Taking Taxes Into Account When Saving & Investing

It isn't always top of mind, but it should be.

Provided by *Benedict A. Mitchell Jr.*

How many of us save and invest with an eye on tax implications? Not that many of us, according to a recent survey from Russell Investments (the global asset manager overseeing the Russell 2000). In the opening quarter of 2014, Russell polled financial services professionals and asked them how many of their clients had inquired about tax-sensitive investment strategies. Just 35% of the polled financial professionals reported clients wanting information about them, and just 18% said their clients proactively wanted to discuss the matter.[1]

Good financial professionals aren't shy about bringing this up, of course. In the Russell survey, 75% of respondents said that they made tax-managed investments available to their clients.[1]

When is the ideal time to address tax matters? The end of a year can prompt many investors to think about tax issues. Investors' biggest concerns may include any sudden changes to tax law. Congress often saves such changes for the eleventh hour. Sometimes they present opportunities, other times unwelcome surprises.

The problem is that your time frame can be pretty short once December rolls around. You can't always pull off that year-end charitable donation, gift of appreciated securities, or extra retirement plan contribution; sometimes your financial situation or sheer logistics get in the way. It is better to think about these things in July or January, or simply year-round.

While thinking about the tax implications of your investments year-round may seem like a chore, it may save you some money. Your financial services professional can help you stay aware of the tax ramifications of certain financial moves.

Think about taxes as you contribute to your retirement accounts. Do you contribute to a qualified retirement plan at work? In doing so, you can lower your taxable income (and your yearly tax liability). Why? Those contributions are made with pre-tax dollars. In 2014, you can contribute up to $17,500 to a 401(k) or 403(b) account or the federal government's Thrift Savings Plan. If you are 50 or older this year, you can put in up to $23,000 into these accounts. The same is true for most 457 plans. This can reduce your taxable income and lower your tax bill.[2,4]

Think about where you want to live when you retire. Certain states have high personal income tax rates affecting wealthy households, and others don't levy state income tax at all. If you are wealthy and want to retire in a state with higher rates, a Roth IRA may start to look pretty good versus a traditional IRA. Withdrawals from a Roth IRA aren't taxed (assuming the Roth IRA owner follows IRS rules), because contributions to a Roth are made with after-tax dollars. Distributions you take from a traditional IRA in retirement will be taxed.[2]

What capital gains tax rate will you face on a particular investment? In 2013, the long-term capital gains tax rate became 20% for high earners, up from 15%. On top of that, the Affordable Care Act Surtax of 3.8% effectively took the long-term capital gains tax rate to 23.8% for investors earning more than $200,000.[2,3]

Greater capital gains taxes can actually be levied in some cases. Take the case of real estate depreciation. If you sell real property that you have depreciated, part of your gain will be taxed at 25%. The long-term capital gains tax rate for collectibles is 28%. Own any qualified small business stock? If you have owned it for over five years, you typically can exclude 50% of any gains from income, but the other 50% will be taxed at 28%. Lastly, if you sell an asset you've held for less than a year, the money you realize from that sale will be taxed at the short-term rate (i.e., regular income), which could be as high as 39.6%.[2,3]

Are you deducting all you can? The mortgage interest deduction is not always noticed by taxpayers. If a home loan exceeds $1.1 million, interest above that amount may not qualify for a deduction. Itemizing can be a pain, but may bring you more tax savings than you anticipate.[2]

A tax-sensitive investing approach is always specific to the individual. Therefore, any strategy needs to start with an in-depth discussion with your tax or financial professional.

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