It Pays To Be a Tax-Savvy Investor

by Eve Kaplan, CFP(R) Practitioner

Be a tax-savvy investor and employ strategies to reduce taxes. Various strategies include 1) asset location, 2) tax-managed mutual funds, 3) index Exchange Traded Funds (ETFs) and 4) tax loss harvesting. Finally, higher income earners (individuals and jointly filing couples who exceed $200,000 and $250,000 of modified adjusted gross income, respectively) may consider some investments (municipal bonds, qualified dividend-paying stocks) to reduce net investment income in light of the 3.8% surtax that began last year.

Asset Location: Location, location, location! Think of your investment portfolio as a garden. Certain plants do well in full sunlight, but others benefit from shade. Plants designed to flourish in the shade can wilt and die in full sunlight. Similarly, some investments do exceptionally well in tax-deferred accounts but others are better suited to taxable accounts. Ideal investments for tax-deferred accounts include Real Estate Investment Trusts (REITs), commodities, most bonds and bond funds and high dividend-paying stocks. Conversely, self-described tax-efficient stock mutual funds, growth-oriented stocks and untaxed municipal bonds all fare better in taxable accounts. Your time horizon also counts – if you’re in your 50s, concentrate more bond holdings in tax-deferred accounts. However, if you’re several decades from retirement, hold relatively more stocks in your tax-deferred accounts since they should outpace bond growth for an extended period before being tapped. Roth IRAs are ideal for holding stocks that you can allow to run for decades (no Required Minimum Distribution).

Not everyone has the ability to allocation perfectly between
taxable and tax-deferred accounts. If most of your money is concentrated in taxable or tax-deferred, asset diversification may trump tax efficiency. Here are some red flags when I review clients who come to me from brokerage houses: little or no difference between taxable and tax-deferred investment holdings, REITs and commodities in taxable accounts, untaxed muni bonds in tax-deferred accounts.

Ways to Reduce Investment Taxes in Taxable Accounts.

You’d be surprised how quickly additional tax savings deliver better investment returns. Strategies here include investing in “tax-managed” (or “tax advantaged”) mutual funds – if you can find them – and avoiding high-turnover mutual funds. Additional recommendations include investing in index ETFs and tax-harvesting. Finally – although few investors do it – mining a fund prospectus can help identify funds with large unrealized appreciation so you can give them a wide berth.

If you’re a do-it-yourself investor, Vanguard (example) has several “tax managed” mutual funds that reduce your tax bite. I use tax-advantaged Dimensional Fund Advisors mutual funds (www.dfaus.com) with my clients in their taxable accounts.

Investing in Index Exchange Traded Funds (ETFs) in taxable accounts lowers taxes on investments. Index ETFs can be far more tax efficient than mutual funds due to lower turnover; ETFs don’t have to sell stock positions to meet redemptions.

Mutual funds are required to distribute capital gains to shareholders... beware of holding mutual funds that have fallen out of favor and are selling positions to meet redemptions. The result can be significant capital gains tax; the tax bite is even worse if the fund held the position less than one year. To rub salt in the wound, imagine holding a fund that’s fallen in price AND makes a capital gains distribution to you – the shareholder. In this instance, tax harvesting can reduce the sting. I utilize a tax optimization program for my clients but you may find your own tax harvesting opportunities if
you're a do-it-yourself investor. A May 26, 2014 article by William Baldwin (“Are Mutual Funds Boosting Your Taxes?”) in Forbes Magazine gives a great example: you purchase a fund for $78 and it distributes a $18 long-term gain a month later. Your $78 share price is reduced to $60 and you owe tax on this $18 long-term gain. His advice? Sell the fund so the $18 share price loss cancels out the $18 distribution. You break even at tax time.

Reducing net investment income subject to the 3.8% surtax: A new 3.8% surtax introduced in 2013 affects net investment income if your modified adjusted gross income (MAGI) exceeds $200,000 (individuals) or $250,000 (couples filing jointly). Some investments that suppress investment income include municipal bonds and investments in dividend-paying stocks with “qualified” dividends.

In sum, there are various ways to put more sizzle in your investment return by lowering taxes but the tax tail should not wag the investment dog. A good advisor will structure a diversified investment portfolio that utilizes asset location and tax techniques to give you the best of all possible worlds: less volatility combined with returns that outpace inflation and lower your tax bill.

Copyright (C) by Eve Kaplan, 2014. All Rights Reserved.