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JOURNAL REPORTS: WEALTH MANAGEMENT

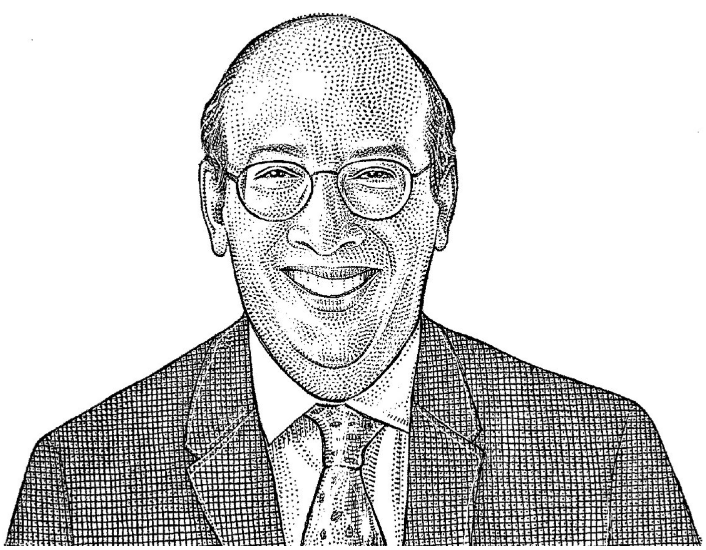
The Smart Ways to Be a Tax-Savvy Investor

Don't make investment decisions solely for tax purposes. But don't ignore taxes either.

Many investors would benefit by paying more attention to tax-savvy investing techniques all year long. PHOTO: MIKEL JASO

By Tom Herman

Feb. 10, 2019 10:06 pm ET



Investment pros often remind clients: It's not how much you make that counts. It's how much you take home after tax collectors grab their share.

"Taxes can be a major drag" on investment returns, says Christine Benz, director of personal finance at investment research firm Morningstar Inc.

Few among us enjoy thinking about taxes, especially at this time of year as we struggle with tax-law complexities and worry about how soon our refunds will arrive, or how much more we might owe. Even so, Ms. Benz and other experts say many investors would benefit by paying more attention to tax-savvy investing techniques all year long—and by learning to steer clear of painful tax traps that have ensnared unsuspecting investors.

ASK US A QUESTION

- Have a tax-related question? Email Tom Herman at taxquestions@wsj.com.

"To make a move solely for tax purposes is silly, but to ignore taxes when investing is equally as foolhardy," says Robert Gordon, president of Twenty-First Securities. "There are hundreds of basis points of after-tax return available to those that invest tax efficiently."

Many costly myths and misunderstandings have sprung up on this subject, involving even the seemingly stodgy $3.8 trillion municipal bond market. Here are a few thoughts from tax and investment professionals on improving tax efficiency.

Municipal bonds

Millions of investors seeking tax-exempt income and relative safety invest in bonds issued by state and local governments and municipalities, either directly or through mutual funds. Munis are especially popular among upper-income taxpayers living in high-tax areas such as New York City or California.

But don't make the mistake of assuming all municipal bonds pay tax-free income. State and local income-tax considerations can vary, says Michael Decker, a managing director at the Securities Industry and Financial Markets Association. The general rule is that muni-bond-interest income typically is tax-free at the federal, state and local levels on bonds issued by your home state or a municipality within that state. But if you buy out-of-state munis and live in a state that has an income tax (as most states do), the interest typically would be taxable in your home state.

That's why many upper-income investors in high-tax areas often buy primarily bonds issued within their home state, or single-state bond funds. However, before deciding whether to limit yourself to a single-state strategy, check whether it would be better to diversify by buying out-of-state bonds, or funds packed with out-of-state bonds, even if it would mean paying additional tax.

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Among other issues to consider: Some munis ("taxable munis") pay interest that isn't tax exempt. Muni-bond income can affect how much of your Social Security benefits may be taxable. You may face capital-gains taxes from selling bonds or fund shares. Also, some munis pay interest that's subject to the alternative minimum tax (but many fewer taxpayers are ensnared by the AMT these days).

Tax-advantaged accounts

Focus on the many opportunities offered by tax-favored retirement accounts, says Sidney Kess, senior consultant at Citrin Cooperman and of counsel to the Kostelanetz & Fink law firm. These include individual retirement accounts, 401(k)s, 403 (b) plans and so-called 529 education-savings accounts. Many investors underestimate the importance of tax deferral.

Consider making maximum use of your employer plan. "And if your employer matches some or all your contributions, contribute at least enough to get all the matching dollars," says a Vanguard publication. "It's free money; don't pass it up." Thinking of donating to charity? Taxpayers 70½ or older typically may transfer as much as $100,000 a year directly from their IRA to qualified charities without including any of it as income. This so-called "qualified charitable distribution" counts toward fulfilling your required minimum distribution.

Taxable accounts

Pay attention to holding-period rules. "Short-term" typically means a year or less, while "long-term" generally means more than a year. Short-term capital gains are taxed at the same rates as ordinary income, which now can range as high as 37%. Long-term rates generally can be zero, 15% or 20%, depending on such factors as your taxable income and filing status. Many upper-income investors face an additional tax of 3.8 percentage points on net investment income, driving up their actual top rate for capital gains to 23.8%—and that's before state and local income taxes.

Separately, experts recommend the use of broad market index funds and exchange-traded funds, or ETFs, featuring low turnover and high tax efficiency.

Take advantage of capital-loss rules. They can transform lemons into lemonade. Losses can be used to soak up realized capital gains on a dollar-for-dollar basis, Mr. Kess says. When losses exceed gains, deduct as much as $3,000 a year ($1,500 if married and filing separately) from ordinary income. If you have remaining unused losses, carry them over into future years. While this strategy often attracts the most attention around the end of each year, financial advisers often urge clients to consider dumping losers throughout the year to avoid getting caught in the year-end rush.

Warning: To qualify to deduct the loss, don't buy the same stock or securities, or something "substantially identical," within 30 days of the sale. That 30-day period refers to 30 days before and after your sale, not just 30 days after. Don't try getting around the rule by acquiring the same thing, or something substantially identical, for an IRA within that time period. That won't work, the IRS says. (These "wash-sale" rules don't apply if you incurred the loss "in the ordinary course of your business as a dealer in stock or securities," the IRS says on its website.)

Another option: "tax-efficient" or "tax managed" mutual funds specifically designed to maximize after-tax returns, says Ms. Benz of Morningstar. These funds seek to avoid taxable capital-gain distributions by limiting turnover and other strategies.

Many investors would benefit by being more sensitive to the "staggering" drain that taxes can impose on taxable accounts, especially over long periods, says Don Peters, portfolio manager of the T. Rowe Price Tax-Efficient Equity Fund (PREFX).

Charitable giving

Don't make the mistake of donating investment losers to charity. Instead, sell them, nail down capital losses and donate the proceeds, Mr. Kess says. However, do consider donating investment winners that you bought more than a year ago and that have increased sharply in value. If you itemize your deductions, you can get a fair-market value deduction for your gift, and you don't owe capital-gains tax on it. (However, tax-law changes probably mean many more people are claiming the standard deduction these days, instead of itemizing).

Miscellaneous

Some wealthy investors, fund managers and real-estate developers are excited about tax incentives, enacted late in 2017, to invest in economically distressed areas, known as "Opportunity Zones," as my colleagues Richard Rubin and Ruth Simon have reported. ...Deciding how to sprinkle your investments among tax-favored and taxable accounts can be surprisingly tricky and may require seeking professional advice. Several funds, including Vanguard offer publications with helpful ideas on this and other aspects of tax-efficient investing.

Mr. Herman is a writer in New York City. He was formerly The Wall Street Journal's Tax Report columnist. Send comments and tax questions to taxquestions@wsj.com.

Appeared in the February 11, 2019, print edition.

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