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Investing and Taxes

MAXIMIZING GAINS WHILE MINIMIZING TAXES

We all know that taxes are one of life's certainties—one that many people would prefer to avoid. However, singularly focusing on minimizing your tax bill each year could compromise your investment plan and its potential gains. A long-term perspective, preparation and planning to manage your annual tax burden can help you strike a balance between paying less in taxes and improving your portfolio's returns over time.

Taxes are a cost—reducing the amount of income and capital gains you keep—and as with all costs, keeping taxes low is a sensible practice. But be wary of "letting the tax tail wag the portfolio dog." By that we mean that investors sometimes take their tax reduction efforts too far and lose sight of the real goal of investing—it's not about writing the smallest check to Uncle Sam, but maximizing your after-tax dollars. The path to one doesn't always lead to the other.

For example, consider two funds with similar growth objectives—one is 99% tax-efficient over the last three years (meaning you lose only 1% of your overall return to taxes) and has an after-tax return of 5% a year, while the other is 90% tax-efficient, but returns 7% a year after taxes. With the first fund, you're paying less in taxes, but ending up with less money in your account after three years; the second fund generates a higher tax bill, while also yielding better gains after all is said and done. That doesn't make it a cut and dried decision, but most investors, given the choice, would prefer more money in their account over writing a smaller check to the IRS.

Every client's situation is different, and there are no universal rules to follow. At Adviser Investments, we work with each of our clients to achieve their individual goals. That said, there is some consensus thinking on the subject that any investor should consider.

Three Account Types to Know

Investment accounts generally fall into one of three classifications when it comes to the U.S. tax code: Tax-free accounts, tax-deferred accounts and taxable accounts.

Tax-free and tax-deferred accounts are appealing because income, dividends and other gains are allowed to compound untaxed. This greatly enhances the long-term growth potential of assets held in these accounts. The primary difference between tax-free and tax-deferred accounts is whether to pay taxes now or later.

With tax-free accounts, including Roth IRAs, Roth 401(k)s and 529 college savings plans, you fund the account with after-tax dollars (paying taxes today), but the assets grow tax-free and you'll owe no tax when it comes time to withdraw the assets.

Tax-deferred accounts like traditional IRAs and 401(k)s work the opposite way; you fund the account with pre-tax dollars but pay taxes (later) when you withdraw the assets.

Tax-free growth sounds great, so what's the catch? Well, tax-free and tax-deferred accounts have penalties if you withdraw money either too soon (before retirement) or for purposes other than a few specific uses (e.g. college education). So in exchange for the tax-free compounding power you give up flexibility in accessing your money. And when you do begin making withdrawals, all of your investment gains in traditional IRAs and 401(k)s are subject to your income tax rate, not the lower capital gains rate.

The power of compounding without the bite of taxes is strong enough that for most investors it's ideal to max out annual contributions to your tax-exempt and tax-deferred accounts if possible. Still, if you need current income from your investments or don't want them locked up until you reach retirement age, you'll need to keep some portion of your assets in the third type of account—a taxable account.

Every time an asset is sold in a taxable account for a gain, or you receive interest or dividend payments, you'll have to pay taxes the following April 15. The two silver linings of taxable accounts? Losses can be booked against gains to reduce your tax bill. And though you'll have to pay taxes along the way, you can take money from the account or add money to it without a penalty.

Tax Efficiency and Stocks

Broadly speaking, owning a stock gives you, the investor, greater control over the tax impact of profitable sales—at least in terms of when you'll owe taxes. If you own a stock that has appreciated in price, you don't owe taxes on those gains until you sell it. And holding a stock (or any asset, really) for at least 12 months before selling means those gains are considered long-term and taxed at a lower rate than if you'd held the stock for less than a year.

But even a long-held stock may still contribute to your tax bill. Stocks that pay dividends generate a tax liability for shareholders even if they are never sold. Around 420 of the 500 stocks in the S&P 500 index currently pay dividends.

Mutual Funds Can Be Tax Efficient

With mutual funds and ETFs you have some, but not as much, control over when you pay taxes. Similar to a stock, if you buy a fund and its price goes up, you don't owe taxes on those gains until you sell shares of the fund. So the longer you hold a fund, the longer you can delay paying taxes.

However, there is a second layer to consider with a mutual fund or ETF. If the manager of the fund sells a stock that has gone up in price, that profit is passed along to fund shareholders, who ultimately pay the taxes on those gains. Mutual funds have to pay out capital gains

After-Tax Returns vs. Tax Efficiency

WE GAVE THE EXAMPLE of the funds with 99% and 90% tax efficiency on page one, but let's take it beyond the hypothetical and look at some real-world results from Vanguard. The table to the right, which ranks Vanguard's 10 most tax-efficient diversified domestic stock funds and the 10 funds with the biggest after-tax returns through May 31, 2017, demonstrates why looking solely at a fund's tax-efficiency can be a costly mistake.

While all of the funds included in the two sections of the table allowed investors to keep 85% or more of their gains after taxes, only five of the funds that showed the best after-tax returns also appear on the list of funds ranked by how tax efficient they were. (Note that the after-tax returns do not include the sale of shares, just taxes on capital gains and dividends—we think this is a more accurate representation of a long-term investor's results.)

Vanguard's most tax-efficient fund over the period, MidCap Growth Index, which allowed investors to keep 96% of their returns after the top applicable tax rate (returning 8.5% a year after taxes over the period), significantly lagged Capital Opportunity, which has a similar growth mandate and was 90% tax-efficient, but returned 11.7% a year after taxes. Put in dollar terms, MidCap Growth Index investors would have $12,765 after paying an estimated $207 in taxes on an initial $10,000 investment over the three years; that same investment in Capital Opportunity would incur more than four times the taxes on distributions ($968), but would be worth $13,950 after taxes—a nearly $1,200 advantage over the index fund.

As the tables show, tax efficiency tells you nothing about a fund's returns—it only measures the portion of a fund's return you're likely to keep.

Tax-Efficiency and After-Tax Returns Tell the Tale

Vanguard funds ranked by tax-efficiency	3-year return	3-year after-tax return	Tax efficiency
MidCap Growth Index	8.8%	8.5%	96.5%
Admiral Tax-Mgd. Growth & Income	13.7%	13.2%	96.1%
Growth Index	11.0%	10.6%	96.0%
Admiral Tax-Mgd. SmallCap	9.8%	9.4%	95.5%
FTSE Social Index	10.6%	10.0%	94.5%
SmallCap Growth Index	7.0%	6.6%	94.4%
Market Neutral	1.0%	0.9%	94.3%
MidCap Index	8.8%	8.3%	94.2%
Admiral Tax-Mgd. Capital App.	10.0%	9.3%	93.4%
Total Stock Market Index	9.5%	8.9%	93.2%

Vanguard funds ranked by after-tax return	3-year return	3-year after-tax return	Tax efficiency
Admiral Tax-Mgd. Growth & Income	13.7%	13.2%	96.1%
Capital Opportunity	13.1%	11.7%	89.5%
PRIMECAP	12.4%	10.8%	86.8%
Growth Index	11.0%	10.6%	96.0%
PRIMECAP Core	12.1%	10.4%	86.3%
FTSE Social Index	10.6%	10.0%	94.5%
Admiral Tax-Mgd. SmallCap	9.8%	9.4%	95.5%
U.S. Growth	10.9%	9.3%	85.3%
Admiral Tax-Mgd. Capital App.	10.0%	9.3%	93.4%
500 Index	10.0%	9.3%	93.2%

Source: Morningstar. Note: Returns are annualized through 5/31/17. After-tax returns assume shares were not sold and include 20% capital gains rate and 43.4% income tax rate (which includes the 3.8% health care surtax on high-income earners) as applicable.

at least once a year (if they have them), and as a shareholder in a taxable account there isn't much you can do about it.

At this point you might think that if trades made by the portfolio manager lead to a big tax bill for you and me, then managers that don't trade as much will have smaller tax bills. Generally that's true, but it's not always the case: A high level of turnover (a standard measure of how often securities move into and out of a mutual fund) might mean the fund manager is harvesting losses—reducing the portfolio's tax liabilities.

Index Funds Aren't a Tax Cure-All

Many investors fall back on a basic rule of thumb that index funds will generate the smallest tax bills. And there is some truth to that, as index funds tracking the S&P 500 or other broad market indexes are typically among the most tax-efficient funds around. But even they too must buy and sell stocks when their benchmark constituents change. And those stocks still pay (taxable) dividends. In short, index funds are not immune from turnover or taxes, and the more narrow the benchmark the index fund tracks, the greater the potential for a tax surprise at year-end.

Just because many index funds are tax efficient and have low turnover doesn't mean they'll make you richer, faster. We believe, and our research bears out, that there are active portfolio managers who, despite generating a bigger tax bill, will also produce index-beating after-tax returns.

Tax Efficiency and Bonds

Bonds and bond funds are usually considered tax inefficient because a large portion of their return comes from monthly distributions of interest, which are taxed as ordinary income and thus are subject to an investor's maximum tax rate. This is especially true when compared to stocks, where, in general, returns primarily come from price appreciation and are taxed at the capital-gains rate when shares are sold.

Some bonds do have tax advantages: Treasury bond income is exempt from state taxes but not federal taxes, while income from municipal bonds is tax-free at the federal level (and sometimes at the state level, depending on the issuer). Due in large measure to their built-in tax advantage, municipal bonds typically yield less than comparable corporate or Treasury bonds. However, for some

Sometimes Taxable Income Is Preferable

IMAGINE YOU HAVE $100,000 TO INVEST in a short-term bond fund. Given its 1.21% yield (on May 31, 2017), you could buy Vanguard Limited-Term Tax-Exempt and potentially earn $1,210 in tax-exempt income over the next 12 months and owe no taxes. Or you could buy Vanguard's Short-Term Investment-Grade, which carries essentially the same interest-rate risk and sports a 1.91% yield, and earn $1,910 of taxable income. If you're in the second-highest federal tax bracket of 35%, you'll owe $668 in taxes, leaving you $1,241.

In this scenario, choosing Limited-Term Tax-Exempt saved you the aggravation of paying taxes, but if you're more interested in maximizing after-tax dollars, Short-Term Investment-Grade would've been the better play.

However, investors in the top tax bracket of 43.4% (including the health care surtax) would have been better off in the tax-exempt fund, as taxes would have taken an $829 bite out of Short-Term Investment-Grade's $1,910 in income, leaving them with $1,081, less than Limited-Term Tax-Exempt's $1,210. This example shows why it's important to know how investment choices can affect your tax situation, and that there is a time and place for both taxable and tax-exempt investments for the tax-sensitive investor.

Federal Income Tax Rates for Tax Year 2017

TAXABLE INCOME			TAX RATE	
Single	**Married/Joint**	**Head of Household**	**Ordinary Income and Short-Term Capital Gains**	**Long-Term Capital Gains and Qualified Dividends**
$37,950 to $91,900	$75,900 to $153,100	$50,800 to $131,200	25%	15%
$91,901 to $191,650	$153,101 to $233,350	$131,201 to $212,500	28%	15%
$191,651 to $$416,700	$233,351 to $416,700	$212,501 to $416,700	33%	15%
$416,701 to $418,400	$416,701 to $470,700	$416,701 to $444,500	35%	15%
>$418,400	>$470,700	>$444,550	39.60%	20%

Source: Internal Revenue Service.
Note: Table does not include additional 3.8% Medicare tax rate on investment income in excess of adjusted gross income of $200,000 ($250,000 for married filing jointly) and 0.9% on salary and self-employment income exceeding this amount. Also excludes 10% and 15% tax brackets, which are not subject to long-term capital gains taxes.

taxable investors, the level of income paid by municipal bonds compares favorably to taxable bonds once taxes are taken into account.

Despite certain advantages that municipal and Treasury bond income offers, we (once again) urge you to prioritize after-tax gains over minimizing taxes. Corporate bonds can at times outperform a tax-exempt municipal bond even after you've paid taxes on the income from it. The easiest way to compare tax-free and taxable yields is to calculate a taxable-equivalent yield (the taxable yield you need to earn before taxes to equal a bond fund's tax-free yield). You can calculate a taxable-equivalent yield by dividing the yield on a tax-free municipal bond by 1 minus the tax rate. For example, if a tax-free bond has a 3.0% yield and the tax rate is 25%, you'd need to find a taxable bond that yields at least 4.0% [3 ÷ (1 - 0.25) = 4.0] to make it worth the investment.

Taxes and Your Portfolio

As we said at the start, every investor is different, and what makes sense for your neighbor might not make sense for you. If you have any questions or concerns about the tax efficiency of your portfolio, we recommend that you confer with a trusted tax or investment professional before making any moves. Investors' year-end tax planning should always encompass their entire financial picture and consider all of their investment accounts, a service we provide for our clients and one that we feel every experienced adviser should offer.

Sometimes, not making a move is the best choice—while it may be possible to save more on taxes in any given year, we think it's more important to stick with a long-term strategy focused on maximizing your after-tax returns.