BEACON WEALTH
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FIVE STRATEGIES FOR TAX EFFICIENT INVESTING

As just about every investor knows, it's not what your investments earn, but what they earn *after taxes* that counts. After factoring in federal income and capital gains taxes, the alternative minimum tax, and any applicable state and local taxes, your investments' returns in any given year may be reduced by 40% or more.

For example, if you earned an average 8% rate of return annually on an investment taxed at 28%, your after-tax rate of return would be 5.76%. A $50,000 investment earning 8% annually would be worth $107,946 after 10 years; at 5.76%, it would be worth only $87,536. Reducing your tax liability is key to building the value of your assets, especially if you are in one of the higher income tax brackets. Here are five ways to potentially help lower your tax bill.[1]

Invest in Tax-Deferred and Tax-Free Accounts

Tax-deferred accounts include company-sponsored retirement savings accounts such as traditional 401(k) and 403(b) plans, traditional individual retirement accounts (IRAs), and annuities. Contributions to these accounts may be made on a pretax basis (i.e., the contributions may be tax deductible) or on an after-tax basis (i.e., the contributions are not tax deductible). More important, investment earnings compound tax deferred until withdrawal, typically in retirement, when you may be in a lower tax bracket. Contributions to nonqualified annuities, Roth IRAs, and Roth-style employer-sponsored savings plans are not tax deductible. Earnings that accumulate in Roth accounts can be withdrawn tax free if you have held the account for at least five years and meet the requirements for a qualified distribution.

Pitfalls to avoid: Withdrawals prior to age 59½ from a qualified retirement plan, IRA, Roth IRA, or annuity may be subject not only to ordinary income tax, but also to an additional 10% federal tax. In addition, early withdrawals from annuities may be subject to additional penalties charged by the issuing insurance company. Also, if you have significant investments, in addition to money you contribute to your retirement plans, consider your overall portfolio when deciding which investments to select for your tax-deferred accounts. If your effective tax rate -- that is, the average percentage of income taxes you pay for the year -- is higher than 15%, you'll want to evaluate whether investments that earn most of their returns in the form of long-term capital gains might be better held *outside* of a tax-deferred account. That's because withdrawals from tax-deferred accounts generally will be taxed at your ordinary income tax rate, which may be higher than your long-term capital gains tax rate (see "Income vs. Capital Gains").

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Income vs. Capital Gains
Generally, interest income is taxed as ordinary income in the year received and qualified dividends are taxed at a top rate of 20%. (Note that an additional 3.8% tax on investment income also may apply to both interest income and qualified (or nonqualified) dividends.) A capital gain (or loss) -- the difference between the cost basis of a security and its current price -- is not taxed until the gain or loss is realized. For individual stocks and bonds, you realize the gain or loss when the security is sold. However, with mutual funds you may have received taxable capital gains distributions on shares you own. Investments you (or the fund manager) have held 12 months or less are considered short term, and those capital gains are taxed at the same rates as ordinary income. For investments held more than 12 months (considered long term), those capital gains are taxed at no more than 20%, although an additional 3.8% tax on investment income may apply. The actual rate will depend on your tax bracket and how long you have owned the investment.

Consider Government and Municipal Bonds

Interest on U.S. government issues is subject to federal taxes but is exempt from state taxes. Municipal bond income is generally exempt from federal taxes, and municipal bonds issued in-state may be free of state and local taxes as well. An investor in the 33% federal income-tax bracket would have to earn 7.46% on a taxable bond, before state taxes, to equal the tax-exempt return of 5% offered by a municipal bond. Sold prior to maturity or bought through a bond fund, government and municipal bonds are subject to market fluctuations and may be worth less than the original cost upon redemption.

Pitfalls to avoid: If you live in a state with high state income tax rates, be sure to compare the true taxable-equivalent yield of government issues, corporate bonds, and in-state municipal issues. Many calculations of taxable-equivalent yield do not take into account the state tax exemption on government issues. Because interest income (but not capital gains) on municipal bonds is already exempt from federal taxes, there's generally no need to keep them in tax-deferred accounts. Finally, income derived from certain types of municipal bond issues, known as private activity bonds, may be a tax-preference item subject to the federal alternative minimum tax.

Look for Tax-Efficient Investments

Tax-managed or tax-efficient investment accounts and mutual funds are managed in ways that may help reduce their taxable distributions. Investment managers may employ a combination of tactics, such as minimizing portfolio turnover, investing in stocks that do not pay dividends, and selectively selling stocks that have become less attractive at a loss to counterbalance taxable gains elsewhere in the portfolio. In years when returns on the broader market are flat or negative, investors tend to become more aware of capital gains generated by portfolio turnover, since the resulting tax liability can offset any gain or exacerbate a negative return on the investment.

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Pitfalls to avoid: Taxes are an important consideration in selecting investments but should not be the primary concern. A portfolio manager must balance the tax consequences of selling a position that will generate a capital gain versus the relative market opportunity lost by holding a less-than-attractive investment. Some mutual funds that have low turnover also inherently carry an above-average level of undistributed capital gains. When you buy these shares, you effectively buy this undistributed tax liability.

Put Losses to Work

At times, you may be able to use losses in your investment portfolio to help offset realized gains. It's a good idea to evaluate your holdings periodically to assess whether an investment still offers the long-term potential you anticipated when you purchased it. Your realized capital losses in a given tax year must first be used to offset realized capital gains. If you have "leftover" capital losses, you can offset up to $3,000 against ordinary income. Any remainder can be carried forward to offset gains or income in future years, subject to certain limitations.

Pitfalls to avoid: A few down periods don't necessarily mean you should sell simply to realize a loss. Stocks in particular are long-term investments subject to ups and downs. However, if your outlook on an investment has changed, you may be able to use a loss to your advantage.

Keep Good Records

Keep records of purchases, sales, distributions, and dividend reinvestments so that you can properly calculate the basis of shares you own and choose the shares you sell in order to minimize your taxable gain or maximize your deductible loss.

Pitfalls to avoid: If you overlook mutual fund dividends and capital gains distributions that you have reinvested, you may accidentally pay the tax twice -- once on the distribution and again on any capital gains (or underreported loss) -- when you eventually sell the shares.

Keeping an eye on how taxes can affect your investments is one of the easiest ways you can enhance your returns over time. For more information about the tax aspects of investing, consult a qualified tax advisor.

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Source/Disclaimer:

[1]Example does not include taxes or fees. This information is general in nature and is not meant as tax advice. Always consult a qualified tax advisor for information as to how taxes may affect your particular situation.

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