FPA FINANCIAL PLANNING PERSPECTIVES

Four Tips for Tax Smart Investing

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Savvy investors have long realized that what their investments earn after taxes is what really counts. After factoring in federal income and capital gains taxes, the alternative minimum tax (AMT), and potential state and local taxes, your investment returns in any given year may be reduced by 40% or more. Luckily, there are tools and tactics to help you manage taxes and your investments. Here are four tips to help you become a more tax-savvy investor.

Tip #1: Invest in Tax-Deferred and Tax-Free Accounts

Tax-deferred investments include company-sponsored retirement savings accounts such as traditional 401(k) and 403(b) plans and traditional individual retirement accounts (IRAs). In some cases, contributions to these accounts may be made on a pre-tax basis or may be tax deductible. More important, investment earnings compound tax-deferred until withdrawal, typically in retirement, when you may be in a lower tax bracket.

Contributions to Roth IRAs and Roth 401(k) savings plans are not deductible. Earnings that accumulate in Roth accounts can be withdrawn tax free if you are over age 59 1/2, have held the account for at least five years, and meet the requirements for a qualified distribution.

Tip #2: Manage Investments for Tax Efficiency

Tax-managed investment accounts are managed in ways that can help reduce their taxable distributions. Your investment professional can employ a combination of tactics, such as minimizing portfolio turnover, investing in stocks that do not pay dividends, and selectively selling stocks that have become less attractive at a loss to counterbalance taxable gains elsewhere in the portfolio. In years when returns on the broader market are flat or negative, investors tend to become more aware of capital gains generated by portfolio turnover, since the resulting tax liability can offset any gain or exacerbate a negative return on the investment.

Tip #3: Put Losses to Work

At times, you may be able to use losses in your investment portfolio to help offset realized gains. It's a good idea to evaluate your holdings periodically to assess whether an investment still offers the long-term potential you anticipated when you purchased it. Your realized losses in a given tax year must first be used to offset realized capital gains. If you have "leftover" losses, you can offset up to $3,000 against ordinary income. Any remainder can be carried forward to offset gains or income in future years.

Tip #4: Keep Good Records

Keep records of purchases, sales, distributions, and dividend reinvestments so that you can properly calculate the basis of shares you own and choose the most preferential tax treatment for shares you sell.

Keeping an eye on how taxes can affect your investments is one of the easiest ways to help enhance your returns over time. For more information about the tax aspects of investing, consult your tax professional.

The information in this article is not intended to be tax advice and should not be treated as such. You should consult with your tax advisor to discuss your personal situation before making any decisions.

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