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Thinking About Taxes

The purpose of tax-efficient investing is to help increase investors' assets' after-tax value.

There Are Many Ways to Own an Asset Class

For example, investors can own individual securities, or they can invest in traditional mutual funds or conventional exchange-traded funds (ETFs) representing portfolios of securities.

All Investment Earnings Are Not Created Equal

Stock income (dividends and capital gains) generally enjoys lower rates than taxable bond income (interest).

Some Types of Accounts Offer Tax Deferral

Income from retirement accounts, such as traditional IRAs and 401(k) plans, is tax-deferred until withdrawals are taken.

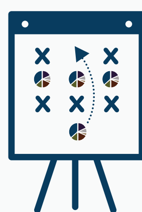
How and When To Purchase and Sell—That Is The Question

Trading is generally determined by your investment strategy, but timing and consideration of your tax basis can reduce your tax bill.

How Can Tax Planning Affect the Way I Invest?

Key Takeaways

- Your investment strategy should be based primarily on your financial goals.
- How you implement your strategy can make a big difference in your tax bill.
- The account types you use to hold your assets can affect your taxes.



Taxes Can Affect Your Investment Strategy . . .

Your strategy—how much of various asset types to own—depends on your financial goals, risk tolerance, and other factors, including tax circumstances.

How You Implement Your Strategy Can Have Tax Consequences

The types of investment accounts you own, the products you select, and how you trade can make a big difference tax-wise.

Decisions	Considerations
What to own?	Your investment goals help determine your asset allocation.
When to buy/sell it?	Timing of purchases/sales can affect capital gains tax and qualification of dividends.
Where to hold it?	IRAs, 401(k)s, and other tax-advantaged accounts can defer tax on your more tax-exposed assets.
What form to hold it in?	Individual securities, mutual funds, and ETFs each have their own tax pros and cons.

Understanding the Tax Rules of Investment Earnings

Yes, it's complicated. What an investor earns on investments isn't always taxed at the same rate as other income, which is called "ordinary income." Congress has chosen to tax long-term capital gains and qualified dividends at a lower rate—usually, but with exceptions. To make borrowing more affordable for states and cities, it has exempted the interest on municipal bonds from tax—usually. It is important to remember that there can be exceptions, depending on where you live, how high your income is, and many other factors. Also, although most states generally follow federal income-tax rules, their rules differ in some cases.

Investment and Insurance Products: ▸NOT FDIC Insured ▸NO Bank Guarantee ▸MAY Lose Value

When to Buy and Sell

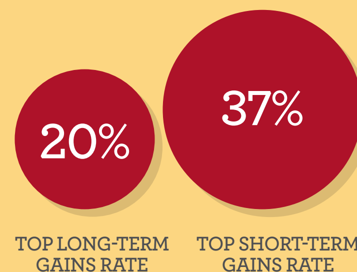
Enjoying Lower Rates on Dividends

Dividends on U.S. stocks and some foreign stocks currently enjoy a favorable tax rate, provided that they are "qualified," meaning the shares have been held for more than 60 days (90 days for preferred stocks), including the ex-dividend date. This is a consideration if you plan to sell a stock you have not held very long.

Deferring Capital Gains

Investors have a lot of control over the timing of realized capital gains if they hold securities individually. Should investors choose to hold them in the form of a mutual fund, they give up some timing flexibility.

Long-term capital gains enjoy lower tax rates. The top rate for long-term gains is currently 20%, while it's currently 37% for short-term gains. But holding on to an asset just to wait for a lower tax rate could involve too much downside risk. Your investment professional may be able to suggest strategies that may help limit the downside potential of the asset while avoiding a premature sale.



Portfolio Rebalancing

Portfolio rebalancing is a key step in helping manage portfolio risk and keeping your investment strategy on track in changing markets. This classic exercise of buying low and selling high could generate realized capital gains. However, before selling overweighted assets from your portfolio, consider using cash flows to restore balance. That is, if contributing to accounts on a regular basis, direct the new money to underweighted assets. Also consider whether participation in automatic dividend reinvestment is contributing to an overweight in stocks if the security has been held for more than one year.

Giving Capital Gains to Charity

If a security an investor wants to sell has a low cost basis and a long-term holding period and is pursuing a philanthropic goal, consider donating the security. That way investors would avoid capital gains tax while potentially generating a tax deduction based on the security's fair market value.

Offsetting Capital Gains with Losses

A strategy for reducing tax bills is to realize a capital loss to offset a capital gain. However, beware of the "wash sale" rule, which says you can't utilize a capital loss on something you sell if you have bought a substantially identical security within 30 days before or after the loss-generating sale.

Where to Hold Investments

Since retirement is likely one of an investors financial goals, they may have opened an IRA or participate in their employer's 401(k) plan. The tax advantages of retirement accounts can be especially valuable to shelter investment income that is taxed at your ordinary income rate. For example, if an asset allocation calls for fixed income, a traditional IRA or 401(k) would be a good place for taxable bonds since they have no favorable tax rate on their interest and can benefit most from the tax deferral that IRAs and 401(k)s afford until withdrawal. Tax-exempt bonds can be held in taxable accounts to create tax-free income. Knowing where to hold equities may be a bit trickier. Stocks would benefit less in a tax-deferred account because, upon withdrawal, the dividends and long-term gains will be taxed at ordinary-income rates and thus lose the favorable rates that these types of income currently enjoy. However, they are growing tax-deferred so depending on the time frame and objective a tax-deferred account may be appropriate. A Roth IRA or Roth 401(k), however, has the advantage that withdrawals are not subject to tax if the assets are held in the account at least five years and the investor is at least age 59½, meaning that years of capital gains will permanently escape tax. Thus it would be a good place for stocks and other growth assets. Of course, a Roth IRA or Roth 401(k) is funded with after-tax contributions.

Keep in mind that the broad rules outlined below have exceptions—this is tax law, after all. Withdrawals from retirement accounts may be subject to tax penalties as well as income tax if they are made too early.

	Contributions Deductible?	Withdrawals Taxed?	Best Suited Asset Types
IRA (pre-tax) or 401(k)	Yes	Yes, at ordinary income rates	Taxable fixed income—interest is already taxed at ordinary income rates; commodities—income is taxed at ordinary income or "collectibles" rates
IRA (after-tax)	No	Yes, at ordinary income rates on the increase in value	
Roth IRA or Roth 401(k)	No	No, if held for 5 years and until age 59½	Growth assets—capital gains, if any, will potentially never be taxed
Regular Investment Account	No	Not applicable	Stocks and other potential growth assets—long-term gains and qualified dividend income are tax-favored

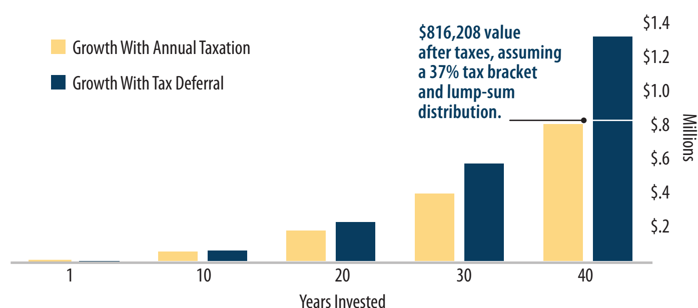
Why Tax-Efficient Investing?

You may wonder why you should concern yourself with tax-efficient investing. Simply stated, taxes can reduce net return.

The chart to the right shows taxes' potential long-term effects. This example illustrates a hypothetical 8% rate of return on a $5,000 annual investment for 40 years. If an investor were in the 24% tax bracket, tax deferral could give an investor $505,740 more than the $789,543 had they invested that same amount in a taxable account. If the money was withdrawn all at once and the taxes were paid at today's top rate of 37%, an investor could still end up with $26,485 more than they would have with a taxable account.

If an investor is a different tax bracket, numbers will vary, of course, but the principle remains the same—an investor could end up with more if they do not have to pay taxes annually on their earnings.

Tax-Advantaged Accounts Can Potentially Improve Returns



Source: Wells Fargo Investment Institute

Information assumes no withdrawals during the period. State taxes and annual fees and charges are not reflected in the illustration and would reduce the performance shown if they were.

Lower maximum tax rates on capital gains and dividends may make the investment return for the taxable investment more favorable, thereby reducing the difference in performance between the accounts shown. Individuals should consider their personal investment horizons and income-tax brackets, both current and anticipated, when making an investment decision, as these may further affect the results of the comparison. Changes in tax rates and the tax treatment of investment earnings could affect the results shown.

This illustration is hypothetical in nature and is not intended to represent an actual investment. The hypothetical 8% rate of return is not guaranteed and is not an indication of the past or future performance of any investment. Investments fluctuate in value, and there can be no assurance any investment will increase in value.

In What Form Should You Hold Your Investments?

Individual Securities
Separately Managed Account

Owning individual securities gives an investor the most flexibility, as we said above. Investors can control the timing of realized capital gains and losses. If you're working with an investment manager, that manager can monitor your realized gains and harvest offsetting losses throughout the year according to your guidelines without compromising your investment strategy. However, it isn't always possible to assemble a diversified portfolio at a reasonable cost.

Mutual Funds

Mutual funds allow investors to hold a diversified basket of securities at low cost. Although some funds may realize minimal capital gains (index funds) or be designed to limit tax consequences (equity tax-managed funds), mutual fund investors give up control over the timing of realized gains and losses. If a fund plans a distribution soon, selling shares beforehand won't sidestep the gain because the shares' value would be higher by the gain amount until it is paid. However, if the planned distribution comprises primarily short-term gains, and if an investor has owned shares for a long time, preemptive selling could make the realized gain long term rather than short term. Investors probably would not want to buy a mutual fund before a large planned distribution—they'd be getting some of their own money back, and would owe tax on it.

ETFs

Although not all types of ETFs are considered tax efficient, many do not distribute capital gains. ETFs continuously offer and sell shares through a daily in-kind purchase-and-sale process to "authorized participants" and not to investors. As a result, the ETF does not incur tax when securities are sold and investors do not incur capital gains taxes until they sell their shares.

Annuities

A non-qualified annuity may be an income solution for some investors, and it has the advantage of deferring any taxable income until the contractual payouts begin. By that time, the recipient might be in a lower tax bracket than at the time of purchase. Keep in mind, earnings on the payout will be taxed at ordinary income tax rates and not capital gains rates. Generally, one would not enter into an annuity solely to defer tax because it involves giving up ownership of the assets used to purchase it.

Keep in mind annuity payouts are based on the claims-paying ability of the issuing insurance company.

Did We Mention That Taxes Are Complicated?

The information in this report is general in nature and may not apply to your situation. Tax laws regarding investing, retirement accounts, and taxes in general (e.g., alternative minimum tax [AMT], the 3.8% Medicare surtax, unwanted foreign-tax withholding) are always subject to change. Please speak with your tax advisor before making any decision that may have tax consequences.

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