Managing Taxes on Your Investments

Presented by LifeTime Asset Management, LLC

When it comes to your money, it's not what you earn, it's what you keep. Here are some ideas that may help lessen your income tax burden, so you can keep more of your investment earnings.

Invest for the Long Term

Generally, income isn't taxed until it is received, so you may find it beneficial to delay realizing gains by investing for the long term. Try to hold an asset for more than a year; that way, earnings will be taxed at the lower long-term capital gains tax rate—currently 15 percent or 20 percent (0 percent for taxpayers in lower tax brackets). If assets are held for a year or less, earnings are considered short-term capital gains and taxed at ordinary income rates, which can be as high as 37 percent.

You may be able to invest for the long term and still receive current income from your investment in the form of dividends. If you receive qualified dividends, they are taxed at long-term capital gains rates, as long as you meet the holding period requirement. Generally, qualified dividends are those paid by domestic corporations or by foreign corporations whose stocks trade on an established U.S. stock exchange.

Harvest Losses

If you do realize gains, you may be able to offset them with losses. When your losses exceed your gains, you can offset up to $3,000 ($1,500 if married filing separately) of ordinary income, and the rest of your capital losses can be carried forward to be used in future years.

When harvesting losses, be aware of the wash sale rule. If you purchase a substantially identical position within the period that begins 30 days before you take a loss and ends 30 days after that date, you will have to delay recognizing the loss until you sell the new position. To keep a similar asset allocation while realizing a loss, you can reinvest in securities that are not substantially identical but are expected to move in the same direction as the investment you sold, or you can buy the same security outside of the 61-day window. There isn't much IRS guidance on what is considered "substantially identical," but Congress's intent with the wash sale rule was to prevent investors from taking a loss and keeping the same economic position within the waiting period.

A companion to loss harvesting is individual security identification. To use this method, you must identify the specific lot (i.e., the set of shares bought at a given time and price) that you want to sell at the time of sale, and your broker must acknowledge your identification in writing within a reasonable time thereafter. By identifying a specific security, you can choose to sell for a long-term gain and for smaller gains or bigger losses. Individual security identification can be used for stocks and bonds. For mutual funds, you can specify shares if you are not using an averaging method.

Contribute to Charity

If you have a large long-term gain position in stock and a charitable intent, you might consider gifting the stock to charity. You may get a tax deduction based on the fair market value of the stock at the time of he gift, and the charity can sell the stock without paying taxes. Your deduction may be limited to 20 percent–30 percent of your adjusted gross income, and the excess can be carried forward for five years. You can use your tax savings to diversify your portfolio.

Diversify Bond Holdings

Bonds may be a part of your diversified portfolio. Interest from municipal bonds is exempt from federal taxes, and, for bonds issued in your state, it's typically exempt from state taxes as well. State tax treatment of out-of-state bonds varies. Although the tax-free income from investing only in your state's bonds might be alluring, consider diversifying into other state bonds to help minimize risk. Traditionally higher-quality bonds, such as Treasury bonds, may also be part of your holdings; Treasuries are state tax free but subject to federal tax.

Consider the tax-equivalent yield of your investments. This is the pretax yield your taxable bonds would have to pay to equal the tax-free yield of a municipal bond in your tax bracket. For example, if you are in the 35 percent tax bracket, a taxable bond would have to yield 6.15 percent to equal a 4 percent yield on a municipal bond.

Consider Taxable Versus Tax-Deferred Vehicles

Another key to tax efficiency is the location of assets. You may want to keep investments that produce current income in a tax-deferred account and investments that produce long-term gains or tax-free income in a taxable account. For example, you can hold corporate bonds and dividend-paying stock in an IRA, so you can defer paying taxes until distribution. Likewise, you can keep growth stock and municipal bonds in a non-retirement brokerage account to get long-term capital gain treatment on the stock and tax-free treatment on the municipal bond interest.

Tax-efficient distributions are also important. Distributions from traditional IRAs are taxable, and qualified distributions from Roth IRAs are tax free. If you have more assets in traditional IRAs, you may consider converting some of those assets into a Roth IRA in a year in which you may have lower taxable income or when tax rates are low. Income limitations for Roth conversions no longer apply.

During retirement, you can choose from which vehicles you withdraw money (traditional IRA, Roth IRA, variable annuities, or nonretirement brokerage accounts) to keep from going into a higher tax bracket.

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