6 Ways to Lower the Taxes on Investment Portfolios

and Put More Money in Your Pocket

How many of us save and invest with an eye on tax implications? Not too many, according to a recent survey. Just 35% were interested in tax-sensitive investment strategies. The other 65% were apparently happy with paying more taxes. Oh well. For the rest of us who take pride in legally paying less taxes with tax-smart strategies, here you go:

#1 Municipal Bonds – AKA Munis

Municipal bonds are issued by state and local governments and their agencies to fund capital expenditures on public projects, like schools, bridges, or hospitals.

The chief advantage of investing in munis is that the interest income is exempt from federal income taxes and often state and local taxes as well.

The investor's tax bracket is important when deciding whether municipal bonds are a good investment or not. The higher your tax-bracket, the better benefit you receive. Tax-free munis can be very appealing.

#2 Tax-Deferred Annuities

There are safe and secure ways to delay the impact of taxes on your savings. In a taxable vehicle like a CD or money market account, you must pay taxes on your earnings each year. But in a tax-deferred account, like an annuity, earnings are free from taxation until withdrawal. It makes good economic sense to delay paying taxes until you need the money.

Annuities come in all shapes and sizes and are offered by hundreds of insurance companies. Seek expert financial advice from a well-qualified, experienced investment professional before purchasing an annuity. To learn more about annuities, go to GreatInvestor.org and download the FREE booklet called "Retirement Money Deserves a Good Home" or listen to the podcast on annuities.

#3 Tax-Managed Equity Mutual Funds

Some mutual funds are managed specifically to minimize the investor's tax burden by using strategies like:

- Holding stocks for an extended period of time to avoid short-term capital gains.
- Avoiding dividend paying stocks.
- Offsetting capital gains with losses.

Tax-managed mutual funds put you in control of when you incur taxes on gains because they deliver most of their capital gains in the form of unrealized gains, which simply means you don't pay taxes until you sell your shares of the fund.

#4 Index Funds

Index mutual funds are tax efficient because of their low turnover. Index funds simply replicate the holdings of an index like the S&P 500, which means they do very little trading – therefore, there are minimal costs, fees, and taxes. By virtually eliminating short-term capital gains (which are taxed at a higher rate), index funds can help investors lessen the tax bite from Uncle Sam.

#5 Retirement Accounts*

Among the biggest benefits available to most investors are the deferral benefits offered by retirement savings accounts such as 401(k)s, 403(b)s, and IRAs. These accounts can offer a double dose of tax advantages – the contributions you make may reduce your current taxable income, saving you cash this year, and any investment growth is tax deferred, saving money while you are invested. What's more, saving in these accounts can help lower your adjusted gross income, and that could help you avoid income limits for additional tax credits and deductions.

Generally, the first step to tax-advantaged savings should be through workplace savings plans, IRAs, or both.

Take full advantage of any company match.

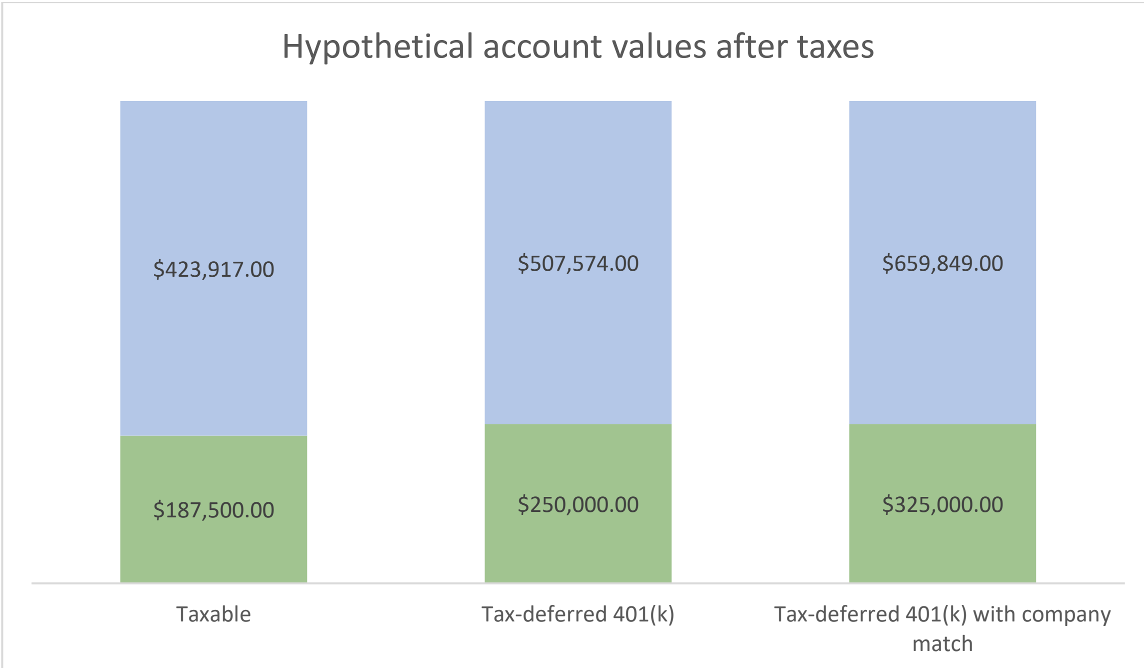
If you have a 401(k), 403(b), or governmental 457(b) plan and your employer offers a matching retirement contribution, take full advantage of it. In addition to receiving the company match, you get the added potential benefits of any tax-deferred growth and compounding returns.

Let's say, hypothetically, your company offers a match of 50 cents on every $1 you contribute, up to 3% of your salary. If you make $60,000 a year and contribute 3%, or $1,800, and your company kicks in another $900, your annual contribution could add up to $2,700. Assuming a hypothetical compound annual growth rate of 7%, your savings could grow to more than $37,000 in ten years.

Saving in a tax-deferred account has the potential to let your balance grow faster, and taking advantage of an employer match makes workplace retirement savings an important part of a tax strategy. This hypothetical scenario compares the value of saving $10,000 a year for 25 years in a taxable account, a tax-deferred 401(k), and a tax-deferred 401(k) with an annual match of $3,000.

(This scenario assumes a 7% annual return.)

* Source: Fidelity.com



#6 Roth 401(k) and Roth IRAs

Roth 401(k)

Companies may offer a Roth 401(k) in addition to a traditional 401(k) option.

Taxes

The main difference between the Roth 401(k) and the traditional is when the money is taxed. Roth 401(k) contributions are made with after tax dollars, so you do not receive a tax break today. However, the balance of your Roth contributions and earnings are not taxed when you take a qualified distribution when you retire.

Contribution limits

The contribution limit for 2020 is $19,500, or $26,000 if you're 50 or older.[**] (This does not include employer match.)

Employer match

Make sure you invest at least enough to take advantage of your full company match. The company match works a little differently with Roth 401(k)s, though. According to the IRS, your employer can only allocate your designated Roth contributions to your designated Roth account. Any employer contributions to match designated Roth contributions must be directed into a pretax account, just like matching contributions on traditional, pretax 401(k) contributions.

[**] Sources: Morningstar and CNN Money

How is a Roth IRA Different Than a Traditional IRA?

The main difference between the two types of IRAs is when you pay taxes on your investments, traditional IRAs can delay the taxes until retirement, but with Roth IRAs you pay tax now rather than later.

Here's how it works: With a Roth IRA, there is no up-front tax break, but you don't have to pay tax on withdrawals in retirement. That's the opposite of a traditional IRA, which may allow you to deduct at least part of your contributions if you qualify, but requires you to pay income tax on money you withdraw in retirement. Both accounts allow investments within them to grow without getting clipped by taxes each year.

There are other differences, too.

Roth IRAs offer a bit more flexibility than traditional IRAs do. You may withdraw your contributions to a Roth IRA penalty-free at any time for any reason (but you'll be penalized for withdrawing any investment earnings before age 59½, unless it's for a qualifying reason). If you converted money from a traditional IRA into a Roth IRA, you can't take it out penalty-free until at least five years after the conversion.

Roth IRAs also let you leave your money untouched for as long as you like. With a traditional IRA, you *must* start making withdrawals called "required minimum distributions" after you reach age 72. You can keep contributing to a Roth and regular IRA regardless of your age if you still have earned income.

I truly love the advantages of a Roth. Why? Taking my money out and the gain at a later date tax-free is extremely attractive!

So, there you have it, 6 ways to lower the taxes on your investment portfolio and put more money in your pocket.

Feel free to share our website, GreatInvestor.org with your friends and family, so they can learn how to be a great investor. Please like us on Facebook.

Thanks, and Blessings,

Richard Everett

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