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Four tax-saving strategies to consider when markets decline

A significant market decline can be unnerving. However, there are strategies to reduce tax liabilities in both the short and long term. Of course, tax rules can be complicated and may change, so a tax advisor should be consulted.

1. Perform a Roth conversion

A market decline may be an opportune time to convert tax-deferred savings into tax-free Roth assets. A conversion could help lower required minimum distributions (RMDs) starting at age 72, allow for lower Medicare premiums for some higher-income recipients, improve tax-management in retirement and provide tax-free income for loved ones after the owner passes away. In addition to considering any savings in a traditional IRA, workers should check to see if their workplace 401(k), 403(b) or 457 plan offers a designated Roth account. If so, plan assets could be considered for a conversion. Shifting assets to a tax-free Roth account now could mean considerable savings later.[1]

Tax must be paid on the converted funds — but the value is down, so taxes are less than they'd be if the Roth conversion had been done at market peak. The hope is that the money could be recovered and even grow in the Roth IRA. It would then be tax free at withdrawal (or become a tax-free inheritance).

2. Harvest long-term capital losses

Doing so can offset long-term capital gains from the same year. If an investment in a taxable account had been sold at a gain earlier in the year before the market declined, taking a strategic long-term loss could help offset the taxes on the gain.

Also, up to $3,000 of capital losses can be used to offset ordinary income each year.

Lastly, taxpayers can carry forward any capital loss into future tax years until all of it has been offset by future realized capital gains.

Note that short-term losses are subject to different rules; consider them carefully.

3. Exit or reduce a highly appreciated holding

Sometimes an investment might have grown considerably — which is what one hopes for, but it means that selling could lead to a large tax bill. In a down market, however, a taxpayer may be able to harvest a significant capital loss on other assets, creating an opportunity to offset a long-term capital gain on the highly appreciated one.

Another possibility: If a taxpayer is in the 0% capital gains bracket,[2] they can sell some or all of the shares and immediately rebuy them, effectively getting a free step-up in basis. Retired clients in the 15% capital gains bracket may find it more tax efficient to draw income from a stock sale rather than a source subject to ordinary income tax rates.

[1] Qualified distributions from a Roth IRA can be withdrawn income tax free. To be a qualified distribution, the Roth IRA has to be more than five years old and the owner has to be over age 59.

[2] Married clients filing jointly with total taxable income of $94,050 or less (2024). The $94,050 is inclusive of the capital gain.

4. Purchase life insurance

For clients who want to ensure that their heirs receive a specific amount of inheritance, life insurance may be a suitable solution. In a market downturn, a retiree over age 59½ could consider withdrawing from a traditional IRA and buying life insurance. Tax would be owed on the IRA withdrawal, but assuming that the value of that account were down at the time, the tax would be lower than at market peak. When the insured client dies, the goal of leaving a financial legacy would be achieved with an income tax-free death benefit.

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