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6 Tax Planning Tips To Consider For 2017

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With many Americans completing their 2016 tax returns, it might seem early to start working on reducing your 2017 taxes. But with taxes being a drag on net investment performance, it makes sense to shelter your investments to the maximum extent possible. It's always best to consult with your tax advisor on all tax related matters, but here are 6 steps to consider as early in the year as possible:

1. Shelter your interest inside your retirement accounts. If your investment portfolios are going to hold bonds, then it might be best to hold those bonds inside tax-deferred retirement plans such as IRA's and 401(k) plans. Most bonds pay periodic interest that is often taxed at ordinary income tax rates. But when these instruments are held inside a retirement plan account, the interest earned may avoid current taxation. Of course, tax-free municipal bonds may be an exception to this approach as they can pay federal and sometimes state tax-free interest; therefore municipal bonds are often suited for taxable accounts (and not usually for retirement accounts).

2. Review your taxable account investments. Consider using tax-efficient mutual funds or separately managed accounts that strive to limit the number of taxable events inside your portfolio. With combined federal and state capital gains rates possibly totaling over 30 percent, buy-and-hold strategies may be a suitable option for some investors.

3. Rebalance your portfolio by using cash flow. Selling existing investments to rebalance a portfolio should typically be a last resort because selling can generate taxable gains. Instead, consider using cash flows to rebalance; use dividends and interest earned inside the account, new deposits, and proceeds from tax-loss harvesting as the source of funds to rebalance. An added benefit of this approach is that it may also help reduce transaction costs.

4. Realize tax losses throughout the year. Consider selling investments that are at a loss; by doing so you can generate a tax deduction. You are allowed to realize annual net investment losses of up to $3,000, and this can be used to lower taxable income or offset gains that have been realized. When you sell at a loss, there are rules governing how you can then reinvest those proceeds; so be sure to adhere to the "wash sale rules." These rules stipulate that you cannot reinvest those same proceeds into a nearly identical investment for the 30-day window before or after the sale. If you do, you may not be entitled to recognize your tax loss.

5. Make a contribution to an IRA or a Roth IRA. The maximum contribution amount is the lesser of your taxable compensation for 2017, or $5,500. If you are age 50 or older at any time during the year, you can add another $1,000. These maximum contribution limits apply to all your IRAs combined so that there is no "double dipping." There may also be income limits for your eligibility to contribute; so please carefully review the guidelines and work with your tax advisor before deciding on any IRA or Roth IRA contributions. For more on this topic, visit IRS.gov.

6. Consider a Roth IRA conversion for longer-term tax benefits. As noted above, there are some income limits which may preclude some investors from contributing to a Roth IRA; but anyone with assets in an employer-sponsored retirement plan or Traditional IRA can complete a Roth conversion without being subject to income limits. You can convert eligible funds from your employer-sponsored retirement plan or Traditional IRA into a Roth IRA. At conversion, you create a taxable event whereby you must pay taxes on the amount converted as ordinary income for the year of conversion distribution (except if a portion is treated as a return of any after-tax IRA contributions). Younger investors have a longer time period to then potentially grow the Roth IRA account and make up for the tax paid at conversion. Therefore a Roth conversion may have greater benefit for younger investors. Remember that Roth IRA contributions are made with after-tax dollars, and since gains inside a Roth IRA may not be subject to income tax, qualified distributions can be federal income tax free—but this is provided you adhere to the IRS guidelines—so be careful if you need to make any withdrawals from a Roth IRA prior to age 59.5.

Contributor's Bio

Mark Avallone is the author of Countdown To Financial Freedom, and founder and President of Potomac Wealth Advisors, LLC a financial advisory firm serving clients through holistic financial planning and wealth management. Avallone writes on a variety of financial topics, and his contributions have appeared in the Wall Street Journal as well as in Forbes where he is a regular contributor. He has appeared on CNBC and has been a repeat guest on the Fox Business Network. His insights have also appeared in USA Today, U.S. News & World Report, The Washington Post, and other leading publications.

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