Tax-Mindful Investing for Financial Independence

Our retirement should be a place, ideally, where we can enjoy greater freedom to do what we want and what we feel our faith and our heart draws us to do. Therefore, protecting our future and maximizing (as much as we can) the potential impact of our savings and investments becomes important.

One of the biggest obstacles or enemies of successfully achieving this kind of financial independence in the future is taxes. And while we may know what our average tax rates are currently, we don't know for sure what our average tax rates will be in the future. What may appear to be "enough" to retire comfortably on for life now could be dramatically cut short because of increased tax drag on your annual retirement income from your savings and investments. With this in mind, we often introduce an idea to our clients that we call tax-category diversification. Tax-category diversification is something that can often be beneficial because you are adding and building more assets that will receive tax advantages long-term.

Here are 3 specific ways to add one or more tax-advantaged assets to your plan. You may want to consider these as you seek to build your wealth in a more tax-mindful manner.

1. Qualified Retirement Plans

Roth 401K, 403B, and SEP IRA Plans

Let's begin by mentioning something most of us these days have access to through our jobs: what is generally referred to as employer-sponsored qualified retirement plans. These consist primarily of either 401K, 403B, or SEP IRA plans. You should, if possible, at least contribute up to whatever percentage that your employer is offering matching contributions. You should then try to contribute up to the maximum amount the IRS allows you to. If you are over 50, this contribution limit is higher due to what is called catch-up contribution limits.

The reason maximizing your contributions is a good idea is that all your investing and appreciation in these kinds of plans happens pre-tax. Your contribution comes out pre-tax from your paycheck, and your growth and earnings all are also tax-deferred or pre-tax. While these are great in regards to accumulating wealth, they are not so great when it comes to living off these assets or passing them on to a beneficiary. Because the IRS will get its tax on these dollars eventually, 100% of any withdrawals from these kinds of plans are taxable. These kinds of plans can become increasingly costly and exposed to a much higher level of tax exposure (to whatever extent the tax rates get increased over time) due to what we've mentioned thus far about the future likelihood of potentially confiscatory tax rates. If your plan offers you the opportunity to direct your contributions to a Roth within your employer sponsored plan, you should seriously evaluate and consider taking advantage of this. *(Cont.)*

1. Qualified Retirement Plans *(Cont.)*

Again, if you are concerned that you'll have higher tax rates in retirement, then paying the tax now as opposed to later would potentially be a smart idea. Also, by doing so, you are getting all future growth outside the income tax system as well. We can't be sure how long Roth retirement savings will be permissible by law, as some federal legislators have indicated they want to eliminate these. If you have access to this option in your plan, it could be well worth your while to consider directing your contributions to a Roth while you can.

Self-employment

If you are self-employed and don't have a 401K, you may have a SEP IRA or a Simple IRA. The same advice I just mentioned for employees applies to you. Consider maximizing what the IRS permits you to contribute each year and consider maximizing Roth contributions inside whatever retirement plan you are using as much as you possibly can.

Individual Retirement Accounts

If you don't have access to an employer-sponsored plan or a self-employed retirement plan, you can still save for retirement using an Individual Retirement Account. The IRS generally has lower contribution limits for these kinds of accounts, but there are still age 50+ catch-up contribution limits, and you can also choose to do these as Roth IRAs if you want. So, same advice as above; it may be worth evaluating whether maximizing Roth contributions is the best approach to your long-term financial independence objectives.

Roth Conversion Strategies

If you already have some measure of significant retirement savings in a 401K, 403B, SEP IRA, Simple IRA, or Traditional IRA, you might want to consider a possible Roth conversion strategy. Converting to a Roth is a taxable event, so you'll want to consider either how you will best pay the income tax, or perhaps integrate a charitable deduction strategy to reduce or offset tax. There are specific AGI limitations on how much of these kinds of deductions you can take each tax year, so again work with an expert to model this out and plan how to best phase in any Roth conversions over a period of years if necessary. Again, you'll need to decide for yourself whether an approach like this makes strategic sense within your situation and bigger picture.

2. Non-qualified Taxable Investments

EFTs

ETFs are most certainly worth learning more about, and perhaps making a bigger part of your investment portfolio. These investments are similar to index mutual funds, as they mirror an underlying index, such as the S&P 500, the Russel 1000, the NASDAQ, etc. There are hundreds of indexes for which ETFs have been created, including sector indexes, country indexes, precious metal, other alternative investment class indexes, and so on.

In general, ETFs are highly efficient in terms of cost and in terms of annual taxable income because of their relatively low turnover on an annual basis. If you are interested in exploring these investments more seriously, they can often add real value to your taxable investments—if you can find a platform that has a proven track record of systematically harvesting losses and applying those losses against future gains. Some financial institutions have gotten quite effective in their tax management using ETFs in this manner, creating as much as 1% to 2% on average per year in what is often referred to as tax alpha. Due to the extent taxes are minimized or avoided on average, you could think of it as the equivalent of increasing your return by a similar amount, as these taxes for many investors would have been paid out of the underlying investment account.

Seek Out Investments With Dividends

When it comes to your taxable investments, be intentional about seeking out investments that will create dividends or long-term capital gains, rather than ordinary income or short-term capital gains. This is because dividends and long-term capital gains still, for now at least, receive more favorable tax rates than ordinary income or short-term capital gains, which are also taxed as ordinary income.

3. Security-based Insurance Products

Individual Retirement Accounts

If you are looking for ways to save more in a tax-advantaged way than the IRS permits you to contribute to your employer sponsored, self-employed, or individual retirement accounts, you may want to consider a life insurance retirement plan. Some form of these are used by most Fortune 100 companies in conjunction with what is referred to as deferred compensation plans. In this context, you would be setting one up on your own.

One very valuable detail is that there are no contribution limits, no required minimum distributions, and there may be no income tax on withdrawals if the underlying life insurance policy is designed and managed properly. The key in this context is working with a true life insurance professional who takes a fiduciary approach to design, underwriting, and policy management. If this makes sense for your needs, you should consider adding to this tax-advantaged category that many people are lacking and wanting more of. The life insurance retirement plan and the Roth IRA are two of the only potentially long-term tax-free sources of income that are permissible under current tax law. As we've mentioned, the value of adding and building a tax-advantaged category to your investment program could become increasingly important in a future with higher tax rates applicable to distributions from your various savings and investment accounts.

3. Security-based Insurance Products *(Cont.)*

Low-cost Deferred Variable Annuities

You may want to also consider adding a low-cost deferred variable annuity that has an institutional quality of underlying investments to choose from. These can usually offer similar internal expenses as active mutual funds, but with long-term income tax deferral. If you choose a company and product that has received a private letter ruling from the IRS, it may even provide tax advantaged distribution from the account during retirement because of the application of the exclusion ratio.

Buffered Annuities

Lastly, you should research and consider adding a buffered annuity as a bond alternative. These can be a low cost, equity-based investment option by way of available index crediting methods used inside the annuity. People sometimes like that these effectively provide a way to continue investing in equity markets, but as a bond alternative, since they have these built-in downside buffers or protections from volatility loss to a specified extent over a specific time. Lots to understand on these types of investments, but especially as we head into an inflationary cycle like it appears we are beginning to, these assets can potentially be a valuable addition to your investment program. Not only for tax reasons, but also as a way to more strategically diversify in a period when bonds may be acutely subject to redemption risk. As a result, finding bond alternatives could become more important for protecting your portfolio from unnecessary downsides and risk of loss.

Please keep in mind that none of these specific ideas are certain to be appropriate for you and your unique situation, goals and objectives. Please find an expert who can advise you on these financial solutions wisely within the context of your comprehensive personal financial plan.

We'd be happy to talk with you and see if we can help you. If you'd like a no cost, no obligation assessment of your situation and planning, please contact us.

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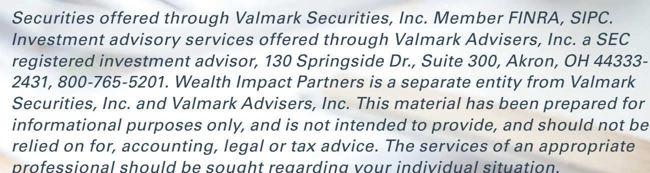

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