HOLD ON TO MORE OF YOUR MONEY WITH TAX-EFFICIENT INVESTING

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It's a fact of life: Everyone has to pay taxes on their money. And no one – regardless of how much money they have – enjoys paying the IRS. That's the primary reason we're constantly searching for opportunities and financial strategies that help us manage, defer, and reduce our tax liabilities.

One such opportunity individuals often overlook is tax-efficient investing. Not only can this strategy potentially reduce your tax bill, but also it can help you keep more of your hard-earned money to invest and grow for your future.

While the key drivers of your investment planning should be your goals, timeline, and risk tolerance, considering a tax-efficient investment strategy that factors in your tax liability may help you build your wealth at a much faster pace.

Generally, tax strategies can be broken down into three distinct time periods for individuals and families. You may want to consider the following strategies for minimizing your tax burden based on your life stage.

DURING YOUR WORKING YEARS

During your working years, consider focusing on tax-efficiency. The more you're aware of your tax situation, the greater potential you have to minimize your tax burden. But this does require some planning and effort on your part.

INVEST IN PROPER VEHICLES TO PREPARE FOR FUTURE USE

Pre-tax contributions to retirement accounts reduce your current income and lower your taxes. For example:

- **401(k)s and 403(b)s**. If your employer offers a 401(k) or 403(b) savings and investing plan, take advantage of the opportunity to participate – you get a tax deferral on the money you set aside for retirement. The best part of these savings vehicles is that you can also get "free money" if your employer matches some or all of your contribution. When you deposit funds directly from your paycheck, the IRS doesn't tax you on that money. However, you will be responsible for paying income taxes when you take future distributions. For 2021, you can contribute up to $19,500 per year into your 401(k) – $26,000 if you're 50 years of age or older.
- **Traditional Individual Retirement Accounts (IRAs)**. Account contributions to these plans also are pre-tax, so you benefit from immediate tax deductions and tax-deferred growth. Again, you will be responsible for paying income taxes when you take future distributions. The annual individual contribution limit for 2021 is $6,000 – for those who are age 50 or older, the limit is $7,000 per year. You should check with your financial advisor and tax professional regarding participation guidelines and income cap rules—if your modified AGI (adjusted gross income) is above the IRS limit, you may not be able to deduct your contributions.
- **Roth IRAs**. Roth contributions to retirement accounts take advantage of current tax brackets and allow assets to grow and be distributed on a tax-free basis in retirement. In other words, you pay the taxes upfront

– not when you withdraw funds in retirement. The same 2021 contribution limits apply to Roth IRAs as for Traditional IRAs. Individuals can contribute $6,000 per year until age 50, when the annual limit increases to $7,000. Like traditional IRAs, the same participation and income cap rules apply to Roth IRAs.

- **529 plans.** These savings accounts operated by most states are designed to help families save for college. While contributions to 529 plans are not deductible on your federal income taxes, you may be able to claim them on your state return. The earnings on your contributions grow tax-free. When used for qualified educational expenses, withdrawals from 529s also are tax-free.
- **Health Savings Accounts (HSAs)**. If you're enrolled in a health insurance plan with a high deductible, you may want to consider taking advantage of an HSA. The benefits are threefold: (1) Your contributions to the account are deductible. (2) The funds in your account grow tax-deferred. (3) When you remove funds for qualified medical expenses, the withdrawals are tax-free.

Keep in mind after-tax contributions to taxable investment accounts not only provide more flexibility but also keep assets accessible and penalty-free before retirement.

GROWTH VS. INCOME

Capital gains are taxed at lower tax rate than income. You can shelter less tax-efficient investments in retirement accounts to avoid capital gains taxes, or you can generate less capital gains and minimize the impact of taxes on your assets by putting more tax-efficient investments in taxable brokerage accounts.

If you're in a higher tax bracket, municipal bonds may provide a better net return through tax-free income. It's important to consult with your financial advisor and tax professional regarding which types of investments are more appropriate and advantageous to place within certain types of accounts.

DURING RETIREMENT PRE-RMD (REQUIRED MINIMUM DISTRIBUTION) YEARS

Throughout the pre-RMD stage of retirement, your focus should shift to income-efficiency while managing your tax liability. Likely your income will be reduced in retirement – during this stage, it's important to revisit the growth vs. income conversation with your financial and tax professionals for the following reasons:

- Because you'll probably be in a lower tax bracket at this point, income-producing securities may be more attractive for your portfolio and financial situation.
- Tax equivalent yield of municipal bonds may have lost its value.

This is a good time to consider opportunities to improve tax characteristics of assets. For example, before taking RMDs, fill up lower tax brackets via Roth conversion.

DURING RETIREMENT RMD YEARS

From a tax perspective, think about turning your focus to supplementing income and legacy positioning when you begin taking RMDs during your retirement years (beginning at age 70-1/2 if you were born before July 1, 1949, or at age 72 for individuals who turn 70-1/2 on or after January 1, 2020). During this period of your life, you'll want to balance distributions from traditional and Roth retirement accounts with after-tax investments to meet expenses. It's important to keep in mind:

- Roth distributions are tax-free.
- After-tax assets can be harvested at capital gains rates.
- Additional withdrawals from IRAs, 401(k)s, and 403(b)s are ordinary income.

You'll also want to work with your estate planning, legal, and tax professionals to evaluate the tax ramifications for heirs and beneficiaries regarding assets likely to be left as an inheritance. Roth conversions take over some of the tax burden ahead of time. Additionally, highly appreciated stocks currently receive a step-up in basis upon your death.

WE CAN HELP

When it comes to timing tax strategies for investing, you'll find that some investments are more tax-efficient than others. The tax laws are numerous and complicated – it's important to seek the advice of your tax, legal, and financial advisors to help you determine which vehicles are the most appropriate and advantageous for your financial planning goals. Contact Commerce Trust Company today—we're here to answer all your questions regarding your options and help you make informed decisions that are in your best interest.

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Kevin is a financial planner with The Commerce Trust Company. He is a member of the financial advisory services team, a dedicated financial planning practice within Commerce Trust that provides objective financial advice to clients. Following a thorough assessment of a client's unique situation and thoughts regarding wealth, Kevin develops holistic and coordinated plans to help clients meet their short-term and long-term goals as well as take full advantage of various planning, tax, and investment strategies along the way. His areas of focus includes planning for financial independence, retirement, divorce, executive compensation, estate preservation, and business succession. Kevin joined Commerce Trust in 2015 after starting as a Commerce Bank Trainee/Credit Specialist in 2014. He previously worked at Edward Jones as a Financial Advisor Trainee. Kevin received his bachelor of science degree in business administration and finance from Southern Illinois University Edwardsville and has earned his CERTIFIED FINANCIAL PLANNER™ designation.