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8 things you can do year-round to plan for taxes

Taxes August 3, 2017

Jacklin Youssef

If it's not April or December, you're probably not thinking about taxes. But it's time to acknowledge the elephant in the room.

We think you should think about taxes year-round. (Sorry.)

That's because planning ahead—even a little—could work out well for you.

Don't delay

Most people don't think about taxes until it's time to prepare their tax returns.

But taking some or all of these steps now could spare you the agony of writing a check next April.

1. **Sock away pre-tax money**
   Contributing to a traditional IRA, or a 401(k) if your employer offers one, can be a win-win situation. You lower your current taxable income and save for retirement at the same time. Consider making an IRA contribution early in the year to allow more time for your money to grow. There are contribution and income limits for these accounts, so make sure you qualify.

2. **Sock away post-tax money**
   Roth IRAs and Roth 401(k) accounts give you another option for saving for retirement. The difference is you fund these accounts with after-tax money so that you'll have tax-free earnings and withdrawals during retirement.* "Fund both traditional and Roth retirement accounts if you can," said Jacklin Youssef, a senior tax and wealth planning specialist in Vanguard Personal Advisor Services®.

   "Getting a tax break *today* from contributing to a traditional retirement account is great," said Youssef. "But consider your tax rate *down the road*, which may not be lower than your current rate because of a pension, Social Security, required minimum distributions (RMDs) from traditional retirement plans, etc. Multiple retirement account types can give you tax diversification.If you want to manage your future taxable income, you could withdraw from a traditional IRA until you reach a certain tax bracket and then withdraw from a Roth account."

3. **Make a healthy contribution**
   If you're covered by a high-deductible health plan, think about adding money to a health savings account (HSA). "Any money you add to an HSA is triple-tax-advantaged," said Youssef. "That means your contribution is tax-deductible up to certain limits, your earnings grow tax-deferred, and withdrawals for qualified medical expenses at any age are tax-free. So if you have an HSA and find yourself with some extra cash after a midyear bonus, think about maximizing your contribution to an HSA and investing those funds for your retirement years instead of spending that cash."

4. **Pick the right location**
   Taxes can eat away at your returns. That's why the concept of asset location is important in your taxable investment accounts, according to Youssef. "Consider placing tax-inefficient securities, like taxable bonds and actively managed equity funds, in your tax-deferred retirement accounts. Conversely, think about placing tax-efficient options, like stock index funds and tax-exempt bonds, in your taxable accounts to help minimize that tax bite."

5. **Harvest investment losses**
   You can offset capital gains and up to $3,000 of income through a practice known as tax-loss harvesting.** "Basically, you're selling some investments at a loss to lower the current taxes you'd owe on other investments' gains," said Youssef. You should consider consulting a financial or tax advisor if you want to try this strategy.

6. **Be charitable**
   Many people give to their favorite charities at the end of the year. While charities will take gifts anytime, many close their fiscal years at the end of June. So if you're planning on donating anyway, consider giving over the summer months.

   Donating appreciated securities rather than cash is a valuable charitable option that can help lower your taxes. "Instead of writing a check to your favorite charity, you could donate a stock that's increased in value," explained Youssef. "The charity gets the full value of your stock, and you don't have to pay taxes on those gains." Most large charities accept appreciated securities, but it's a good idea to check before donating.

   If you're taking RMDs, another way to gift to charity is to consider making a qualified charitable distribution (QCD).

7. **Make tax-efficient withdrawals from your portfolio**
   When you're ready to take money out of your retirement accounts, think about the first account you'll tap into. Strategically spending your retirement savings can help you maximize how much you can spend in your lifetime.

   "If you're 70½ or older, take your RMDs first, since you'll be hit with a severe penalty if you don't," said Youssef. "Next, consider taking cash generated from your investments, such as interest on bond investments and dividend income from your taxable accounts, since that money will be taxed whether you spend it or reinvest it."

After your taxable accounts are depleted, the new question is whether to take money from your tax-deferred or tax-free accounts.

"Like many things in life, the answer is, 'It depends.' If you think your future tax rate will be higher than it is currently because of your Social Security, RMDs, or other income, then think about withdrawing from your tax-deferred, or traditional, retirement accounts before your RMD age. That way you'll take advantage of likely lower tax brackets due to any medical and charitable contribution deductions. It may also be advantageous to consider starting to make Roth conversions during this time," explained Youssef. "If, on the other hand, you think your future tax rate will be lower, consider withdrawing from your tax-free, or Roth, retirement accounts first."

8. **Adjust your withholding or make estimates**
If you're employed, you have to choose how much tax to withhold from each paycheck. (If you're retired, you can have taxes withheld from IRAs and Social Security benefits.) Take a look at your most recent paycheck and calculate your total withholding for the year as compared with your potential tax bill. If you're withholding more money than you need to, consider lowering that amount—you'll get more money in each paycheck and will come closer to "breaking even" on your federal tax return.

If you're on track to owe a lot of taxes next April, you can also make quarterly estimated payments to avoid unnecessary penalties and interest when filing your return.

Always focus on the big picture

While it's a good idea to look for ways to reduce your taxes now and later, you should avoid making decisions based solely on the tax implications, according to Youssef. "I tell investors to not let the tax tail wag the dog. Avoiding or deferring taxes is just one component of your portfolio; you need to make sure you're taking a holistic, long-term approach and considering all the impacts a decision would have on your portfolio for yourself and your heirs."

Also, it's a good idea to get help. "Taxes can certainly be complicated. We encourage clients to talk with a tax advisor for advice specific to their situations," said Youssef.

*As long as you've held the account 5 years, you're age 59½ or older, or a special exception applies.

**Tax-loss harvesting involves certain risks, including, among others, the risk that the new investment could perform worse than the original investment, and that transaction costs could offset the tax benefit. There may also be unintended tax implications. We recommend that you consult a tax advisor before taking action.

Notes:

All investing is subject to risk, including the possible loss of the money you invest.

When taking withdrawals from an IRA before age 59½, you may have to pay ordinary income tax plus a 10% federal penalty tax.

This article is intended to provide general information and should not be considered tax advice. You should consult a tax advisor for specific information on how tax laws apply to your situation.