How to Help Make Your Financial Life Less Taxing

Sometimes, we suffer big losses because of a market decline. But sometimes, our losses are self-inflicted. One example: the hefty sums many of us lose each year to our portfolio's investment tax bill.

To be sure, you probably can't avoid all investment taxes. You may, however, be able to improve your portfolio's tax efficiency. Here is a look at how you might defer paying taxes – and when you should consider realizing gains.

DELAYING THE PAIN

Everybody's financial situation is different, so it's advisable to consult a tax professional. Still, you might consider managing your portfolio with the goal of deferring taxes for as long as possible.

Why? Deferring taxes may bolster your portfolio's performance, because you hang on to the money involved for longer and potentially can use it to earn additional investment gains. With that in mind, consider two strategies.

First, you could fund traditional Individual Retirement Accounts, 401(k) plans, variable annuities and other accounts that offer tax-deferred growth. Meanwhile, a Roth IRA can give you federal tax-free growth (though you give up the chance to get the initial tax deduction that some other retirement accounts offer).

Second, you might delay selling winning investments in your regular taxable account and thereby postpone paying capital gains taxes. And if you realize gains on taxable-account investments held more than a year, you would pay taxes at 2010's maximum federal rate of just 15%. This special 15% rate also applies to qualifying dividends. By contrast, the current top federal income tax rate is 35%. These tax rates, of course, could be higher or lower in future years.

What do these two strategies mean for your portfolio's investment mix? You might use your tax-deferred retirement accounts to hold your portfolio's investments that tend to generate larger taxable gains each year, such as taxable bonds, real estate investment trusts and actively managed stock funds. That way, you can defer the tax bill on these taxable gains.

Meanwhile, consider using your taxable account to buy more tax-efficient stock funds, such as tax-managed funds and index funds, and also to purchase individual stocks you plan to hold for the long haul. This will allow you to take advantage of today's historically low tax rates on qualifying dividends and long-term capital gains.

If you are in a high tax bracket, you might also purchase tax-free municipal bonds in your taxable account. But before you buy municipal bonds, consider whether you could improve your portfolio's return by instead using your retirement account to purchase taxable bonds, which could have a higher yield.

TAKING THE HIT

While deferring taxes often makes sense, you may sometimes want to boost your portfolio's tax bill. For instance, that could be a smart move if you find yourself in a year with relatively little taxable income because, say, you have been laid off. You might also increase your investment income if you believe Congress is likely to raise tax rates. After all, it may be better to pay taxes at today's lower tax rates than possibly face higher tax rates down the road.

Consider a few examples. Suppose you have a stock fund in your taxable account that has been a disappointing performer, but which you have been reluctant to sell because it would trigger a capital gains tax bill. If you think today's low capital gains tax rates won't last, you might bite the bullet, sell the fund and move the money into other investments.

To trim the resulting capital gains tax bill, you could simultaneously sell any losing investments you have in your taxable account. Those capital losses can be used to offset capital gains and up to $3,000 in ordinary income each year, or $1,500 if you are married and filing separate federal tax returns.

Alternatively, suppose you anticipate your tax bill in retirement will be surprisingly high, thanks to a combination of taxable retirement account withdrawals, pension income and Social Security benefits. Indeed, you fear your tax bill could be especially steep once you turn age 70½ and have to start taking required minimum distributions from your retirement accounts. Those taxable retirement account withdrawals could, in turn, trigger taxes on up to 85%

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of your Social Security retirement benefit.

To head off that tax bill, you might shrink your traditional IRA, by converting part or all of the account to a Roth IRA. You would have to pay income taxes on the taxable sum converted today. But once the money is in a Roth, it will grow tax-free thereafter.

The tax benefits of a Roth IRA conversion don't end there. To pay the conversion tax bill, you will want to use money in your regular taxable account. That will reduce the size of your taxable account — and hence the taxable investment gains that the account generates each year. An added bonus: There's no age at which you have to start taking minimum distributions from a Roth IRA. That means you could leave the account to grow tax-free and potentially bequeath it intact to your beneficiaries.

Even if you have already retired, a Roth IRA conversion might still make sense. If you haven't yet claimed Social Security, started receiving your pension or begun drawing down your retirement accounts, your taxable income may be relatively low — and thus the tax bill on a Roth conversion could be modest.

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While Roth IRAs can give you federal tax-free growth, they are subject to income restrictions, contributions are not tax deductible and early withdrawals on earnings within the first five years are not tax-free.

Depending on your state of residency, some municipal bonds may be exempt from state and local taxes; however, interest may be subject to the federal alternative minimum tax.

If sold prior to maturity you may receive more or less than your original investment. Past performance is not a guarantee of future results.

Bonds are affected by a number of risks, including fluctuations in interest rates, credit risk and prepayment risk. In general, as prevailing interest rates rise, fixed income securities prices will fall. Bonds face credit risk if a decline in an issuer's credit rating, or creditworthiness, causes a bond's price to decline. High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues. Finally, bonds can be subject to prepayment risk. When interest rates fall, an issuer may choose to borrow money at a lower interest rate, while paying off its previously issued bonds. As a consequence, underlying bonds will lose the interest payments from the investment and will be forced to reinvest in a market where prevailing interest rates are lower than when the initial investment was made.

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