Thinking About Taxes

The purpose of tax-efficient investing is to help increase your assets’ after-tax value.

Taxes Should Not Affect Your Basic Strategy

Your strategy—how much of various asset types to own—depends on your financial goals, risk tolerance, and other factors. But how you get exposure to each asset class, the type of account you put it into, and how you trade it can make a big difference tax-wise.

There Are Many Ways to Own an Asset Class

Investors can own individual securities, or they can invest in traditional mutual funds or conventional exchange-traded funds (ETFs) representing portfolios of securities.

All Investment Earnings Are Not Created Equal

Stock income (dividends and capital gains) generally enjoys lower rates than taxable bond income (interest).

Some Types of Accounts Are Tax-Efficient

Income from retirement accounts, such as traditional IRAs and 401(k) plans, is tax-deferred.

How And When To Purchase And Sell—That Is The Question

Trading is generally determined by your investment strategy, but timing and consideration of your tax basis can reduce your tax bill.

How Can Tax Planning Affect the Way I Invest?

Key Takeaways

- Your investment strategy depends primarily on your financial goals, not your tax rate.
- How you implement your strategy makes a big difference.
- The account types you use to hold your assets can affect your tax burden.

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<td>Your investment goals help determine your asset allocation.</td>
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<td>When to buy/sell it?</td>
<td>Timing of purchases/sales can affect capital-gains tax and qualification of dividends.</td>
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<td>Where to hold it?</td>
<td>IRA, 401(k), and other tax-advantaged accounts can shelter your more tax-exposed assets.</td>
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<td>Individual securities, mutual funds, and ETFs each have their own tax pros and cons.</td>
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Understanding the Tax Rules of Investment Earnings

Yes, it’s complicated. What you earn on investments isn’t always taxed at the same rate as your other income, which we call “ordinary income.” Congress has chosen to tax capital gains and dividends at a lower rate—usually, but with exceptions. To make borrowing more affordable for states and cities, it has exempted the interest on municipal bonds from tax—usually. The table below summarizes the most common federal tax treatment of the major asset classes. It is important to remember that there can be exceptions, depending on where you live, how high your income is, and a host of other factors. Also, although most states generally follow federal income-tax rules, their rules differ in some cases.

<table>
<thead>
<tr>
<th>TAX FREE</th>
<th>FAVORABLE TAX RATE</th>
<th>ORDINARY-INCOME TAX RATE</th>
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<tr>
<td>Stocks</td>
<td>Qualified dividends</td>
<td>Nonqualified dividends</td>
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<td></td>
<td>Long-term capital gains</td>
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<tr>
<td>Taxable Bonds</td>
<td>Long-term capital gains</td>
<td>Interest</td>
</tr>
<tr>
<td></td>
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<td>Short-term capital gains</td>
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<tr>
<td>Government Bonds</td>
<td>Interest (at state level)</td>
<td>Long-term capital gains</td>
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<tr>
<td>Municipal Bonds</td>
<td>Interest (at federal level)</td>
<td>Long-term capital gains</td>
</tr>
<tr>
<td>Commodities</td>
<td>Short-term capital gains</td>
<td>Long-term capital gains</td>
</tr>
<tr>
<td>REITs</td>
<td>Long-term capital gains</td>
<td>Dividends</td>
</tr>
</tbody>
</table>

Source: Wells Fargo Investment Institute
When to Buy and Sell

Enjoying Lower Rates on Dividends
Dividends on U.S. stocks and some foreign stocks currently enjoy a favorable tax rate, provided that they are “qualified,” meaning the shares have been held for more than 60 days (90 days for preferred stocks), including the ex-dividend date. This is a consideration if you plan to sell a stock you have not held very long.

Deferring Capital Gains
You have a lot of control over the timing of realized capital gains if you hold your securities individually. Should you choose to hold them in the form of a mutual fund, you give up some flexibility.

Long-term capital gains are more desirable than short-term ones because of their lower tax rates. The top rate for long-term gains is currently 20 percent, while it’s currently 39.6 percent for short-term gains. But holding on to an asset just to wait for a lower tax rate could involve too much downside risk. Your investment professional may be able to suggest strategies that can help preserve the value of the asset while avoiding a premature sale.

Rebalancing Your Portfolio
Portfolio rebalancing is a key step in helping manage portfolio risk and keeping your investment strategy on track in changing markets. This classic exercise of buying low and selling high could generate realized capital gains. However, before selling overweighted assets from your portfolio, consider using cash flows to restore balance. That is, if you are contributing to your accounts on a regular basis, direct the new money to underweighted assets. Also consider whether your participation in automatic dividend reinvestment is contributing to an overweight in stocks if you have held the security for more than one year.

Giving Capital Gains to Charity
If a security you want to sell has a low cost basis and you are pursuing a philanthropic goal, consider donating the security. That way you would avoid capital-gains tax while potentially generating a tax deduction based on the security's fair market value.

Offsetting Capital Gains with Losses
A strategy for reducing your tax bill is to realize a capital loss to offset a capital gain. However, beware the “wash sale” rule, which says you can’t claim a capital loss on something you sell if you have bought a substantially identical security within 30 days before or after the loss-generating sale (see below).
Where to Hold Your Investments

Since retirement is likely one of your financial goals, you may have opened an IRA or participate in your employer’s 401(k) plan. The tax advantages of retirement accounts can be especially valuable to shelter investment income that is taxed at your ordinary-income rate. For example, a traditional IRA or 401(k) would be a good place for your taxable bonds. Since these enjoy no favorable tax rate on their interest, they can benefit most from the tax deferral that IRAs and 401(k)s afford until withdrawal. Your stocks would benefit less because, upon withdrawal, the dividends and long-term gains will be taxed at your ordinary-income rate and thus lose the favorable rates that these types of income currently enjoy.

A Roth IRA or Roth 401(k), however, has the advantage that withdrawals are not subject to tax if the assets are held in the account at least five years and the investor is at least age 59½, meaning that years of capital gains will permanently escape tax. Thus it would be a good place for stocks and other growth assets. Of course, a Roth IRA or Roth 401(k) is funded with after-tax contributions.

Keep in mind that the broad rules outlined below have exceptions—this is tax law, after all. Withdrawals from retirement accounts may be subject to tax penalties as well as income tax if they are made too early.

<table>
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<tr>
<th>Contributions Deductible?</th>
<th>Withdrawals Taxed?</th>
<th>Best Suited Asset Types</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRA (pre-tax) or 401(k)</td>
<td>Yes</td>
<td>Yes, at ordinary-income rates</td>
</tr>
<tr>
<td>IRA (after-tax)</td>
<td>No</td>
<td>Yes, at ordinary-income rates on the increase in value</td>
</tr>
<tr>
<td>Roth IRA or Roth 401(k)</td>
<td>No</td>
<td>No, if held for 5 years and until age 59½</td>
</tr>
<tr>
<td>Regular Investment Account</td>
<td>No</td>
<td>Not applicable</td>
</tr>
</tbody>
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Why Tax-Efficient Investing?

You may wonder why you should concern yourself with tax-efficient investing. Simply stated, taxes can reduce your net return.

The chart to the right shows taxes’ potential long-term effects. This example illustrates a hypothetical 8 percent rate of return on a $5,000 annual investment for 40 years. If you were in the 28 percent tax bracket, tax deferral could give you almost twice the $770,630 you would have if you had invested that same amount in a taxable account. If you withdrew the money all at once and paid the taxes at today’s top rate of 39.6 percent, you could still end up with $74,308 more than you would have with a taxable account.

If you’re in a different tax bracket, your numbers will vary, of course, but the principle remains the same—you could end up with more if you do not have to pay taxes annually on your earnings.

**Tax-Advantaged Accounts Can Potentially Improve Returns**

**Growth With Annual Taxation**

**Growth With Tax Deferral**

$844,938 value after taxes, assuming a 39.6% tax bracket and lump-sum distribution.

Lower maximum tax rates on capital gains and dividends may make the investment return for the taxable investment more favorable, thereby reducing the difference in performance between the accounts shown. Individuals should consider their personal investment horizons and income-tax brackets, both current and anticipated, when making an investment decision, as these may further affect the results of the comparison. Changes in tax rates and the tax treatment of investment earnings could affect the results shown.

This illustration is hypothetical in nature and is not intended to represent an actual investment. The hypothetical 8% rate of return is not guaranteed and is not an indication of the past or future performance of any investment. Investments fluctuate in value, and there can be no assurance any investment will increase in value.

Source: Wells Fargo Investment Institute

Information assumes no withdrawals during the period. State taxes and annual fees and charges are not reflected in the illustration and would reduce the performance shown if they were.
What Form to Hold Your Investments In

Individual Securities
Separately Managed Account
Owning individual securities gives you the most flexibility, as we said above. You can control the timing of realized capital gains and losses. If you’re working with an investment manager, that manager can monitor your realized gains and harvest offsetting losses throughout the year according to your guidelines without compromising your investment strategy. However, it isn’t always possible to assemble a diversified portfolio at a reasonable cost.

Mutual Funds
Mutual funds allow investors to hold a diversified collection of securities at low cost. Although some funds may realize minimal capital gains (index funds) or be designed to be tax efficient and limit tax consequences (equity tax-managed funds), mutual fund investors give up control over the timing of realized gains and losses. If a fund you own plans a distribution soon, selling your shares beforehand won’t sidestep the gain because the shares’ value would be higher by the gain amount until it is paid. However, if the planned distribution comprises primarily short-term gains, and if you have owned your shares for a long time, preemptive selling could make the realized gain long term rather than short term. You probably would not want to buy a mutual fund before a large planned distribution—you’d be getting some of your own money back, and you’d owe tax on it.

Exchange-Traded Funds
Although not all types of ETFs are considered tax efficient, many do not distribute capital gains. ETFs continuously offer and sell shares through a daily in-kind purchase-and-sale process to “authorized participants” and not to investors. As a result, the ETF does not incur tax when securities are sold and investors do not incur capital gains taxes until they sell their shares.

Annuities
An annuity may be an income solution for some investors, and it has the advantage of deferring any taxable income until the contractual payouts begin. By that time the recipient might be in a lower tax bracket than at the time of purchase. However, one would not enter into an annuity solely to defer tax because it involves giving up ownership of the assets used to purchase it.

Did We Mention That Taxes Are Complicated?

The information in this report is general in nature and may not apply to your situation. Tax laws regarding investing, retirement accounts, and taxes in general (e.g., alternative minimum tax [AMT], the 3.8 percent Medicare surtax, unwanted foreign-tax withholding) are always subject to change. Please speak with your tax advisor before making any decision that may have tax consequences.

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