Taxes and investing:
How to be a “tax-conscious” investor

“I want you!” goes the slogan on that old Uncle Sam recruiting poster. He also wants you to pay taxes. On the income from your employment. On what you earn from many of your investments. On a portion of the gain from the sale of those investments.

But there is a difference between the need to pay tax and paying more than your fair share. By being “tax conscious” as you consider your investment choices, it is possible to lower the overall amount of tax that you will have to pay.

Tax-deferred retirement plan investments

As you know, if you are a participant in a 401(k) or similar retirement plan (or if you own an IRA), the income that you earn from these investments is tax deferred. The same is true for the income earned on the investments in an IRA. Tax deferral has the major advantage of allowing your investments to grow significantly over time. Therefore, when you are years away from retirement, you have the opportunity to accumulate a significant sum.

Thus, it make sense to take advantage of tax-deferred retirement plans. However, it is important to recognize that, at some point, tax deferral will end, and tax will have to be paid. Keep in mind, too, that, in most cases, the tax will be paid at ordinary income tax rates—instead of receiving preferential treatment as long-term capital gain.

Should you consider tax exempts?

The answer is different for different investors. Tax-exempt investments yield a lower annual return than taxable investments. The logic of investing in tax exempts, then, rises and falls on making certain that the income from the lower yield will provide you with more than the after-tax return that you would receive from a taxable investment.

Certainly, high-income taxpayers will find a place in their portfolios for tax exempts. However, in light of lower income tax rates, the answer may become less clear-cut. Thus, investors should seek professional guidance before deciding whether they should be considering tax-exempt investments.

Taxes and mutual fund investing

The tax rules for buying and selling mutual funds are the same as for your other investments, but there are some added complications.

Fund managers regularly trade stocks and bonds, realizing gains and losses along the way. A mutual fund must distribute all of its income and net realized capital gains. You may

reinvest these distributions in additional shares rather than take them in hand. Nevertheless, you are responsible for the taxes on the distributions—the income earned as well as the short- and long-term capital gain realized.

The complications may turn out to be even more frustrating. For instance, a distribution may be made in a year in which the overall fund price has declined. What's more, distributions declared during the last three months of the year, but not paid the following January, are taxable in the year that they were declared.

Most mutual funds will report the projected timing and amount of an upcoming distribution. One way that you can protect yourself is to find out before you purchase a fund when it plans to make its next distribution.

A strategy for the "tax-conscious" investor

What can you do to adopt the role of tax-conscious investor? Consider the following steps:

1. Put taxes on the list of considerations in developing your investment strategy and making your investment choices.

2. Look carefully at your trading habits. For instance, limiting your transaction activity in taxable mutual fund investments helps limit the capital gains from the sale of your shares—reducing your tax exposure.

3. Keep track of your investment gains and losses during the year. If you are realizing gains during the year, for example, you'll want to look for potential losers to sell before December 31. By balancing your gains against your losses, you may be able to wipe out some otherwise taxable gain.

4. You may want to look at tax-efficient or tax-managed mutual funds—those that are designed to use special strategies to limit capital gains distributions. Funds such as large-cap or broad-market index funds fall into this category.

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Any developments occurring after January 15, 2007, are not reflected in this article.