Chapter 9

Forward Tax Planning[12]

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Russell Rogers CFP™ is a partner at Summit Investment Advisors where he helps clients make the best decisions through careful and thoughtful planning and analysis.

Russell began his career in finance in 2007, following the footsteps of his father, a retired Edward Jones financial advisor. He also served as a Human Resources Officer in the Minnesota Army National Guard, achieving the rank of Captain.

Russell lives in Arden Hills with his wife Jena and their children Calvin and Lucia. In his spare time he enjoys fishing, camping, playing the drums and guitar.

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[12] This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor. Traditional IRA account owners have considerations to make before performing a Roth IRA conversion. These primarily include income tax consequences on the converted amount in the year of conversion, withdrawal limitations from a Roth IRA and income limitations for future contributions to a Roth IRA. In addition, if you are required to take a required minimum distribution (RMD) in the year you convert, you must do so before converting to a Roth IRA.

The Importance of Tax Planning

Many investors do not take the time to meet with a professional to develop a plan regarding taxes. This is a mistake. Taxes probably play a much bigger role in your finances than you think. Every dollar that is removed from your portfolio in order to pay taxes is no longer compounding. The time and money you spend on tax planning will most likely be eclipsed by the benefit of having a plan.

What is Tax Planning?

To put it succinctly, tax planning is structuring your affairs in order to minimize the tax cost over a period of time.

You could have a tax plan designed to minimize taxes for a short period of time, but after that, your tax bill may actually be higher than it otherwise would be. In contrast, most people are interested in minimizing taxes long-term or for the remainder of their lives. A good tax plan can also continue to work long after the life of the investor and benefit their beneficiaries.

Perhaps the most fundamental concept in tax planning is potential money and the tax cost of that potential money. Every dollar you intend to utilize from various sources will have a tax cost associated with it. Sometimes that tax cost is relatively high, sometimes it is zero.

Tax Planning & Retirement Income

Let's say you just retired, and now you want a certain amount of money to live on. That amount is not your gross income, it is a net figure or after-tax cost figure.

Most retirees have multiple places to meet this income need, and depending on the amounts and timing, the tax cost can vary drastically. A good starting point might be to identify potential money with the lowest tax cost. Keep in mind that if you only use the potential money with the lowest tax cost, it is a short-term strategy. You may be able to keep your tax cost very low or even at zero for the first several years of retirement, but you may have very little ability to control your tax bill after that.

A long-term tax plan will aim to minimize taxes over a long timeframe, often increasing tax cost in the short-term. A prime example of this is a Roth conversion. You may be in a situation where your income needs are met and if you do nothing further, your tax bill will be relatively low. But because you are planning for the long haul, you decide to get some money out of your IRA, pay the tax, and convert it to Roth. You just increased the total tax on this year's income tax return, but your future tax liability from the time you must take Required Minimum Distributions (RMDs) to your death may have been reduced.

Tax planning always involves tax estimates. Potential money has a price tag attached to it, and that price tag is the tax cost. Every source of potential money has its own tax cost but will almost always affect the tax cost of other sources of potential money (and vice versa). This is why it is necessary to run multiple tax estimates and manipulate these estimates until you reach the desired outcome.

Favorable Tax Cost

Another important concept in tax planning is favorable tax cost.

When is the tax cost favorable or a good deal? The answer is somewhat relative but if I have a high tax cost for some potential money and I find a way to unlock that money with a lower tax cost, then it is likely favorable.

Let me give you an example. It may be very favorable to convert IRA money to Roth if you are paying a total effective tax rate (federal and state if applicable) of 18%, but you may not want to do so if the effective tax rate is 33%. It is often the case that you have an amount of potential money that you can unlock at a lower tax cost, but then if you continue to do more, the cost will go up. Therefore, at some point you want to stop because it is no longer favorable.

When determining tax cost, you need to consider the marginal ordinary income brackets, but that is not all. There are thresholds which create additional taxes if they are crossed. Three common thresholds which can create additional tax are Social Security thresholds (based on provisional income), net investment income tax (based on modified adjusted gross income) and Medicare premium surcharges (based on adjusted gross income). You may or may not want to trigger these based on the idea of favorable tax cost.

Taxes will always play a very significant role in your financial life. Without a plan you will almost certainly pay more taxes than necessary over your remaining lifetime. Tax planning can be complicated, but it is worth the effort to partner with a professional or team of professionals that can help you develop a

plan. No one regrets having a tax plan, but too many people regret not having one.

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