Effective Tax Savings	**$0**	**$33,792**	**$57,592**

While this hypothetical scenario is unlikely to mirror any person's tax situation perfectly, it illustrates the enormous financial benefit of looking ahead and planning strategically. While each of the examples discussed are unique to specific circumstances, the key ingredient for each is not changing either behavior or portfolio construction but understanding future financial goals and expectations in order to optimize long-term spendable wealth.

[1] Assumptions: 8% Annualized Return; 24% Federal Tax Bracket on Income; 6.85% State Tax Bracket on Income & Capital Gains; Growth in Taxable account is 25% Income/75% Capital Gains
[2] Assumptions: 22% Federal Tax Bracket; 6.85% State Tax Bracket

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