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Tax-Efficient Investing – Less To Uncle Sam, More To You

By Karen DeRose, CFP®, CRPC® & Anthony DeRose, JD*, MBA, CPA*

Many of you will be receiving the dreaded 1099 Forms, reporting income from brokerage accounts. For those who are investing with us, we are taking many steps to minimize taxes for you on an ongoing basis. However, for many Americans, the weeks leading up to April 15 are the only time of year when they give much thought to their taxes. However, investors can improve returns by applying year-round strategies to minimize their tax burden.

Do I need to be concerned?

Before I get into the many tenets of tax-efficient investing, first there is a question as to what types of accounts require the need for tax management. The key is determining whether your account is a *qualified* account – work retirement accounts (401k, 403b, 457, etc.), IRAs (Roth, traditional and non-deductible) and 529 plans. If all of your investments are tied up in such accounts, you do not have to be concerned with being tax efficient – your account(s) is tax advantaged already.

Traditional IRAs and work retirement accounts defer taxes completely until you make distributions, thus you do not have to manage taxes on an ongoing basis. With Roth IRAs/529 plans, you pay taxes upon contribution, and the proceeds from distributions are tax free, thus taxes on income/growth is not a concern (NOTE: for 529 plans, this applies so long as you utilize such funds for qualified education expenses). With Non-deductible IRAs, you only pay taxes on the gain upon withdrawal, but since you pay such taxes at that time, there is no need to worry about the tax efficiency each year.

If you have a brokerage account/UTMA, i.e. taxable accounts, then you absolutely should read on. Why? Interest/dividends earned in taxable accounts are taxed at an investor's normal high ordinary income tax rate. Also, capital gains can have negative tax repercussions if not planned for appropriately.

What type of investments ARE Tax Efficient/Tax Inefficient?

One of the most highly owned types of securities in taxable accounts is also one of the most tax *inefficient* vehicles – mutual funds. If you can avoid placing mutual funds in a brokerage account, the better your "tax life" will be. Why? Because at year end, mutual funds distribute capital gains to its investors. Thus, on an annual basis, you have to deal with the negative effects of taxes – even if you did not *sell* the mutual fund (explained in detail below)! What compounds the situation even further is that it is possible to pay such taxes even in a down market – thus your portfolio may have dropped, but you *still* owe taxes on mutual fund capital gains.

Thus, it is incredibly important to make sure that you either a) place mutual funds in tax advantaged accounts (see the last paragraph), b) avoid mutual funds altogether or c) make sure you are sensitive to taxes when picking your mutual funds.

However, mutual funds are not the most tax inefficient investments. You also have to be aware of placing certain types of bonds (high yield/taxable/TIPs), real estate investment trusts and (to a certain extent) dividend paying (value) stocks in taxable accounts. This is due to the fact that such investments create income each year on an ongoing basis that will trigger taxes. These investments, like mutual funds, are best suited for qualified (I.E. retirement) accounts.

As a rule of thumb, the following list is a breakdown of the most tax *inefficient* investments to the most tax *efficient* investments. The higher the investment is on the list, the more necessary it may be to put such investment in a qualified account.

- High Yield Bonds
- Taxable Bonds
- TIPs
- REITs
- Balanced Funds
- Small Value Stocks
- Small Growth Funds
- Large Value Funds
- International Funds
- Large Growth Funds
- Index Stock Funds
- Tax Managed Stock Funds

- Savings Bonds/MMs
- Tax Exempt Municipal Bonds

You will notice that tax managed stock funds and index funds are lower on the list and thus more tax efficient. Tax managed funds have an investment mandate to be tax efficient, and index funds by definition are longer term strategies that do not trade as often, thus leading to less of a tax hit on a long term basis.

Any Tax Efficient Investments Similar to Mutual Funds?

As opposed to mutual funds, which are by definition tax inefficient, you may want to consider ETFs (exchange traded funds). ETFs offer tax advantages to investors that you simply cannot obtain with mutual funds. First, they are mostly passive investments, thus ETFs tend to realize fewer capital gains than actively managed mutual funds.

ETFs are also more tax efficient than mutual funds because of the way they are created and redeemed. For example, suppose that an investor redeems $50,000 from a traditional Standard & Poor's 500 Index (S&P 500) fund. To pay that to the investor, the fund must sell $50,000 worth of stock. If appreciated stocks are sold to free up the cash for the investor, then the fund captures that capital gain, which is distributed to shareholders before year-end. As a result, shareholders pay the taxes for the turnover within the fund.

On the other hand, if an ETF shareholder wishes to redeem $50,000, the ETF doesn't sell any stock in the portfolio. Instead it offers shareholders "in-kind redemptions", which limit the possibility of paying capital gains each year.

Any Proactive Steps I Can Take To Minimize Taxes Each Year?

You really should consider tax loss harvesting for your taxable accounts if you are not already doing so. If you have your investments with us, we are most likely doing this for you.

Let’s say you have sold a stock with a large capital gain in a given tax year (current market value is significantly higher than the price you purchased it at). Using tax-loss harvesting, you could sell another investment where current market value has fallen below the price you purchased it at. This creates a capital loss that can offset the capital gain and reduce your tax bill. If you take the further step of replacing the investment that fell with something similar, you can maintain your predetermined portfolio balance.

I would caution that you are careful if you take this step in order to avoid what is known as the wash-sale rule. If you harvest a loss, you can't buy the same security back right away; you must wait 30 days to buy it back, otherwise you will face a penalty - the amount of the loss is added to the cost basis of the security that you bought back. This can lead you to an accounting headache that you will want to avoid, on top of the negative repercussion of having to still be concerned about the capital gain on the security.

Do Not Allow the Tax Tail to Wag the Dog

While tax management is an important part of investing, you should not allow such management to dictate your investment decisions. Over the years I have had many clients with large unrealized capital gains embedded in concentrated investment positions. They did not wish to sell their investment and realize such capital gains due to the tax hit, even though it was the most prudent step to take. Yes, your investment sale may result in a 20% tax hit, but would it not be worse if your investment dropped by *more than* 20%?

If you take anything away from this article, you should realize that tax management is lower on the investment hierarchy than making sound investment decisions. There are steps you can take to unwind a large capital gain, but it is significantly more difficult to work around a poor investment decision. As always, we are here to help. If you have any questions regarding your investments and taxes, please feel free to reach out to Anthony or I.