Investor

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Staying the course

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4 Ways To Aim For Max Tax Efficiency

While tax season shines a spotlight on taxes, you could benefit from keeping an eye on your taxes all year long. Taxes can take a significant toll on your savings if they are not well-managed.

Like most, you invest to grow and protect your money. When your money grows, it's a good thing—except when you have to pay taxes on it. Here are four ideas to help you manage the tax impact on your investments so you have the opportunity to hold on to more of your money.

#1 Activate a tax strategy

When investing, people usually focus on their goals, time horizon, and risk tolerance. These are all key strategies. However, they do not always consider another important way to help meet their performance goals: taking into account the impact of taxes on their investments.

For example, let's say the value of one of your investments goes up and you want to sell it. If you sell within a year from when you bought it, you could be taxed at the higher short-term capital gains tax rate. But if you wait at least a year and a day to sell, you could be able to take advantage of the more favorable long-term capital gains tax rate. By being aware of when you sell, you have the potential to impact your investment-related tax bill.

#2 Be mindful of munis

If you have taxable dollars and are interested in generating income in the form of interest income, you may want to consider municipal bonds. One of the main advantages of munis is that their interest income is usually exempt from federal income taxes and potentially from state and local taxes, too. Make sure to consider the inherent risks of municipal bonds, such as the risk of default, before investing. Also discuss with your financial advisor if municipal tax-exempt mutual funds fit into your overall portfolio to possibly help boost your after-tax returns.

#3 Start thinking about dividends

Consider investing in stocks that pay qualified dividends, which are typically taxed at a lower tax rate than ordinary income. Most dividends paid by U.S. corporations are qualified. Make sure to keep in mind how long you need to own the stock to qualify for the tax-advantaged rate. Usually you must own common stock for 60 days and preferred stock for 90 days. Also, your tax rate will depend on your tax bracket. Make sure to discuss the benefits and risks of dividend investing with your advisor.

#4 Contribute now to your IRA

Contributing to an Individual Retirement Account (IRA) is a relatively easy way to help manage your taxes. If you have earned income, you have the opportunity to contribute to an IRA every year. An IRA allows your investments to grow either tax-deferred in a traditional IRA or contributions can be made with after-tax dollars in a Roth IRA. These tax-advantaged retirement accounts offer you the potential to save more money over the long run. If you are under 50, you can contribute $5,500 to an IRA in 2017. If you are 50 or older, you can contribute an additional $1,000 as a "catch-up" contribution. Once you turn age 59 1/2, you can withdraw any amount from your IRA without having to pay a penalty. Withdrawals before age 59 1/2 are taxed as income and generally incur a 10% penalty on that withdrawal within a traditional IRA. Do not wait until tax day to contribute to your IRA. You can fund it throughout the year to maximize your investment. If you haven't made your 2017 contribution, do it today. You also can set up automatic contributions to help ensure you're investing on a regular basis – whether it's once a year or at set intervals.

Key Takeaway

By understanding the impact of taxes on your investments, you're investing in an opportunity to save and spend more of your hard-earned money instead of handing it over to Uncle Sam. Your trusted financial advisor can work with you to help maximize the tax efficiency of your investments.

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Investors should consider how the combined risks impact their total investment portfolio and understand that different risks can lead to varying financial consequences, including loss of principal.

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