Understanding the taxability of investments

Managing your portfolio to help control your tax bill

Investors need to consider many factors in the process of choosing investments. One at the top of many investors' minds is an investment's tax cost. In fact, for some individuals, this issue may be among the more influential factors when selecting investments.

Capital gains taxes

The current long-term capital gains rates apply as follows:

- The 0% long-term capital gains rate applies for those in the 10% and 15% tax brackets.
- Taxpayers in the 25% through 35% tax brackets will have a 15% long-term capital gain tax rate.
- Taxpayers in the 39.6% tax bracket will pay 20% on long-term capital gains.

The following are some points to consider about the tax efficiency of different investments you may hold in taxable accounts. Taxpayers with modified adjusted gross income in excess of $200,000 for single individuals and $250,000 for married couples may also be subject to an additional Medicare surtax of 3.8% on net investment income. The appeal of some of these investments may change depending on whether you are subject to this additional tax.

Stocks

If your goal is tax efficiency, consider stocks geared more toward growth with a low dividend yield to reduce your current taxable income. The growth is tax-deferred until you sell the stock. This ability to defer tax provides some flexibility because you control when you trade your stocks. If you hold the stock for more than one year, the gain will be eligible for a lower long-term capital gain rate as opposed to the ordinary income tax rate.

If you need an income-producing stock, consider one that will pay dividends that qualify for the reduced qualified-dividend rates versus ordinary income rates. The rate for qualified dividends is the applicable capital gains rate. Bear in mind that dividends are not guaranteed. A company may reduce or eliminate its dividend at any time.

Qualified dividends are paid by U.S. corporations and some foreign corporations. A qualified foreign corporation is one that is incorporated in a U.S. possession, eligible for tax-treaty benefits with the United States or traded on an established United States securities market. Income from preferred instruments qualifies to the extent that it represents an equity instrument rather than a debt instrument. Mutual fund dividends do not qualify unless the dividends passed through are from qualified corporations, as described above. It's important to note that real estate investment trust (REIT) dividends do not qualify for the reduced rate.

The return and principal value of an investment in stocks fluctuates with changes in market conditions. Upon redemption, it may be worth more or less than the original investment.

Bonds

Municipal bonds, which state and local governments issue, pay interest that's exempt from federal income taxes — although some may be subject to the federal alternative minimum tax (AMT). The interest is also often exempt from state taxation if you purchase bonds issued by either the state in which you reside or a local government within that state. Although the interest income is tax-free, capital gains, if any, are subject to taxes.

Before purchasing a municipal bond, you must consider whether the tax-free interest is a big enough advantage to overcome the potential for higher yield that a taxable government or corporate bond may provide. To compare a tax-free versus a taxable bond, consider the taxable-equivalent yield. Generally, a municipal bond with a 3% yield, for example, would compare to a corporate bond with a 4% equivalent yield (assuming you are in the 25% income tax bracket and excluding state tax). A decision between these two bonds might still favor the tax-free bond because the taxable bond would add to adjusted gross income (AGI) and the calculations related to AGI and AMT.

In addition, tax-free municipal bond interest is not included in investment income for the 3.8% Medicare surtax. Interest from taxable bonds is included for the tax computation.

Investing in fixed income securities involves certain risks, such as market risk, if sold prior to maturity and credit risk, especially if investing in high yield bonds, which have lower ratings and are subject to greater volatility. All fixed income investments may be worth less than original cost upon redemption or maturity. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline of the value of your bond investment.

Mutual funds

You may be able to reduce your taxes by choosing funds that have historically been managed with low turnover and minimal yields. The yield will provide an indication of the amount of interest and dividend distributions. The turnover ratio measures the fund's trading activity. Funds with higher turnover ratios typically distribute more capital gains, which are taxable to the investor whether they are paid out or reinvested. To help evaluate the effects of taxes on mutual fund returns, use Morningstar's Tax Cost Ratio, which represents the percentage reduction in an annualized return that results from income taxes. This can provide an estimate of how much of your investment return you would lose to taxes.

This type of planning can provide some guidance on the taxability of the annual distribution. However, the fund manager's actions will ultimately determine the capital gains distributions for the year, which can have significant tax implications. Of course, as with any financial decisions, investment considerations should take priority over tax issues.

There are risks associated with investing in mutual funds. Your investment return and principal value will fluctuate, and you may receive more or less than your original investment when you redeem your shares.

Annuities

If you invest in a deferred annuity in a taxable account (nonqualified annuity), you can defer taxes on income earned. However, unlike a qualified retirement plan contribution, you receive no income tax deduction for contributions made to the annuity. The earnings on the investment are deferred until the money is withdrawn, which in many cases is during retirement.

This tax deferral is a benefit for investors who believe they will be in a lower tax bracket during their retirement years. An annuity investment has the opportunity to grow more if you do not withdraw assets each year to pay taxes. Of course, the impact of these tax benefits may be offset somewhat by an annuity's internal insurance and administrative expenses. Annuities bear some risk associated with the issuer's credit worthiness.

Upon withdrawal, the earnings portion of an annuity is taxed as ordinary income rather than as a capital gain. With a few exceptions, a 10% IRS penalty will apply to the earnings if they are withdrawn prior to age 59½.

Annuities' various payout options generally provide some ability to manage the timing of taxable income. For example, if you take a partial or lump sum distribution, the earnings withdrawn will be taxable. With this type of payout, the distribution is deemed to come first from earnings and then from principal for tax purposes.

The investor may also choose to annuitize. In this scenario, the investor receives substantially equal payments over a period of time, which may be life. For tax purposes, each payment includes a tax-free portion that's a return of principal (until it is completely paid out) and a portion that's taxable earnings.

An annuity may offer the tax-planning benefits you are looking for, but keep this in mind: *Annuities are intended to be long-term investments and may not be suitable for all investors. Your principal and investment return in a variable annuity will fluctuate in value. Your investment, when redeemed, may be worth more or less than the original cost.* Also consider these important points before investing in an annuity:

- Your age, tax bracket, and time horizon for the investment
- The tax penalty for early withdrawal
- The potential for surrender charges

Master limited partnerships

Master limited partnerships (MLPs) are publicly traded partnerships. Each investor purchases units of the MLP and is considered a limited partner in the partnership.

One advantage of MLPs is their potential for regular cash distributions that compare favorably to other income-producing investments. Unlike other income-producing investments, distributions are generally treated as a tax-free return of capital and not current taxable income. This tax treatment may also have an added benefit for investors paying income tax on Social Security benefits. By substituting MLP units for other income-producing investments, provisional income may be reduced enough to effectively lower the Social Security benefits subject to income tax.

These advantages do not come without a cost. The tax treatment of MLPs is much more complex than that of most investments. After year-end, the investor receives a Schedule K-1 showing income and expenses of the MLP that must be reported on the investor's own tax return, even if there are no corresponding distributions of cash flow. Usually, the cash distributions exceed the K-1 income. The difference between annual cash distributions and K-1 income is due largely to a reduction in income for depreciation or depletion. In the year the MLP units are sold, the cumulative amount of these depreciation or depletion deductions is taxed as ordinary income.

In some cases, the amounts on the K-1 from operations for the year may actually indicate an overall loss. However, this loss is not deductible in the current year. The loss may be used in future years, but only against net income earned by the same MLP that generated the original loss. Any remaining loss becomes fully deductible when all partnership units are sold.

Tax reporting for MLPs is very complex. Typically, investors may need to file for an extension and may be required to file multiple state tax returns. Due to the complexity of the tax preparation and potential for additional costs, investors should talk with their tax advisors before choosing this type of investment.

Risk factors that could lead to MLP investments underperforming the overall stock market include rising interest rates, inability to access external capital to fund growth, a decline in metal or oil and gas prices, an adverse regulatory environment, terrorist attacks on energy infrastructure and an overall economic downturn. You could lose all or a substantial amount of your investment.

Master limited partnerships (MLPs) are not appropriate for all investors, and are particularly not appropriate for tax-deferred or tax-free retirement accounts. Also, an MLP shareholder, i.e. a limited partner unit holder, receives a K-1 instead of a 1099. Investors should contact their tax accountant for further tax implications before investing in MLPs. Wells Fargo Advisors is not a legal or tax advisor.

You can count on us

Your Financial Advisor can help you manage your portfolio tax efficiently. To get started, contact him or her about a portfolio review, which will analyze your investments in terms of your risk tolerance, time horizon, and objectives, as well as the tax implications.

Exchange-traded funds

Exchange-traded funds (ETFs) are mainly passively managed portfolios designed to track the performance of a certain index or basket of stocks. They trade on a stock exchange like a stock but share many attributes with mutual funds. Like many mutual funds, there are ETFs that are limited to certain kinds of stocks, such as healthcare or technology. Unlike a mutual fund, each stock in the ETF is supposed to remain at a certain percentage of the overall ETF portfolio; occasionally, stocks are automatically sold if they have appreciated or bought if they have depreciated to balance the ETF to achieve the prescribed percentages. However, with the expansion of the ETF market, some issuers have now introduced actively-managed ETFs. These may be less tax-efficient than their passively managed predecessors.

ETFs are generally tax-efficient investments. Because they typically have low turnover, they generally produce little or no capital gains; capital gains are usually realized only when a change in the underlying index is made or when the ETF's stocks are rebalanced. In addition, ETFs do not have to sell stock to meet investor redemptions, thereby avoiding taxable gains. Given their low expense ratios and tax-efficient nature, ETFs may be well suited for long-term, diversified equity exposure. However, there is one additional point to consider: Because ETFs share an underlying basket of stocks, similar to mutual funds, the dividends they pay may not qualify for the reduced tax rate. The tax treatment will depend on the nature of the underlying stocks that paid the dividends.

There are risks associated with investing in ETFs. Your investment return and principal value will fluctuate, and you may receive more or less than your original investment when you redeem your shares.

Look at the whole picture before you invest

Though our focus here is on tax-efficient investing, remember that just because an investment offers tax advantages doesn't necessarily mean it's appropriate for your portfolio. However, it is a factor to consider — especially if you're in one of the higher tax brackets. Before you invest, you need to consider your goals regarding return and risk as well as your time horizon. It's only by taking all of these factors into consideration that you can determine whether a particular investment is right for you.

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