We scramble to do whatever we can to save on taxes.

Unfortunately, there?s little firepower in the form of itemized deductions since the Tax Cuts and Jobs Act (TCJA) was initiated. The www.taxfoundation.org estimates that nearly 90% of taxpayers will continue to take the expanded standard deduction which has increased from $6,500 to $12,000 for single filers; $13,000 to $24,000 for those married filing jointly. If you recall, the income tax changes under TCJA expire at the end of 2025.

CPAs, professionals in the financial industry and the media constantly tout the advantages of pre-tax accounts like traditional 401ks and deductible IRAs to help consumers reduce their current tax liabilities.

The sole focus on tax reduction today could be a shortsighted mistake paid for dearly down the road.

I?ll explain:

Most financial professionals advise with an **accumulation** mindset. The emphasis is to help clients accumulate and invest primarily in tax-deferred accounts with little consideration to tax implications of this guidance when the day arrives to withdraw funds - most likely at retirement.

Rationale for this tax-deferred myopia is based on a compelling three-part story: First, the ?snowballing? of compounded investment returns which occurs as would-be annual tax dollars work 100% for the investor sheltered from taxation for years, perhaps decades. Second, a company retirement account contribution is generally a dollar-for-dollar reduction of gross income which ostensibly reduces taxable income.• Finally, the blanket statement about how households are going to drop to the lowest tax bracket in retirement is stubbornly alive and well. Only one component of this story remains valid.

The tax-deferred snowball story touted throughout the 80s and early 1990s made sense as ten-year annualized returns on the S&P 500 ranged consistently between 10 to 15%. What a snowball, right? From the mid-90s to today, returns on the large company index have been half or less than half what investors previously realized. If we?re correct at RIA about forward-looking stock returns closer to 3%, the attractiveness of socking every dollar away in tax-deferred accounts based on the compounding story is as small as a snowball in Texas.

But Rich, what if marginal tax rates do indeed move higher? Wouldn?t it be worth maximizing my savings in tax-deferred accounts while I?m still working? Well, that is clearly the conventional wisdom ? *worry about taxes today, never tomorrow* (and tomorrow arrives sooner than you think!)

However, unless there?s a proactive strategy to the invest tax dollars that are saved by maxing out pre-tax accounts, (in an after-tax account or Roth IRA), why not bite the bullet, pay taxes now while you?re a career-driven, human capital earnings machine, as opposed to the time when you are no longer in the workplace and need every tax-friendly dollar to live comfortably?

If we consider taxation on Social Security benefits and couple that with future disappointing investment returns, it makes sense that investors should place greater focus on tax-free account vehicles such as Roth vs. traditional pre-tax choices which just postpone future tax pain.

If you?re a rare breed of taxpayer who believes marginal tax rates will fall in the future, taxation on Social Security benefits is not eventually headed higher and Medicare IRMAA surcharges will only increase down the road for higher-income households, then there?s no reason to consider a change to your current focus on pre-tax retirement accumulation.

If you believe taxes have one direction to go (and that?s up), then read on.

With the proliferation of exchange-traded funds, investors now have a great opportunity to invest tax-efficiently in after-tax brokerage accounts. The inherent tax-efficiency of ETFs allows investors to still buy in to the snowball compounding tale (if they must), of stocks, but in a tax-friendly manner.

The advantage would be the reduction of ordinary income tax liability and increase in long-term capital gains, which are currently taxed at lower rates. For example, a married retiree with income at the 22% marginal tax rate (married filing jointly with taxable income of $19,401-$78,950), would pay a more palatable 0 ? 15% on long-term capital gains on the sale of investments held for a year or longer.

Keep in mind, short-term capital gains (gains from a sale on assets held for a year or less), are currently taxed as ordinary income. Noted, there?s always a risk that favorable long-term capital gain rates are not as tax-friendly in the future. Personally, I?m willing to take the risk as I believe long-term capital gain rates will always be taxed favorably vs. current income as the wealthiest Americans (including members of Congress), don?t survive paycheck-to-paycheck. They thrive off capital gains.

At the least, maintaining pre-tax, after-tax and tax-free accounts allows for greater lifetime tax control. It?s especially important throughout the retirement income distribution phase.

At RIA, we teach the importance of ?diversification of accounts? whereby a retiree is able to maintain greater distribution flexibility and control over tax liabilities when unexpected expenses arise or ordinary-income distributions risk placing a retiree in the next highest marginal tax bracket.

Recently, a client required $50,000 to pay off the mortgage on his primary residence. Because he believes in account diversification, we were able to withdraw $20,000 from his pre-tax rollover IRA, $10,000 from his Roth conversion IRA and the remainder from his after-tax brokerage account which helped minimize the overall taxes he would have incurred if the entire $50,000 needed to be distributed solely from his pre-tax rollover IRA. ••

Unless you?ve undertaken holistic financial planning that includes tax-friendly retirement income distribution planning modeled for the sunset of current tax laws in 2025, and then *know for a fact* you?re going to be in the lowest tax bracket in retirement, here are several other tax-friendly ideas to consider:

Maximize annual contributions to ROTH IRAs.

A Roth comes in two flavors: Contributory and conversion. People tend to mix them up. So, let?s start with the smarter, more handsome sibling of the traditional IRA: The contributory Roth IRA. Roth accounts overall offer tax-free growth and most important: **Tax free withdrawals.**

The annual contribution limit per individual is $6,000 for 2019; $7,000 if you?re 50 or older.• Roth IRA contribution levels phase out based on household adjusted gross income. For example, if your filing status is married filing jointly and modified adjusted gross income is less than $193,000, you may contribute up to the limit. Once MAGI is greater than $193,000 but less than $203,000, contribution levels are reduced. Based on the generous AGI phaseout levels, most wage earners will have no excuse and should be able to fund Roth IRAs every year.

Since Roth IRAs are funded with after-tax dollars obviously, a current tax deduction is not available (*remember my commentary about focusing on taxes tomorrow vs. taxes today?*). After a five-year period, which begins January 1st of the year a contribution is made, earnings may be distributed 100% tax free. If younger than 59 1/2, unfortunately, a 10% premature distribution penalty applies to withdrawn earnings.

Contributions, which are after-tax, may be withdrawn at any time without taxes or penalties. For many investors, the five-year waiting period for earnings is a quick walk in the park as funds should be considered long-term for retirement.

Keep in mind, a Roth IRA is not subject to required minimum distribution rules where at 70 1/2, distributions from traditional retirement accounts must begin or a retiree may face a draconian 50% penalty on the amount that should have been withdrawn.

Another benefit to Roth IRAs and Roth 401(k) options: *Withdrawals are not included in the provisional income formula used to tax Social Security; distributions will not add to income that may generate Medicare IRMAA surcharges.*

> *Keep this in mind if you follow a Pay Yourself First strategy: In almost every case a Roth is a better choice.•I?m not concerned about your current tax bracket; nor am I worried about your possible tax bracket in retirement. I do care about how you?re going to gain more consumption dollars in retirement and the impact of taxation on Social Security benefits.*

> *John Beshears a behavioral economist and assistant professor of business administration at Harvard Business School in a study ??Does Front-Loading Taxation Increase Savings?: Evidence from Roth 401k Introductions,?•along with co-authors, outlines that plan participants who place their retirement savings on auto-pilot and direct a percentage of gross income, say 10%, into a Roth vs. a traditional pre-tax 401k, will wind up with more dollars to spend in retirement.*
>
> *•It?s rare when a financial rule-of-thumb is a true benefit. And you don?t need to do much to receive it! The reason the strategy works is front loading of taxes. In other words, sacrificing tax savings today (when working and paying the taxes isn?t as much of a burden as it would be in retirement when earning power drops dramatically), and*

failing to adjust the percentage of auto-pilot savings to compensate for the current tax impact of switching from pre-tax to Roth, allows for additional future consumption dollars.•

From Lauren Lyons Cole Business Insider article on the study:

?If a worker saves $5,000 a year in a 401(k) for 40 years and earns 5% return a year, the final balance will be more than $600,000. If the 401(k) is a Roth, the full balance is available for retirement spending. If the 401(k) is a traditional one, taxes are due on the balance. Let?s say the person?s tax rate is 20% in retirement. That makes for a difference of $120,000 in spending power, which a life annuity will translate into about $700 a month in extra spending.? John Beshears

Switch to a ROTH 401(k) at work.

I know. Sounds weird. We?ve been so brainwashed to invest in traditional pre-tax 401k plans; it just feels odd to consider a Roth alternative. Most likely, your place of employment offers a Roth 401k; you just never bothered to check - they never bothered to make a big deal about offering it.

A Roth 401k operates the same as the traditional brethren with several important differences ? contributions are after-tax; there is no current tax benefit for paycheck contributions. In other words, if you decide to max your employee contributions (and I hope you do), then $19,000 ($25,000 if 50 or older), will not reduce your household income. Employer-matched contributions remain pre-tax and deposited in your traditional, pre-tax 401k. •

But Rich, this is painful! I get it. As you recall, tax savings realized in the current can be a tax enemy in waiting when retirement arrives and you require *every tax-free dollar to maintain a lifestyle*. Let?s consider a compromise (*and I do need to make this deal. Sometimes the tax-deferred story is too deeply ingrained to discount completely*). •

You decide to ignore my advice. I have no idea what I?m talking about. Fine. So, you make the maximum contribution to a pre-tax 401(k). Hey, I?m just happy you?re saving money! Now, please go ahead and ask your tax advisor how much was saved in current taxes due to the contribution. Whatever that sum turns out to be, I want you to please contribute 100% of it if possible, in a Roth contributory IRA. See? I?m all about compromise. At the least, you?ll be working on diversification of accounts. For that, I commend you.

I?m proud of how we?ve helped attendees at our Right Lane Retirement Classes and clients to realize the long-term benefits of Roth. So much so, we have many clients who max their Roth 401k AND Roth contributory accounts on a consistent basis.

If your company doesn?t have a Roth retirement plan option, I?d suggest you speak to your benefits department to inquire as to why one isn?t offered. In the meantime, my recommendation is to invest up to the match in your tax-deferred plan and continue the remainder of your savings in an after-tax brokerage account.

Consider annual surgical ROTH conversions.

People ask me about the viability of Roth in light of massive federal government deficits. I?m not concerned about the government changing the tax-free status of Roth. Why? *They?re like J.G.*

Wentworth! They need cash now! However, I?m extremely concerned how political parties envision tax-deferred accounts as fatted calves ? all too tempting not to bring to eventual tax slaughter.

The $100,000 AGI ceiling on Roth conversions was removed years ago to allow traditional IRA owners to convert to Roth without limitation (J.G Wentworth!).

A Roth conversion allows withdrawals from a pre-tax retirement account, most likely a rollover IRA, and subsequent conversion to Roth. Withdrawals are taxed as ordinary income. Therefore, careful analysis and discussion with a financial and tax advisor is crucial.

I partner with a ?young? retiree, a client for over a decade now ? 57 years old, on a surgical Roth conversion plan. If you recall from previous blog posts, I?ve written how the fortunate few who still have pensions, employer-based retirement healthcare pre-Medicare, and are disciplined savers to boot, earn the luxury of retirement in their 50s.

I outlined a five-year surgical Roth conversion strategy to fully maximize the 22% tax bracket. Considering a 37-year life expectancy, we were able to estimate an increase in his lifetime withdrawal and/or legacy plan by $871,466 compared to conventional wisdom whereby we remain passive and just distribute money every year from his tax-deferred accounts beginning at age 60, to meet specific spending goals. With the surgical Roth strategy, we were also able to reduce overall tax liability and loss of tax control that comes with required minimum distribution requirements.

In addition, years ago we initiated a process where our client proactively made an effort to NOT sock every investment dollar away into tax-deferred accounts. Ostensibly, we now have cash to pay all taxes on Roth conversions from his after-tax source. This allows 100% of his IRA dollars to be directed into the Roth. Having the money available from an outside source to pay taxes on the conversion instead of withheld from the traditional IRA, avoids the 10% premature distribution penalty he would have incurred before 59 1/2.

A trusted tax advisor with a bit of fine tuning was able to validate the plan before we moved forward.

There are times when pervasive financial dogma is harmful to your wealth. For some reason, Roth is not discussed often enough.

I?m no conspiracy theorist. However, I do believe there?s a profit incentive behind it all for Wall Street and the financial industry which prevents Roth from becoming the popular choice.

As a reader of RIA, now you know better.