INVESTING

Taxes and Your Portfolio

Taxes are an **inevitable part** of investing. The tax code **complicates investment planning**, and the impact of taxes has been **steadily increasing** as investment planning becomes more individualized.

With careful planning, you can minimize the effect that taxes have on your investments. Your focus should be on the return generated at the end of your investing time horizon—after tax and transaction returns—making taxes an important concern for all
Types of Taxes

A seemingly endless list of potential taxes could affect your investments, portfolio and net worth. Some of the more critical ones are as follows:

Interest

Interest you earn on investments (typically from bonds and large cash holdings) is subject to tax rates that are the same as your ordinary income tax rate.

Dividends

You'll have to pay taxes on dividends that come from stock you own, but dividends are taxed with preferential treatment in comparison to ordinary income and interest income. To receive this treatment, the dividend must meet several requirements to be considered a qualified dividend.

Capital gains

When the value of your investments in stocks, bonds and other assets increases from the purchase price and you sell it for a profit, you'll trigger a capital gains tax. Similar to dividends, long-term capital gains are taxed at lower rates than ordinary income.

Estate tax

For investors with significant holdings, estate taxes can have a substantial effect on the total value they can pass on to heirs or charity. Planning for estate taxes is especially important, and there are many strategies to maximize the value of portfolio holdings.

When looking at changing tax rates, it is most important to focus on both the changing landscape of tax rates as a whole, as well as how changes in your income will affect which tax bracket you fall under.

Tax-advantaged Accounts

Retirement Accounts

One of the most prominent ways to take advantage of tax-friendly regulations is to create retirement accounts. These accounts include 401(k)s or 403(b)s (depending on type of employer), Individual Retirement

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Accounts (IRAs) and Keogh plans. All of these accounts qualify for preferential tax treatment and therefore are often referred to as qualified accounts. The benefits of deferring taxes can dramatically compound over time. For example, $1,000 invested in an IRA at a tax-deferred rate of 8 percent grows to $10,063 over 30 years. In a taxable account (assuming 28 percent tax rate), the funds would grow to only $5,366.

Roth and traditional IRAs are both effective ways to save for retirement. With a Roth IRA, you contribute money that has already been taxed in exchange for the ability to make tax-free withdrawals upon retirement. In a traditional IRA, your contributions are pre-tax, but you pay taxes on distributions later on. But how do you choose between the two? Your choice depends on how you think your future tax rate compares to your current tax rate. If you assume your individual tax rate is not going to change between now and retirement, then the net result will be the same regardless of which type of IRA you choose. When looking at changing tax rates, it is most important to focus on both the changing landscape of tax rates as a whole, as well as how changes in your income will affect which tax bracket you fall under. Generally, as people age they earn more money and enter higher tax brackets. In this case, and assuming no change in the overall level of taxes, it would be more beneficial to pay the taxes now, at a lower rate. However, if you believe that your tax rate will decrease, then traditional IRAs will be more beneficial.

Educational Accounts

Coverdell and 529 plans are tax-advantaged accounts that are similar in nature to 401(k) and IRA accounts. The difference is that Coverdell and 529 accounts can only take advantage of tax deferral if they are used for qualified educational purposes. Like retirement accounts, this characteristic can help maximize the funds that are set aside for educational funding needs. There are many different rules for these plans depending on their type and the state the account is initiated in, so appropriate planning is important before initiating educational accounts.

Tax-advantaged Investments

In addition to tax-advantaged accounts, you can also choose tax friendly investments. For instance, municipal bonds are an ideal way to invest in fixed income while limiting the effect of taxes. Municipal bonds are any bonds issued by a U.S. city or other local government. The interest received by bondholders is generally exempt from the federal income tax and from income tax in the state in which they are issued. On the other hand, municipal bonds are usually priced higher to account for these tax effects. However, the tax exemption on interest income will be more beneficial for individuals with significant income. Therefore, investing in municipal bonds may minimize the tax effect on investments for individuals in higher tax brackets.

In addition to taxes, you should also be aware of the effects of transaction costs and fees on your investments' growth. Tax-advantaged accounts help to alleviate these costs as well, making them practical for investors who want to save for retirement or education expenses. The uncertain outlook for taxes as they relate to investment planning makes it critical to stay up to date with new developments, and discuss strategies to minimize your tax burden with your financial and tax advisor.

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