
## It's Time to Start Thinking About Taxes

It's ironic that many investors will avoid financial management of their portfolios for fear of management fees in the range of 1-3% yet make no plans to manage taxes on their investments that can cost 20 to 50% of their gains. Taxes are easily one of the most corrosive elements in the financial world. The best time to reduce the impact of taxes on your income is long before you start compiling information for filing your taxes. By the fourth quarter of the year, the countdown is on for putting effective strategies in place.

Managing the tax bite starts with understanding what triggers tax liability.

**The structure of your account**
If your funds are invested in a tax-deferred account - such as an Individual Retirement Account, 401(k), 403(b), SEP-IRA, etc., you are typically able to defer taxes on earnings you contribute to the account and all gains from profitable sale of assets, interest, and dividends until monies are withdrawn from the account at retirement. You don't have to worry about tracking income or profits. Everything will be taxed at your personal income level when withdrawn (unless you withdraw funds before retirement, in which case you will incur additional penalties).

If your funds are invested in a taxable account, such as a regular brokerage account or mutual fund account, you will incur taxes every year on (1) any interest, ordinary dividends, and short-term capital gains you receive, taxed at your top personal income tax rate and (2) qualified dividends and long-term gains from the sale of securities in the account (less losses), taxed at fixed levels - 0%, 15% and 20% at the federal level - based on your income tax bracket. High-income taxpayers are assessed an additional 3.8% tax on certain investment income, as part of the Affordable Care Act.

Profits from the sale of securities are considered short-term gains for assets held for less than one year or long-term gains for assets held for more than one year before sale.

What if your investments have gone down in value? It doesn't matter as far as the taxman is concerned. All that matters is whether or not you had gains from actual interest and/or dividends paid, or from the sale of assets in the account.

**The mutual fund tax impact**
Internal transactions within mutual funds will impact you from a tax standpoint. While most funds managers are relatively adept at limiting short-term gains, gains from the sale of positions within the fund and dividends must be distributed to shareholders on, at minimum, an annual basis and must be reported on your taxes, even if you do not sell shares or withdraw the gains. At the end of the year, the mutual fund will issue Form 1099-DIV, detailing long and short-term gains and distributions for your use in compiling your tax return.

All dividends, short and long-term gains, on which you are taxed, increase your tax basis in your mutual fund. When you liquidate positions in a taxable mutual fund, taxes are calculated based on the price of the shares when sold less your original purchase price and ALL previously taxed gains - this reduces the tax impact when you sell fund shares and assures that you are taxed on gains only once.

**Basic guidelines to help reduce taxes:**
***Defer taxes by maximizing your use of tax-advantaged accounts***, such as retirement accounts. Withdrawals will be taxed at the investor's personal income tax rate, but will be able to grow and compound tax-deferred.

***If you have both taxable and tax deferred accounts, match the right account with the right investment.*** Investments or investment approaches that incur a primarily short-term gains, dividends, and distributions are best placed in a tax-deferred account.

Use a taxable account for individual investments most likely to be held in excess of a year generating primarily long-term gains. This will typically result in the lowest tax impact for these investments. The investor also has the flexibility to plan capturing losses to offset gains.

***When investing in index funds, use Exchange Traded Funds (ETFs)*** rather than mutual funds. Mutual fund managers must constantly re-balance the fund by selling securities to accommodate shareholder redemptions or to re-allocate assets. This potentially creates capital gains for all shareholders, even for shareholders who may have an unrealized loss on the overall mutual fund investment. An ETF manager accommodates investment inflows and outflows by creating or redeeming "creation units," which are baskets of assets that approximate the entirety of the ETF investment exposure. As a result, the investor usually is not exposed to capital gains to accommodate redemptions or rebalancing. Exceptions are inverse and leveraged funds - which have proven relatively tax inefficient, international funds and commodity ETFs.

***Take full advantage of deductions.*** Above-the-line deductions don't require itemizing and include expenses such as alimony payments, self-employment taxes, IRA contributions, school supplies, student-loan interest paid, and more. To make the most out of itemized deductions, such as medical and dental expenses, charitable contributions, work-related costs, theft, disaster and casualty losses, and other deductible items, "bundle" those expenses, concentrating deductions in every other year, so that you're able to itemize in one year and take the standard deduction in the next.

In the end, the government will get its share, but there's no reason not to strive to limit the tax bite as much as possible. After all, the less the government takes, the more you have to invest and to ultimately spend on your needs.

If you have questions on taxes and your investments, give us a call and let's review your situation and how your tax bite can be minimized to your long-term advantage.