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Your Guide to Tax-Efficient Investing

Be aware of how taxes affect your investments, but don't let the tail wag the dog.

In early February U.S. investors typically receive their 1099 Forms, reporting income from brokerage accounts. Often, those weeks leading up to April 15 are the only time of year when Americans give much thought to their taxes. However, investors can improve returns by applying year-round strategies to minimize their tax burden.

At the outset, investors should consider their plan for any given investment. The investment objective often determines how a portfolio is structured for optimal tax efficiency.

Many investors hold tax-deferred retirement accounts, such as a 401(k) or individual retirement account. Until the account owner withdraws money from one of these qualified accounts, he or she enjoys portfolio gains without having to pay taxes. A Roth IRA requires no taxes on withdrawals, since account contributions are made with after-tax dollars.

However, taxable events do occur in nonqualified brokerage accounts, and that's where a tax strategy becomes crucial. In these accounts, any earnings, such as dividends, are taxable for the year in which they are received. In addition, investors pay a higher tax on gains from an investment held less than one year. The tax code favors investors with capital gains on investments held more than one year, known as long-term capital gains.

Because of the potential tax consequences, it's necessary to have a plan for your money at the time you invest, says Kevin Kelly, managing partner and chief investment officer at Recon Capital Partners, headquartered in Greenwich, Connecticut. If money is earmarked for some specific purchase in the future, or just to finance normal life expenses, investors can take capital gains into account upfront.

"You have to decide how much you need in cash flow, and when you need your capital back," he says. "Do you need your capital back in one year, or can you sit in the investment for three years or five years?" Those different time frames would have an impact on taxes owed on withdrawals.

Lloyd Grissinger, managing director at the Memphis, Tennessee, office of accounting firm CBIZ, says if an investor needs his or her money within a few years, it's often best to use a taxable account. If the investor's time horizon is longer, the tax-deferred structure is usually preferable.

Because of capital gains consequences, the timing of stock transactions is also critical. Beyond the question of whether a sale would incur a long- or short-term capital gain, investors should consider how it would affect their tax bill in a particular calendar year, Grissinger says. In some cases, it may make sense to wait until January to sell a stock, pushing the capital gains tax into the following year.

"I went through this myself late last year. There were a couple holdings I wanted to sell, and fortunately they had some pretty good gains. I decided to sell in early January and defer the gain until next year," he says.

Grissinger points out that there is risk to this strategy. For example, an investor with a particularly volatile stock may want to pocket profits sooner, rather than wait and risk a price decline.

There's also a way to develop a tax strategy if you have portfolio losses. Using tax-loss harvesting, an account owner would sell an investment where value has fallen below its purchase price. This creates a capital loss that can offset capital gains and decrease an investor's tax bill. If you take the further step of replacing the investment that fell with something similar, you can maintain your predetermined portfolio balance.

Grissinger cautions that investors must be aware of what's called the wash-sale rule. "If you harvest a loss, you can't buy the same security back right away," he says. "You have to wait 30 days to buy it back, or you can roll into a similar type of investment."

For example, if an investor has a loss in a technology stock, he or she can maintain that sector exposure through an exchange-traded fund that tracks a technology index.

On the fixed-income side, municipal bonds can offer tax efficiency. Municipal bonds are simply debt issued by city, county or state governments, Grissinger says. Municipal bondholders are exempt from paying federal income tax on interest earned. Many states also offer an income-tax break on municipal bonds purchased by state residents.

Mutual fund holdings are also an area in which investors can eke out tax efficiency. That's particularly true for funds held in taxable accounts.

Donna Skeels Cygan, owner of Sage Future Financial in Albuquerque, New Mexico, and author of "The Joy of Financial Security," has been reviewing actively managed funds in nonqualified accounts, with an eye for after-tax returns.

"I'm looking at these on a one-, three- and five-year basis, using Morningstar data, comparing after-tax returns to passive index funds that could replace those actively managed funds, if justified," she says.

Typically, mutual funds that track indexes are less likely to distribute taxable gains to investors.

Kelly says investors should seek tax-efficient investments within their portfolios. He notes ETFs generally track an index, which minimizes trading. In addition, the structure of an ETF means investors are not subject to capital gains of any underlying components.

"That's one of the reasons why you're seeing a move from actively managed mutual funds toward ETFs. They are lower-priced products and tend to be more tax-efficient. You don't have surprises on your 1099 at the end of the year. That's why you see big firms like Vanguard and iShares really touting those advantages," he says.

Cygan emphasizes that overall investment philosophy should never take a back seat to tax considerations.

"Sometimes I see people with portfolios that are very concentrated in a stock. It may not even be performing well, but they are resistant to sell because it may trigger a capital gain. That's an example of the tax tail wagging the investment dog, which should never happen," she says.

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