Tax Planning: Not Just for Year End

"This is a question too difficult for a mathematician. It should be asked of a philosopher."

— Albert Einstein, when asked about completing his income tax return

For most people, complaining about taxes is a year-round pastime. Yet, planning for taxes tends to occur during the hectic last few days of December and again just before tax day of the following year.

Winston Churchill famously said that "There is no such thing as a good tax," however, there is such a thing as a good *tax strategy*, and planning ahead can make a meaningful difference. So, as September approaches, we recommend that you start to consider several strategies that might help you minimize the stress and cost of taxes between now and next April.

Retirement plan contributions

One of the most common and effective tax-reduction strategies is to maximize your contributions to retirement accounts such as an employer-sponsored 401(k) or an Individual Retirement Account (IRA). Contributions to a conventional 401(k) plan are always tax-deductible, and most plans include a matching program in which the employer matches a portion of the employee's contributions. This amounts to free money for you from the government and from your employer, so for many taxpayers the 401(k) should be the first tax planning consideration.

If you are not covered by a 401(k) at work or if you are covered but your income is less than $74,000 ($123,000 for married couples), you can make partially or fully tax-deductible contributions to an IRA account as well. The rules and benefits of IRA contributions can be quite complicated, so you should consult your tax advisor well before year-end and discuss the various options available to you.

Tax loss harvesting

If you have a taxable investment account and you own individual stocks, stock mutual funds, or exchange traded funds, it is likely that you will generate some form of taxable capital gains in most years. "Tax loss harvesting" is a tax-reduction strategy that involves selling a security that has declined in value in order to offset all or at least a portion of the capital gains that have accrued from your other positions.

Tax harvesting is a simple but elegant strategy. When you find a security that has a capital loss, you "swap" that security by selling it and simultaneously buying another similar (but not identical) security. This allows you to realize the loss on the original security without having to significantly alter the stock market exposure of your portfolio. And, if you have a strong preference for owning the original security over the newly-purchased one, IRS rules allow you to swap back into the original security after a waiting period of 30 days.

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Many amateur investors, and even some professional advisors, wait until December to look for tax loss harvesting opportunities. However, we recommend looking for them all year long because these opportunities can disappear quickly if the stock market has a strong rally into the end of the year. September tends to be a slower month for personal financial planning, and for financial professionals, so it is a perfect time for you and your advisor to conduct a search for the first round of tax swaps.

Charitable strategies

Making charitable contributions can also help lower your tax bill, but a significant increase in the standard deduction has made this strategy more complex for most taxpayers in recent years. Most taxpayers now elect to take the standard deduction rather than list itemized deductions on their tax returns, and if you do not itemize, you will not receive a deduction for charitable contributions.

Fortunately, there are two strategies that may allow you to retain some tax benefit from your charitable inclinations even if you usually take the standard deduction. The first is known as "bundling" charitable contributions. If you intend to make significant contributions to one or more charities over time but your annual contributions and other deductions do not exceed the standard deduction, you should consider bundling several years' worth of contributions into a single tax year. For example, if you typically make $5,000 of charitable contributions each year, you can instead make $20,000 of contributions once every four years. This could allow you to itemize your deductions in that year while taking the standard deduction in the other three.

Another charitable strategy that applies only to IRA account holders age 70½ or older is the qualified charitable distribution (QCD). A QCD allows you to make contributions directly from your IRA to a qualified charity, and it can be counted towards satisfying the required minimum distribution (RMD) imposed on IRA owners after age 70 ½. You will not be able to take the QCD as an itemized tax deduction, but because the QCD reduces the size of your taxable RMD, it amounts to a de-facto tax deduction *in addition to the full standard deduction that you are already taking.*

If you are going to complain about taxes all year long (and we encourage you to do so), you may as well work on minimizing them throughout the year as well. As you have probably noticed, the strategies addressed here can get complex very quickly, so we recommend you consult your tax advisor about them now to ensure that you do not miss any mid-year opportunities or year-end deadlines. It might seem like a chore in September, but you will thank yourself in April.

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