

Tax-Smart Investing



You've probably heard the old tax adage, "it's not what you make, but what you keep that matters." That's particularly true when it comes to investing.

The IRS rules regarding investment taxation are complex and even small mistakes can result in steep penalties. Fortunately, there are a few simple steps you can take to cut your taxes and keep more money in your pocket.

1. Offset Gains and Losses

When you sell a profitable investment, you normally pay taxes on the gain. One way to reduce your taxes is to also sell some of your losing investments. You can then offset your gains and losses, wiping out all or a portion of your investment-related tax bill.

For example, let's say you have a \$1,000 gain on one stock, and a \$1,000 loss on another. If you sell only your profitable stock, you will owe taxes on the \$1,000 gain. But if you sell both stocks, your \$1,000 gain will be offset by your \$1,000 loss. That's good news from a tax standpoint, since it means you don't have to pay taxes on either position. Just watch out for the "wash sale rule," which precludes you from repurchasing the losing security within 30 days of selling it.

2. Mutual Fund Distributions

Calculating gains or losses from the sale of an individual stock is fairly straightforward. Your basis is simply the price you paid for the shares (including commissions), and the gain or loss is the difference between your basis and the net proceeds from the sale. However, it gets more complicated when dealing with mutual funds.

When calculating your basis in a mutual fund, it's easy to forget to include the dividends and capital gains distributions you reinvested in the fund. The IRS considers these distributions as taxable earnings in the year they're made. As a result, you have already paid taxes on them. By failing to add these distributions to your basis, you may end up reporting a larger gain than necessary when you ultimately sell the fund.

3. Use the Right Accounts

Investments that produce lots of taxable income or short-term capital gains generally should be held in tax-advantaged accounts, while investments that pay dividends or produce long-term capital gains should be held in traditional accounts.

For example, let's say you own 500 shares of General Electric (GE) and intend to hold them for several years. This investment will generate quarterly dividend payments and a long-term capital gain or loss when sold, both of which will be taxed at 15 percent or less. Since these shares already have favorable tax treatment, you gain very little by sheltering them in a tax-advantaged account.

In contrast, most bonds produce a steady stream of interest income. Since this income doesn't qualify for special tax treatment, you will have to pay taxes on it at your marginal rate. Unless you are in a very low tax bracket, holding these investments in a tax-advantaged account makes sense because it allows you to defer these tax payments far into the future, or possibly avoid them altogether.

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