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Reduce the Tax Pain with Four *Tax Efficient Investing Strategies*

By Ian A. Post, CFA

It's that time of year where everyone scrambles to get their taxes done and crossing the finish line often means getting hit with a big tax bill. One of the ways to lessen the tax pain is to utilize tax efficient investing strategies. Following are four strategies for tax efficient investing.

1. Be Aware of Tax Treatments

Generally, investments generate returns through some combination of price appreciation and cash distributions. Cash distributions can have a variety of different tax treatments. Understanding those differences can have a meaningful impact on after-tax returns. For example, replacing a corporate bond position with a municipal bond position in a taxable account may increase after-tax returns and reduce risk simultaneously.

2. Practice Asset Location

Not to be confused with the more frequently discussed Asset Allocation, Asset Location is the practice of strategically placing specific investment classes in different accounts to best match the tax treatment of the account with the tax treatment of the investment. Generally, the idea is to place tax inefficient assets in tax deferred account and tax efficient assets in taxable accounts. So which assets are tax efficient and which aren't? Generally, equities are tax efficient because their returns are generated primarily by capital gains, which can be deferred indefinitely by not selling and dividends that are taxed at preferential rates. At the other end of the spectrum are corporate bonds, (both investment grade and particularly high-yield) which are tax inefficient because they generate most of their returns from interest payments that are taxed at ordinary income tax rates.

3. Avoid Actively Managed Strategies

While the dividends and long-term (positions held longer than one year) capital gains generated by equities are taxed at preferential rates, short-term (positions held one year or less) capital gains are taxed at ordinary income tax rates. Active strategies, whether through trading individual stocks, or by investing in actively managed mutual funds or hedge funds, generate high turnover as fund managers attempt to beat the market through frequent trading. This turnover can generate high levels of short-term gains, increasing the tax drag on investment returns. Instead, utilize index funds or broad-based exchange-traded funds (ETFs), which are inherently more tax efficient.

4. Utilize Tax-Loss Harvesting

As mentioned in a previous article, you can realize losses on losing investments to create tax assets that can be used to offset future capital gains. Any remaining realized losses are available to offset up to $3,000 in ordinary income each year with unused realized losses carried over to future years indefinitely. While people often think of this as an end of year strategy, in fact, it can and should be utilized throughout the year so realized losses can be accumulated.

Utilizing these tax efficient investment strategies can reduce your tax hit in April and boost your after-tax investment returns without taking additional market risk. A true win-win situation…

If you have any questions you would like answered, email Ian at ipost@fifthsetinvestment.com.

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