How to strategize tax diversification

Within personal finance, diversification is most often understood as the practice of spreading investments across various asset classes in order to mitigate overall portfolio risk. However, there is another important form of diversification that often gets overlooked. Strategically allocating assets across accounts with varying tax treatments can help optimize tax efficiency, reduce risk, provide tax flexibility, and potentially maximize after-tax returns.

Tax treatment for investment accounts

We'll first review the tax treatments for the most common investment accounts to highlight the beneficial impact of tax diversification strategies.

Taxable investment accounts: These accounts offer no tax deferral for contributions, and you are subject to taxes on dividends, interest income, and capital gains realized from the sale of investments at differing tax rates directly related to the investor's income level.

Tax-deferred retirement accounts: Contributions to accounts like Traditional IRAs or 401(k)s are often made with pre-tax dollars, which helps reduce your taxable income. However, any withdrawals will be taxed as ordinary income. Upon reaching a specific age, these accounts are also subjected to Required Minimum Distributions (RMDs). These withdrawals could lead to significant tax liabilities if the account is large enough.

Roth IRAs and Rother 401(k)s: Contributions to Roth accounts are made with after-tax dollars, meaning withdrawals in retirement, including earnings, are typically tax-free under specific parameters.

Health Savings Accounts (HSAs): Contributions to HSAs have triple tax benefits in that contributions are tax-deductible, the account grows tax-free, and subsequent withdrawals for qualified medical expenses are tax-free.

Tax diversification strategies

With guidance from your tax professional, Mesirow Wealth Advisors often look to utilize the following tax diversification strategies as part of your overall financial plan:

Maximize contributions to the various account types: Take full advantage of the previously mentioned tax-advantaged accounts by maximizing contributions based on eligibility, income limitations, and financial ability. This allows you to benefit from the unique tax advantages offered with each account type while providing flexibility and protection against potential changes to existing tax laws.

Investment allocation: Strategically place investments, depending on their specific characteristics, between taxable and tax-deferred accounts to help reduce your overall tax burden and potentially increase after-tax returns over the long run. Tax-efficient investments, such as stocks with qualified dividends and index funds, could be held in taxable accounts, while tax-inefficient investments, such as actively- managed mutual funds, may be better suited for tax-deferred retirement accounts.

Roth conversions: Evaluate the potential benefits of converting assets from tax-deferred accounts to Roth accounts. While Roth conversions are taxable events in the year they occur, they can be used to reduce future RMD amounts and future tax liabilities when strategically executed in lower-income years.

Tax-loss harvesting: Regularly review taxable accounts for opportunities to "harvest" tax losses by selling investments that have declined in value and reinvesting in a similar investment to maintain market exposure. Tax-loss harvesting can help offset capital gains and reduce taxable income, enhancing overall tax efficiency. Our Mesirow Wealth Advisors regularly practice this technique when managing client portfolios.

Deliberate withdrawal strategies: Maintain flexibility when making withdrawals from taxable, tax-deferred, and tax-free accounts to minimize taxes generated when supplementing income in retirement. Factors such as RMDs, the current market environment, other existing sources of income, and expense classification should all be considered when determining what accounts to withdraw from. One example would be utilizing your HSA to cover qualified medical expenses versus withdrawing from an IRA. Employing a deliberate and thoughtful approach to making withdrawals allows you to take advantage of unique opportunities to become more tax-efficient as they present themselves.

As with the rest of your financial plan, it's essential to work closely with your Mesirow Wealth Advisor and tax professional to develop and implement a personalized asset diversification strategy tailored to your individual financial goals and circumstances. With careful planning and execution, asset diversification among investment accounts can be a powerful tool for building and preserving wealth, minimizing tax liabilities, and reducing the risk of adverse tax consequences and changes to tax laws.

Finally, tax diversification can benefit retirees who are focused on legacy planning and wealth transfer to heirs. By strategically positioning assets in taxable and tax-advantaged accounts, retirees can increase the tax efficiency of their estate and maximize the potential legacy passed on to their loved ones.

Talk to your Mesirow Wealth Advisor today about strategies you can take to help further diversify your portfolio.

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