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TAXES

Consider These Two Common Strategies to Optimize Your Taxes

Roth IRA conversions could reap significant savings, and tax-loss harvesting can offset capital gains taxes on winning investments.

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After months of sluggish activity, the market recently turned the tide. Whether the market is up or down, it's always a good time to keep your taxes in mind and, more specifically, how you can put yourself in an advantageous position by keeping more of your own money in your pockets.

When it comes to tax optimization, there are two common strategies: Roth conversions and tax-loss harvesting. But, as is always the case in financial planning, there are no be-all, end-all strategies.

Indeed, there are several things to consider when utilizing both of these options.

1. Roth conversions

Taxes are extremely important and can have a huge impact on your retirement income. One strategy that can help lessen your tax burden later in life is converting your accounts to Roth IRAs.

The idea behind Roth conversions is to take money from a tax-deferred IRA, pay taxes on that amount at your ordinary income rate and convert that money into a Roth IRA. By doing this, you'll be clear of future taxes on the amount you converted, and the money you put in grows tax-free for your lifetime!

At the end of 2025, our current income tax brackets will likely revert to their pre-2018 rates. When we look at the national debt and potential changes coming to Social Security, it's likely that taxes will increase in the future.

Even if you stay in the same tax bracket for years to come, the rate that applies to that bracket will likely increase down the road. If you have a tax-deferred IRA, you will pay more in taxes when you withdraw from the account in retirement than you would if you converted now.

You don't have control over the tax rate changes the IRS will make in the future—there are no certainties when it comes to tax policy. But by utilizing Roth conversions *now*, you are guaranteed tax-free withdrawals throughout your retirement years.

What are the main benefits of a Roth?

To understand the tax advantages that come with Roth IRAs, think of an oak tree.

Let's say you own shares with a market value of $300. Those shares are like a small acorn. If you convert those shares to a Roth while they are at a lower value, you'll likely pay less in taxes. As those shares start to increase in value over time, you suddenly have a full-grown oak tree! Let's say those shares are now worth $3,000, and all of that growth is tax-free. By the same token, you can also consider converting shares that have recently depreciated in value and get more bang for your buck!

Another benefit of Roth IRAs is that they are exempt from required minimum distributions (RMDs) because the IRS has already received its share of taxes from the conversions you've made. Therefore, you're able to leave as much money as you'd like in your account without being forced to take distributions.

Those with lots of assets in 401(k)s and traditional IRAs will be required to take out huge RMDs, which will increase their overall income even if they don't need the cash when the RMD is due.

What to consider before converting to a Roth

If you're debating whether you should convert to a Roth, take inventory of where you're at with taxes now. Ask yourself, "What tax bracket will I be in 20 to 30 years from now?" In the past, people believed it was best to pump all your contributions into a traditional IRA because you'd likely be in a lower tax bracket in retirement. However, even if you're in a lower bracket, the tax *rate* might still be higher. The tax rate is what matters more.

Do keep in mind that for each conversion, you must wait five years before you access the converted funds in order to keep their tax-free status.

Additionally, if you're considering leaving your IRA to any beneficiaries, keep in mind that the SECURE Act of 2019 changed how inherited IRAs work. Most non-spousal beneficiaries now have to deplete those inherited funds within 10 years. If you plan on leaving a traditional IRA to your kids, friends or non-immediate family, it will be fully taxable at the beneficiary's ordinary income tax rate.

Lastly, if you don't have individual beneficiaries, converting to a Roth account might not be the best fit for your situation. Assuming you plan to leave that money to a charity or organization, those donations are tax-free anyway, so it is not a good use of your money to pay taxes to convert.

2. Tax-loss harvesting

When you sell securities within a non-qualified account, you typically either have a gain or a loss. Tax-loss harvesting is a strategy used when you sell a security at a loss to offset the capital gains taxes that you owe on a different, more profitable investment.

For example, if you buy a share of a particular stock for $5,000 and sell it when its value reaches $15,000, that is a $10,000 gain on your investment. Since you have gains, you have to pay the capital gains rate, which is typically 15%. However, if you instead had a loss, you can use that for tax planning purposes to offset your gains on another investment, with the net result being less capital gains taxes to pay. For this to work, you must liquidate the losing investment before you can offset any gains on the winning one.

What to consider before harvesting your losses

Before you consider harvesting your losses, you want to make sure that you are comfortable incurring the loss. Don't be willy-nilly and sell a security when the market is down just to harvest a loss. If this is a long-term investment you have faith in, you probably shouldn't sell it. If you think it's going to appreciate in value again, you don't want to be hasty in selling that investment for the sole purpose of harvesting the loss.

Who does (or doesn't) benefit from tax-loss harvesting?

If you're in a higher tax bracket, you have to pay capital gains taxes on your investments, and tax-loss harvesting can afford you huge savings on that tax.

However, in order for tax-loss harvesting to work, you have to have a non-qualifying account—that is, an investment vehicle that can never be subject to tax benefits. Capital gains do not apply to accounts that aren't in this group, so you can't harvest your losses with a 401(k), 403(b) or IRA, for example.

Tax-loss harvesting also doesn't work for someone to whom capital gains taxes do not apply. If you're in an ordinary income tax bracket of 12% or below, you have no capital gains tax to pay, so there is no need to "harvest" losses.

Regardless of market conditions or what stage of life you may find yourself in, there are always strategies to help optimize your taxes. With tax-loss harvesting, you can sell low-performing securities and use that liquidation to offset any capital gains

taxes, and by converting to Roth accounts, you spare yourself future tax liabilities that may come from any growth in value your securities may accrue.

Given the layers of nuance that come with each, it's best to consult your financial advisor and tax advisor before employing either of these strategies.

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