Taxes and Investing

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First things first

- Do not treat this as tax advice
  - Not just a legal disclaimer; only your tax advisor knows the details of your tax situation
- Only consider taxes *after* you have chosen your asset allocation (to determine risk)
- Remember that your goal is to optimize after-tax returns, not minimize taxes
  - Taxes are a cost, and must be weighed against other costs or benefits

How to do tax-aware investing

- Understand taxes
- Then go through the usual stages of investing:
  - Choose accounts
  - Choose investments for each account
  - Manage your accounts
  - Withdraw from the accounts

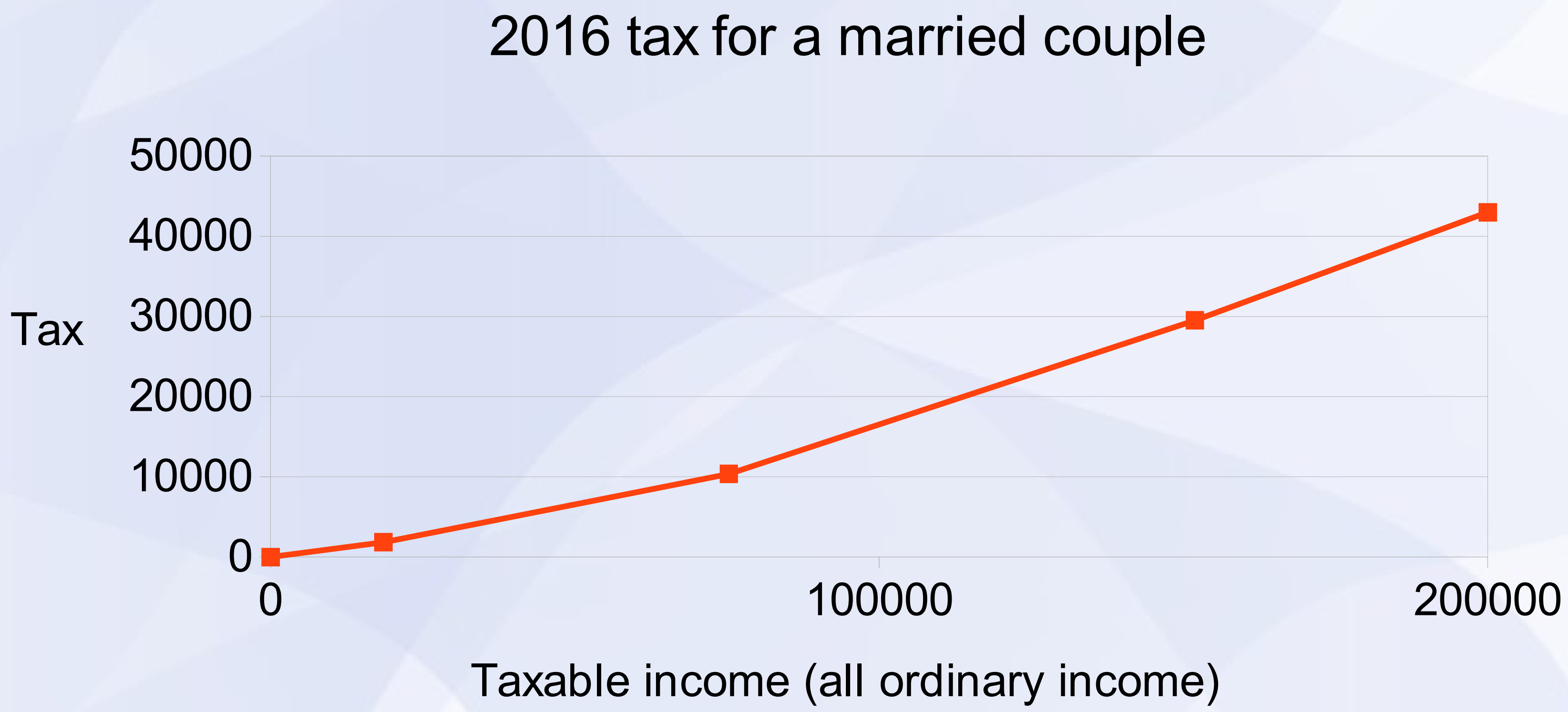
Tax-aware investing questions

- First question: How are investments taxed?
- Which accounts should I invest in?
- What should I hold in which account?
- How should I manage my taxable account?
- Which account should I withdraw from?

How are investments taxed?

- Marginal tax rate
  - How it is determined
  - How to use it for tax decisions
- Types of tax-favored accounts
- Taxation of taxable accounts
- State income taxes

Marginal tax rate: tax on the dollars in each bracket



Marginal tax rate: rates on different types of income

A married couple with $100,000 salary, $10,000 qualified dividends, and $30,000 in deductions and exemptions

$4700 qualified dividends in 25% bracket	Taxed at 15%
$5300 qualified dividends in 15% bracket	Not taxed
$51,450 regular income in 15% bracket	Taxed at 15%
$18,550 regular income in 10% bracket	Taxed at 10%
$30,000 deductions and exemptions	Not counted in bracketing

Marginal tax rates: computing the marginal rate

The couple earns another $1000 in ordinary income. Their tax rises by $300, so their marginal rate is 30%.

$5700 qualified dividends in 25% bracket	$1000 more at 15%
$4300 qualified dividends in 15% bracket	Not taxed
$52,450 regular income in 15% bracket	$1000 more at 15%
$18,550 regular income in 10% bracket	Taxed at 10%
$30,000 deductions and exemptions	Not counted in bracketing

Marginal tax rate: phase-ins/outs affect the rate

- Child tax credit: extra 5% in phase-out
- Education credits also phase out
- ACA surtax: at high incomes, extra 0.9% on salary, 3.8% on investments
- Taxation of Social Security benefits
  - In most of the phase-in, 27.75% marginal rate in 15% bracket
  - A few taxpayers have 46.25% marginal rate in 25% bracket

Marginal tax rate: Alternative Minimum Tax

- Compute tax under regular and AMT rules, and pay the higher tax
- Marginal tax rate is 28%; regular rate of 15%/20% on qualified dividends, LT gains
- Large phase-out of personal exemptions; marginal rates are 35% and 22% then
- State tax is not deductible; add full state tax rate to your marginal rate
- Some munis are taxable under AMT

Marginal tax rate: why it is important

- The effect of a tax decision is based on your marginal rate
  - Example: If you contribute another $1000 to your 401(k), you save tax at your marginal rate
  - When you withdraw this $1000 plus gains, it is taxed at your marginal rate in retirement

Marginal tax rate: using it for comparison

- Say your marginal rate now is 25%, and your 401(k) will double in value
  - You could contribute $1000 to a traditional 401(k), which would grow to $2000, and pay tax when you withdraw it
  - You could contribute $750 to a Roth 401(k), which would give you $1500 in retirement
    - Break-even if you retire at a 25% marginal rate
    - Traditional is better if you retire at a lower marginal rate

Marginal tax rate: rates used for examples

- For most examples, we will use marginal rates for a middle-income investor in a state with no income tax
  - Regular income taxed at 25%
  - Qualified dividends and long-term gains taxed at 15%
- If you pay state tax and itemize deductions, add only 75% of the state tax rate

How are investments taxed?

- Marginal tax rate
- Types of tax-favored accounts
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Types of tax-favored accounts

- Tax-deferred: Traditional IRA/401(k)/etc.
  - Contributions usually deductible
  - Withdrawals taxed (except non-deductible contributions)
- Tax-free: Roth IRA/401(k)/etc, HSA, 529
  - Contributions taxed (except for HSA), can be withdrawn tax-free
  - Withdrawals tax-free if you follow the rules

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Taxation of taxable accounts: dividends and interest

- Bond interest (reported as dividend) taxed at full rate
  - Municipal bonds are exempt from federal tax; most states tax bonds from other states
  - Treasury bonds are exempt from state tax
- Stock dividends taxed at a lower rate if *qualified* according to IRS rules
  - REIT dividends are usually not qualified
  - Most dividends from stock funds qualified, with US often 100%, foreign 70%

Taxation of taxable accounts: capital gains and losses

- When you sell an asset, you have a capital gain or loss equal to the change in price
  - Losses offset gains, and up to $3000 per year of losses offset ordinary income
  - Long-term gains (more than 1 year) taxed at the same rate as qualified dividends
  - No capital-gains tax if you never sell (leave to heirs or donate to charity)
- If a mutual fund sells an asset for a gain, and has no offsetting loss, you pay the tax

Taxation of taxable accounts: visible and hidden tax costs

- Distributions are taxed when paid
- Stocks have an extra tax cost: capital gains when sold (at lower long-term rate)
- Municipal bonds have a hidden tax cost
  - Difference between muni and taxable yields for bonds of the same risk is a cost paid to avoid tax
  - Rule of thumb: 1/3 of muni yield (break-even in 25% bracket)

How are investments taxed?

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State income taxes

- More information on the wiki:
  State income taxes
- Understand what is taxed (and the rate) by your current state/county/city, and by the state you intend to retire in
- If you itemize deductions, this reduces your effective state tax rate by the federal rate
- Caution: the lists of states on the next slides may not be complete

State income taxes: important issues (untaxed income)

- No income tax: AK, FL, NV, SD, TX, WA, WY
- Tax on dividends and interest only: NH, TN
- Large exemption means many retirees pay no tax: GA
- Social Security not taxed: most states
- Retirement income not taxed, or large exemption: many states

State income taxes: important issues (deductions)

- No deduction for IRAs: MA, NJ (gains taxed); PA (gains not taxed after age 59-1/2)
- No deduction for employer plans: NJ (401(k)s are deductible, but not others; gains taxed); PA (gains not taxed for distributions in retirement)
- HSAs not recognized: AL, CA, NJ
- No or very limited itemized deductions: CT, IL, IN, MA, MI, NJ, OH, PA, RI, WV
- Federal tax deductible: AL, IA, LA, OK; limited in MO, MT, OR

Tax-aware investing questions

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Choosing accounts

- Get your employer match first
- Max out HSA if eligible
- Prefer any tax-favored account to taxable
- Contribute to IRA (which usually must be Roth) in preference to an inferior 401(k)
- Traditional versus Roth is a more complicated decision

Choosing accounts: ways to get more money in tax-favored

- Health Savings Account
  - You must have a qualifying high-deductible health plan; compare total costs including tax savings
- Backdoor Roth IRA
  - If over the Roth IRA contribution limit, contribute to non-deductible traditional IRA, then immediately convert to Roth
  - Only works if you don't have another IRA (or convert other IRAs as well)

Choosing accounts: Traditional or Roth?

- More information on the wiki: Traditional versus Roth
- Several versions of the decision
  - Employer offers both Traditional and Roth
  - You are eligible for deductible IRA/401(k) or Roth IRA (always use Roth if traditional is non-deductible)
  - You can convert a traditional IRA to a Roth

Choosing accounts: Traditional or Roth?

- Non-tax considerations
  - Get the full employer match first
  - If you can't contribute enough to a Roth 401(k) to get the full employer match, you can contribute more to the Traditional 401(k) and get a larger match
  - If you have a bad 401(k), prefer an IRA to unmatched 401(k) contributions

Choosing accounts: Traditional or Roth?

- Prefer a Roth if you are likely to retire at an equal or higher marginal tax rate:
  - You are in the 15% bracket
  - You are starting out in a low tax bracket, and expect to be in a higher bracket for most of your career
- Prefer a Roth if you may retire at an equal or slightly lower rate (large Traditional account or pension) and can max Roth out

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What goes in which account: general principles

- Choose the best options in your employer plan; this is more important than tax issues
- In your taxable account, use I-Bonds, low-yielding bonds (municipal bonds in a high tax bracket), and stock index funds and ETFs (either US or foreign)
- What goes in Traditional or Roth doesn't matter much; slight advantage for stocks in Roth

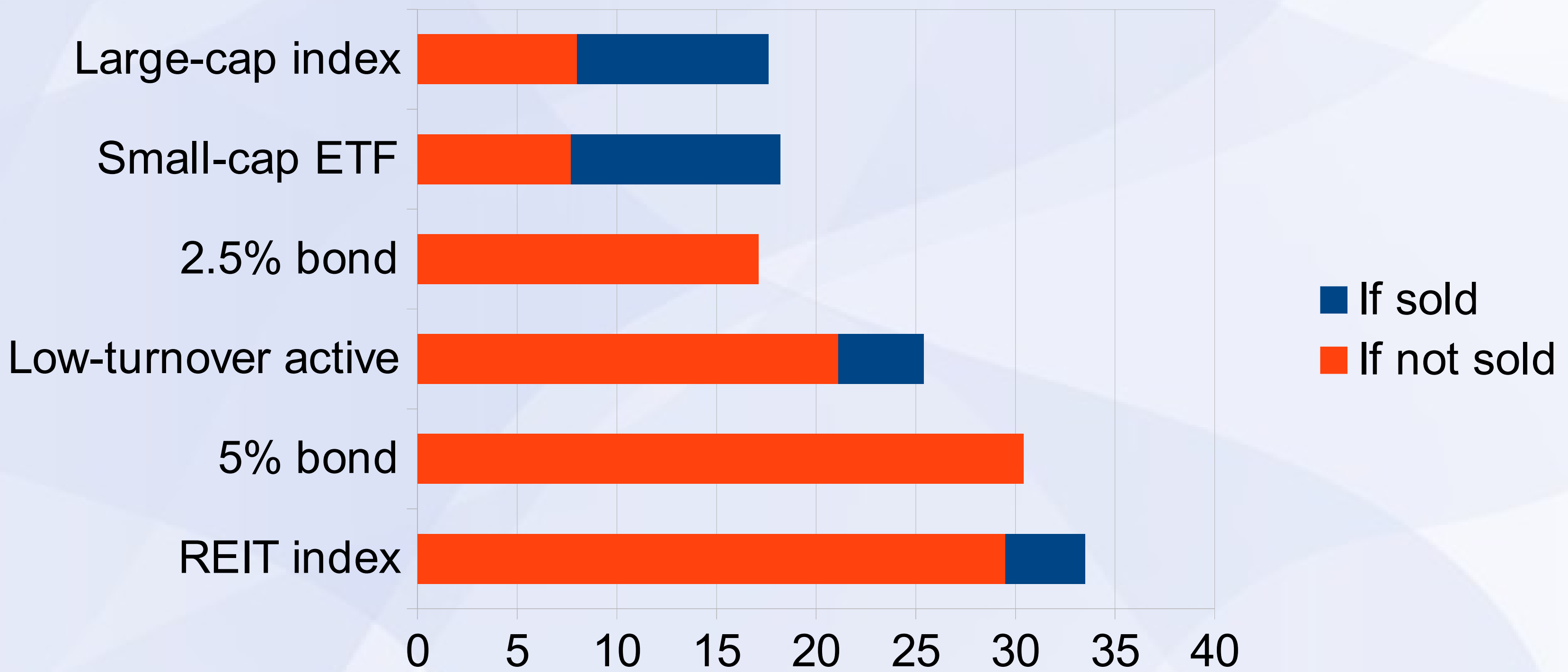
What goes in which account: more information on the wiki

- Tax-efficient fund placement: How to estimate tax costs of different investments
- Tax-managed fund comparison: Vanguard has funds which are explicitly tax-managed; do you need them? (Usually not)
- Tax-adjusted asset allocation: explains why stocks in Traditional or Roth doesn't matter much

What goes in which account: what is best in taxable accounts?

Stocks	Bonds
Large-cap index funds or ETFs	I-Bonds
Small-cap ETFs, or index funds with ETF class	Low-yielding bonds or cash (munis around 2%, taxable under 3%)
Value ETFs, or index funds with ETF class	TIPS, as long as inflation is low
Small-cap or value index funds without ETF class	Medium-yielding bonds (munis around 3%, taxable around 4%)
Low-turnover active funds	Bonds if yields become higher
REITs	
High-turnover active funds	High-yield (junk) bonds

What goes in which account: estimated tax cost over 30 years



What goes in which account: get the most from your employer plan

- Use the best options in the employer plan before optimizing for taxes
- Many employer plans have better options in some asset classes
  - TSP G fund: a bond fund with no risk
  - TIAA Traditional Annuity: also better than any retail fixed-income option
  - Many 401(k) plans have an S&P 500 index fund as the only low-cost option

What goes in which account: bonds or stocks in taxable?

- Tax cost of stocks depends on your bracket
  - 15% bracket: zero tax cost on stocks
  - Most brackets: tax cost on stocks and hidden tax cost on munis are comparable if yields are close
  - 39.6% bracket, or you are in a high-tax state and can use munis from your state: tax cost on stocks is higher if yields are close
- If you start with bonds in taxable, and yields rise, you can switch for little tax cost

What goes in which account: US or foreign in taxable?

- If yields are equal, tax cost on international funds is slightly lower; the foreign tax credit more than compensates for the non-qualified dividends
- International yields have been higher since 2008, making US slightly better
- Whichever way you started, not worth paying a tax cost to switch

What goes in which account: avoid balanced funds in taxable

- You might want to sell bonds (to hold fewer bonds, or a different type of bonds, or bonds in a different account)
  - If you hold bond and stock funds, you can sell bonds for little or no tax cost
  - If you hold a balanced fund, and you want to sell bonds, you must also sell stocks
- If you value simplicity, a target-date fund may keep an appropriate allocation for you

What goes in which account: what goes in traditional or Roth?

- The IRS (and state if applicable) own part of your traditional account; once you adjust, it doesn't matter
  - $7500 in a Roth and $10,000 in a traditional account will have the same after-tax value if invested the same way
  - $10,000 in a Roth has higher expected return if invested in stocks than $10,000 in traditional, but also higher risk, so it isn't really a gain

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Managing taxable accounts

- Use specific identification of shares when selling to reduce taxes
- Use tax loss harvesting, selling shares at a loss (but stay invested in stock; you might buy a similar fund)
- Try to avoid selling for a gain to rebalance, but do sell if you must
- Donate appreciated shares to charity

Managing taxable accounts: specific identification of shares

- You bought 1000 shares for $20, 1000 shares for $40, and want to sell 1000 shares for $50
- IRS default: sell oldest shares, bought for $20, gives a $30,000 capital gain
- Average basis (allowed for mutual funds): average cost $30 gives a $20,000 capital gain
- If you identify that you sell the shares bought for $40, you have a $10,000 capital gain

Managing taxable accounts: how to do specific identification

- You can usually identify when you sell
- For non-covered shares (purchased before 2012), brokerage may not have records
  - For mutual funds, specify by mail or secure E-mail: “Please sell 123.456 shares of the XYZ fund purchased on 7/1/07 for $20 per share, and buy the ABC fund”
  - When you sell, cost basis on your Form 1099 may not be correct, but it isn't reported to the IRS; you can report the correct basis

Managing taxable accounts: tax loss harvesting

- In 2015, you bought $10,000 of a stock fund. In 2016, you sell it for $9000 and buy another fund. In 2030, you sell for $18,000 to spend the money.
  - $1000 capital loss, $250 tax savings in 2016
  - $9000 capital gain, $1350 tax bill in 2030
  - Without harvesting: $8000 capital gain, $1200 tax bill in 2030
  - You saved $100 in tax, and had 14 years to invest $250 before paying the $150 tax

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Withdrawal: order of preference

- Take required distributions first
- Taxable withdrawals with little or no gain
- Taxable withdrawals for a gain when you intend to sell eventually
- Retirement plans, both Roth and traditional; use traditional when tax rates are lower
- Try to leave highly appreciated stock to your heirs (or charity)

Withdrawal: withdrawing from taxable accounts

- Tax efficiency is still important
  - Prefer tax-efficient stock funds
  - If possible, sell bonds and keep stocks in taxable
- If you withdraw $10,000, you can spend:
  - $7500 if the $10,000 is bond interest
  - $8500 if it is a qualified dividend or long-term gain distribution
  - $9250 if you sold a stock fund with a $5000 basis
  - $10,000 if you sold a bond fund with no capital gain

Summary

- Understand your tax situation
- Take advantage of tax-favored accounts
- Put tax-efficient holdings in taxable accounts
- Minimize taxable gains, and harvest losses
- When you withdraw, manage current taxes, and preserve tax deferral

References

- Your tax advisor (who knows your own situation)
- IRS: https://www.irs.gov; state tax bureau
- Much more information on the wiki: Outline of tax considerations for investors
- Tax software can be useful for experimenting with potential tax situations; TurboTax has an online TaxCaster which can be used for testing