REDUCE TAXES THROUGH PROPER INVESTMENT PLACEMENT

Published online at www.accountingtoday.com on April 1, 2014

By Steven Criscuolo and John Burke

Investors try to maximize investment returns while managing the level of risk in their portfolios. But only after-tax investment returns are truly available to the investor. Tax consequences should be considered before making any investments. Tax treatment, good or bad, can have a significant impact on an investment decision.

Investments come in many forms and can fall anywhere on the spectrum of tax efficiency. Portfolios should be structured according to the tax efficiency of particular investments, as well as to an investor's unique set of circumstances. Depending upon the availability of taxable and tax deferred investment account balances, the most tax efficient investments should be placed in taxable accounts, and the least tax efficient investments should be placed in tax deferred accounts. Investment placement should continue using tax efficiency criteria until all assets are placed.

Here are our top investment placement tax strategies to consider:

1. Municipal Bonds – The most widely known asset placement strategy is to purchase municipal bonds in a taxable investment account. Tax free at the federal, and possibly state and local levels (depending upon residency of the investor), municipal bonds typically offer a lower coupon payment because their returns are comparable to after-tax corporate bond returns in a taxable account. Municipal bond yields would typically be uncompetitive, and therefore inappropriate, in a tax deferred account.
2. Corporate Bonds – Conventional wisdom is to place corporate bonds in a tax deferred account because interest is taxed at ordinary income tax rates. However, this is typically less important in today's low interest rate environment, where the short term interest rate a company pays on its debt may be less than the dividend yield on its stock.
3. High Yield Bonds – What's generally true for corporate bonds is especially true for high yield bonds. These bonds pay high rates of interest in order to compensate investors for the higher level of default risk. Interest is taxed as ordinary income, unless these bonds are held in tax deferred accounts.
4. Real Estate Investment Trusts (REITs) – Given their unique tax structure, REITs typically pay relatively large dividends. A significant portion of these dividends is usually treated as "non-qualified," and is therefore taxed at ordinary income tax rates. Investors should try to hold REIT investments in a tax deferred account.
5. Foreign Stocks – Many overseas companies are required by their governments to withhold taxes on dividends paid to foreign investors. The rate of withholding varies by country, but currently ranges from 4.1% to 35% when it applies. U.S. investors can claim a credit on their tax returns for these foreign taxes, effectively recouping this lost dividend, but only if these investments are held in a taxable account.

6. Non-Qualified Dividends – Not all dividends are created equal. "Qualified" dividends are taxable at the favorable long term capital gain tax rates, whereas "non-qualified" dividends are taxable at unfavorable ordinary income tax rates. Dividends of certain foreign corporations, or domestic corporations with unique tax structures, pay non-qualified dividends. They should generally be held in tax deferred accounts.
7. Treasury Inflation Protected Securities (TIPS) – Issued by the U.S. Treasury, TIPS are notes and bonds with built-in inflation protection. Principal and interest payments are indexed to the rate of inflation as measured by the Consumer Price Index. Despite being tax free at the state and local level, TIPS are considered to be tax inefficient because both the interest and the inflation adjustment to principal are taxable as ordinary income for federal income tax. TIPS should generally be held in tax deferred accounts.
8. Precious Metals – Gold and silver are treated as collectibles and are therefore not eligible for the favorable long term capital gain tax rates. The federal tax rate for long term gains on collectibles is 28%. These investments should generally be held in tax deferred accounts.
9. Buy and Hold vs Actively Managed – Buy and hold portfolios have limited exposure to taxes. These investments can be held in taxable accounts. However, an actively managed portfolio with a steady stream of realized capital gains and losses, especially with the potential for short term gains, should generally be held in tax deferred accounts.

For investors with particularly small or particularly large, homogeneous portfolios, these strategies may be less important. But for the "mass affluent" investor, with say $1,000,000 in investable assets held across 401(k)s, IRAs and taxable accounts, asset placement strategies can make a meaningful difference in after tax returns, and ultimately in his or her quality of life during retirement.

The information contained in this report is not a complete summary or statement of all available data necessary for making an investment decision, and does not constitute a recommendation. The information has been obtained from sources considered to be reliable, but we do not guarantee that the foregoing material is accurate or complete. Any opinions are those of Burke Financial Strategies and not necessarily of RJFS or Raymond James. Investments mentioned may not be suitable for all investors. Be sure to contact a qualified professional regarding your particular situation before making any investment decision. Investing involves risk and you make incur a profit or loss regardless of strategy selected. Past performance may not be indicative of future results. Dividends are not guaranteed and must be authorized by the company's board of directors. You shoul discuss any tax matters with the appropriate professional.

Steven Criscuolo, CPA is Chief Financial Officer of Burke Financial Strategies and is a Financial Advisor. Before joining Burke Financial Strategies, Steve spent 20 years as Chief Financial Officer and President of three highly successful, medium-sized, privately held businesses, where he also provided investment advisory and estate planning services.

John Burke, CFP is President of Burke Financial Strategies, an independent firm, and is a Financial Advisor with and offers securities through Raymond James Financial Services, Inc. Member FINRA/SIPC. John has been advising clients and managing assets for 30 years. Throughout his extensive career, John has helped thousands of clients with financial planning and investment management. His firm currently has more than $210,000,000 of assets under management.