Independent Investor

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Strategies for Tax-Efficient Investing

Just about every investor knows, it's not necessarily 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 investment returns in any given year may be reduced by 40% or more.

Adding to the tax planning challenge is the uncertainty surrounding the future of many favorable tax laws. Unless Congress again moves to extend current rules, here are a few of the major changes that will take place in 2013.

- Higher federal income tax brackets. The 10% tax bracket will disappear, and the 25%, 28%, 33% and 35% rates will revert to 28%, 31%, 36% and 39.6%, respectively.
- Higher capital gains rates. Short-term capital gains will continue to be taxed at ordinary income tax rates, although those rates will generally be higher. Long-term capital gains will generally increase to a maximum of 20%, up from 15%.
- Higher dividend rates. Dividends will be taxed at regular income tax rates rather than at the lower "qualified dividend" rates of 15% or less.

Clearly reducing your tax liability is more important today than ever before, especially if you are in one of the higher income-tax brackets.

Here are some strategies that may 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 and traditional individual retirement accounts (IRAs). Contributions to traditional IRAs may be tax deductible, depending on your income level and/or your access to a qualified employer-sponsored retirement plan. Earnings on these investments compound tax-deferred until withdrawal, typically in retirement, when you may be in a lower tax bracket.

Contributions to 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 Earnings that accumulate in Roth accounts can be withdrawn tax free if you have held the account for at least five years and meet the requirements for a qualified distribution. (See IRS Publication 590 Individual Retirement Arrangements (IRA) for more information.)

Pitfalls to avoid: Withdrawals prior to age 59½ from a qualified retirement plan, traditional IRA or Roth IRA may be subject not only to ordinary income tax, but also to an additional 10% federal tax.

Consider Government and Municipal Bonds[2]

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 to equal the tax-exempt return of 5% offered by a municipal bond, before state taxes. 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 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 is 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.

Put Losses to Work

At times, you may be able to use losses in your investment portfolio to help offset realized gains. It is 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 losses in a given tax year must first be used to offset realized capital gains. If you have "leftover" 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 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 can 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.

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

[1]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. No strategy assures success or protects against loss.

[2]Municipal bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Government bonds are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

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