The Ultimate Guide To Tax Efficient Investing

Taxes are the single biggest expense we have in life… yet most investors have a very defeatist attitude on the topic. They accept that a big chunk of their paycheck – or gains in their portfolios – ends up in the coffers of various levels of government.

The reality is that there are numerous strategies that allow you to protect, grow, and transfer your wealth more efficiently.

Taxes are complex. The tax code is more than 70,000 pages, and growing longer and more complex with each year that goes by.

Our goal is to simplify and demystify the powerful strategies that high earners can employ to reduce taxes today, enjoy tax free growth of their portfolios in coming years, and enable tax free withdrawals down the road. We publish a number of videos, tools, and educational guides covering a wide range of topics.

This guide covers some guiding principles for investors looking to protect, grow, and transfer their wealth efficiently.

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#1: Pay What You Legally Owe… And Not A Penny More **3**
#2: Have A Sense Of Urgency **3**
#3: Max Out Tax Advantaged Accounts… **3**
#4: …But Beware The Penalties! **4**
#5: Understand The Cost / Benefit Analysis **5**
#6: Allocate Strategically **5**
#7: Embrace The Advantages Of Taxable Accounts **6**
#8: Don't Forget About State Taxes **7**
#9: Plan Tax Efficient Transfers **9**
#10: Tap Into Real Estate **9**
Depreciation 9
Tax Free Exit Options 9
Bonus: Actionable Tax Saving Strategies **10**
Next Steps **11**

#1: Pay What You Legally Owe… And Not A Penny More

Don't do something dumb that ends up with you in debt, in jail, or both.

This may sound obvious, but the focus of any tax-minded investor should be on ***legal*** tax strategies. Like all things related to investing, there can be a tradeoff between risk and return.

Sure, there's some financial reward to tax fraud – in that you have more money in your pocket than if you'd filed your taxes accurately. But the risk is massive, and should dissuade any rational investor from stepping over the line.

The good news: there are plenty of strategies that are definitively above board and run zero or little risk, which is our focus in this guide and throughout the WealthChannel platform.

#2: Have A Sense Of Urgency

Investors have a tendency to procrastinate when it comes to taxes. Nearly a third of U.S. taxpayers wait until the last minute to file their taxes each year.

But when it comes to maximizing your tax efficiency, procrastination is a huge mistake.

There's a very simple reason for this: most tax savings opportunities are perishable. In other words, some of the most valuable tax advantages expire every year. If you didn't contribute to an IRA in 2022, you'll never be able claim that advantage. That ship has sailed, and you missed an opportunity to create tax free wealth.

Maintain a sense of urgency about identifying the low hanging fruit (more on this below), especially if you're young and your potential tax efficiencies can compound over many decades.

#3: Max Out Tax Advantaged Accounts…

This is the main thrust of any tax efficient strategy. In general, you want to get as much money as possible into tax-advantaged accounts, where they can realize one or more of the primary tax efficiencies:

1. **Tax Deductible Contributions.** If you're able to make tax deductible contributions to an account, this has the effect of lowering your tax liability today. That's a huge win, because it means you can invest that money instead of paying taxes with it.
2. **Tax Free Growth.** In most tax-advantaged accounts, investments experience tax free growth. In other words, dividends and capital gains aren't taxed – which allows you to keep more of your money at work instead of writing a check to the government.
3. **Tax Free Withdrawals.** In some accounts, such as a Roth IRA, investors are able to make tax free withdrawals in retirement. This is obviously a preferred outcome to realizing taxable capital gains when they sell stocks and bonds to fund living expenses.

Different accounts have different tax advantages. The chart below illustrates the advantages of a "backdoor Roth IRA", regular Roth IRA, and Traditional IRA options.

	Backdoor Roth	Roth IRA	Traditional IRA [a]	Traditional IRA [b]	Taxable Account
Tax Deductible Contributions	❎	❎	✅	❎	❎
Tax Free Growth	✅	✅	✅	✅	❎
Tax Free Withdrawals	✅	✅	❎	❎	❎
Available to High Earners	✅	❎	❎	✅	✅

[a] This reflects deductible contributions to a Traditional IRA.
[b] This reflects nondeductible contributions to a Traditional IRA. Withdrawals of nondeductible contributions are not taxed, but growth is.

Unfortunately, the amount of money that you can contribute to tax-advantaged accounts is limited by law. Your focus should be on getting the maximum amount allowed into your 401(k) – including a solo 401(k) if you're self employed – IRA, 529, and any other tax-sheltered accounts available to you.

#4: …But Beware The Penalties!

There is a potentially massive advantage that comes from getting your investments into tax-advantaged accounts such as a 401(k) or an IRA. But there are potential drawbacks as well, perhaps the most significant of which is **limited liquidity**. In other words, you'll often end up paying taxes, penalties, or both if you need to withdraw money from a tax-advantaged account prior to the allowed date.

For example, if you have to withdraw money from a Health Savings Account (HSA) prior to age 65 for a non-medical expense, you'll get hit with taxes AND a 20% penalty. That's likely to wipe out the value of any tax advantages you realized by contributing in the first place.

The same goes for early withdrawals from an IRA or 401(k).

If you have an "overfunded" 529 that still has money in it after paying for college, you have a few different options available to you – but none of them are great.

Here's the bottom line: make sure you have sufficient assets in taxable accounts to cover your anticipated expenses, so that you can avoid tapping into IRAs, 401(k)s, and other tax-sheltered accounts until you can do so without eliminating any of the tax advantages.

#5: Understand The Cost / Benefit Analysis

As discussed above, there is often both a cost and a benefit associated with any tax strategy. It's important to understand the costs – such as limited liquidity – but it's also important to quantify the benefits.

Some tax strategies – like a "backdoor Roth IRA" or setting up a Solo 401(k) – have the potential to create hundreds of thousands or even millions of dollars in incremental wealth.

Others, like a Uniform Transfer To Minors Act (UTMA) account, provide a relatively small tax benefit.

Do the math, and figure out how much value a tax strategy creates. We have a number of tools that help investors to quantify the potential benefit derived from a tax strategy, including our IRA Scenario Tool, IRA Conversion Tool, Solo 401(k) Calculator, and HSA Calculator.

#6: Allocate Strategically

Because there are contribution limits on IRAs, 401(k)s, and other tax-sheltered accounts, most investors are unable to shelter as much of their wealth from taxes as they'd like. In other words, even if you use all the tools available to you, you'll likely end up with significant assets in taxable accounts.

There are tax savings to be reaped by strategically allocating asset classes across taxable and tax-advantaged accounts. As a general principle, you should place the most tax efficient asset classes in a taxable account and the least tax efficient asset classes in your tax-advantaged accounts.

For example: junk bonds are relatively tax **inefficient**, since almost all of the expected return comes in the form of interest payments.

The table below comes from Bogleheads, and provides good high level guidance for assessing the tax efficiency of an asset class.

Asset Class	Efficiency
Money Market / Cash	Most Tax Efficient
Total Stock Market Funds	
Balanced / Target Retirement Date Funds	
Small and Mid Cap Stocks	
Total Market Bond Funds	Moderately Inefficient
Active Stock Funds	
Real Estate / REIT Funds	Tax Inefficient
High Turnover Active Funds	
Junk Bonds	

Investors should generally place tax inefficient assets into their most tax efficient accounts. For example, assets such as junk bonds and REITs should be put into tax advantaged accounts, where investors aren't punished for their tax inefficiency.

On the other hand, short term assets such as cash should be placed into a taxable account.

#7: Embrace The Advantages Of Taxable Accounts

Yes, you read that correctly: there are some **advantages** to taxable accounts.

One of these is the ability to execute tax loss harvesting. This involves selling losing stocks or funds in order to generate a capital loss and offset other income. This same trade executed within a tax advantaged account such as an IRA or 401(k) will have no impact.

Another advantage relates to tax rates. Withdrawals from a Traditional IRA or 401(k) will generally be taxed at the ordinary income rate. Within a taxable account, most withdrawals are effectively taxed at the capital gains rate – which is generally lower.

The devil is in the details here, but the difference here can be significant. The top federal tax rate in 2023 is 37%, compared to a top long term capital gains rate of 20%.

The following table shows tax rates for married couples for 2023:

Ordinary Income		Capital Gains	
Income Range	**Tax Rate**	**Taxable Income**	**Tax Rate**
$0 to $11,000	10%	$0 to $89,250	0%
$11,001 to $44,725	12%	$89,251 to $553,850	15%
$44,726 to $95,375	22%	$553,851 or higher	20%
$95,376 to $182,100	24%		
$182,101 to $231,250	32%		
$231,251 to $578,125	35%		
$578,126+	37%		

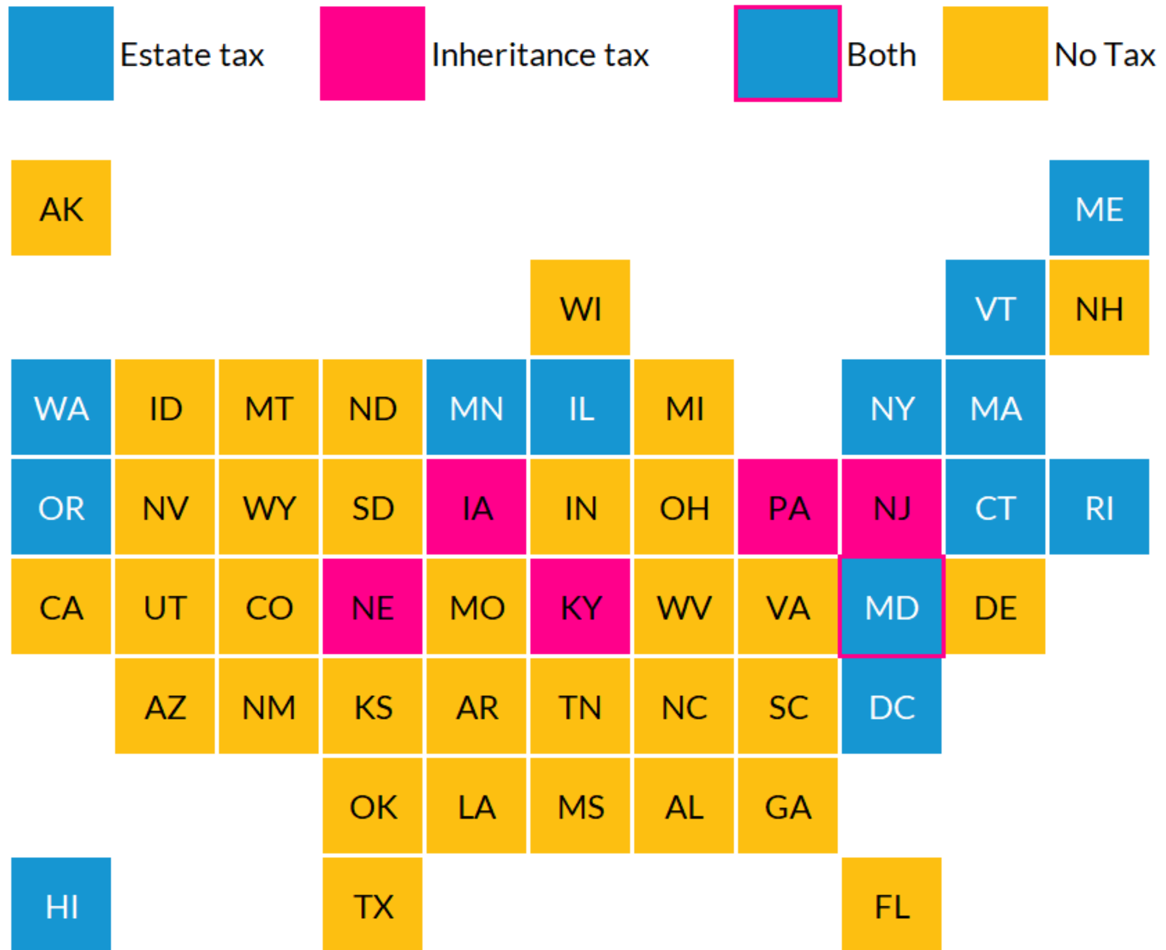
Expected tax rates should be considered when calculating the expected financial benefit of a tax strategy. Many of our free tools allow investors to quantify the impact of these rates.

#8: Don't Forget About State Taxes

Most tax advice you will read focuses on federal taxes and tax rules, but it's important to also keep in mind the impact of state rates and rules. There is a HUGE range of state income and capital gains taxes, ranging from 0% in a handful of states to 13.3% in California.

Tax-minded investors should pay attention to more than just tax rates at the state level, as other rules can have a big impact on tax efficiency. For example, some states do not have an estate or an inheritance tax. Some have one or the other – and Maryland has both.

The table on the following page shows the status of all 50 states as of 2023.



Source: [Urban Institute]

#9: Plan Tax Efficient Transfers

We believe that an optimal tax strategy is one that strives to protect, grow, and transfer wealth in a tax efficient manner. Many investors overlook the final piece of that puzzle, neglecting to think about the tax liabilities that may arise when their wealth is transferred to future generations.

Estate and gift taxes can potentially take a huge bite out of the wealth that you work hard to build and protect, so it’s worth spending time thinking about how to minimize this impact.

Gift and estate strategy is a topic that can depend quite a bit on your residence. While all taxpayers are allowed to transfer specified amounts to future generations tax free, rules for gift and estate taxes at the state level. Oregon and Massachusetts have estate tax exemptions of just $1 million and top tax rates of 16%. Washington’s exemption is about $2.2 million, but the top tax rate is 20%.

#10: Tap Into Real Estate

Owning real estate, either directly or indirectly, can open up additional tax saving strategies for investors.

The tax advantages of owning real estate can get quite complex, and depend heavily on your level of ownership. But there are two primary tax advantages to investing in real estate:

Depreciation

Owners of real estate are able to deduct depreciation, which is a non-cash expense. This depreciation expense can be used to offset taxable income, and potentially to create a taxable loss.

The value of the depreciation benefit will depend on the type of the property, the timing of the purchase, and the type of investor. Ideally, depreciation can be “front loaded” so that investors experience a significant paper loss in the early years of ownership and use that loss to offset other income.

Tax Free Exit Options

When real estate is sold, investors may have easy ways to defer the capital gain realized. This may involve a 1031 exchange, in which the investor essentially rolls their proceeds into a new property. And the Opportunity Zone tax incentive has created additional opportunities to defer and eventually eliminate capital gains taxes by rolling proceeds from a sale into a new property.

Next Steps

If you’re interested in alternative investments, make sure to check out the schedule of upcoming WealthChannel Events.

These events are tailor-made for investors who are interested in private equity, private credit, and real estate investments.

And don’t forget to subscribe to the WealthChannel YouTube channel, updated several times per week with new content that can help you grow your wealth.