WILLMS, S.C.

MEMORANDUM

TO: Clients and Friends of Willms, S.C.

FROM: Willms, S.C.

DATE: October 19, 2018

RE: Tax Planning for Investment Portfolios

Tax Planning for Investment Portfolios
By Andrew J. Willms

Fall has arrived in all its colorful splendor. This means that the end of the year is closer than many of us would like. It also means that there is no time to waste if you want to act to lower the taxes on the investment returns you collected during the year. This post will provide you with information you will need to do so. We begin with an overview of the various taxes state and federal governments impose on investment portfolios, and conclude with a list of steps you can take to lower (and perhaps eliminate) those taxes. Let's get started!

Taxation of Capital Gains

As you undoubtedly know, the federal government and most state governments impose income taxes on the appreciation in a security when the security is sold. More specifically, "realized capital gains" are equal to the sale proceeds minus the amount paid when the investment was acquired (referred to as "tax basis").

Capital gains are broken into two categories: long term and short term. Long term capital gains are gains on investments held for one year or longer, while gains on investments with a holding period of less than one year are short term.

Long term and short term capital gains are taxed at different rates. Short term capital gains must be included in the investor's income for the year in which the sale occurs, and are taxed at ordinary tax rates. Long term capital gains, however, are taxed at a lower "capital gains rate" in an effort by Congress to encourage long term investment. Here are the long term capital gain tax rates for 2018:

Long Term Capital Gains Tax Rate	Single Filing Status	Married Filing Jointly	Head of Household	Married Filing Separately
0%	$0-$38,600	$0-$77,200	$0-$51,700	$0-$38,600
15%	$38,601-$425,800	$77,201-$479,000	$51,701-$452,400	$38,601-$239,500
20%	$425,801 or more	$479,001 or more	$452,401 or more	$239,501 or more

Taxation of Dividends

Dividends are also grouped into two categories for income tax purposes: "qualified" and "ordinary". Dividends paid by a U.S. corporation are generally qualified, so long as you owned the stock for more than 60 days.[1] All other dividends are considered to be ordinary dividends. Qualified dividends are taxed at the same rates as long term capital gains while ordinary dividends are taxed at the same rates that apply to ordinary income.

Taxation of Bond Interest

The taxation of bond interest depends on the type of bond on which the interest is paid.

1. **Government Bonds** are bonds issued by the federal (not state) government and by federal government agencies. Government bonds are generally not subject to state income taxes.

2. **Municipal Bonds** are bonds issued by states and municipalities. Municipal bonds are generally not subject to federal income taxes, and typically avoid state income taxes as well if the investor lives in the same state or municipality as the issuer.[2] Puerto Rico bonds are also exempt from state income taxation regardless of where the taxpayer resides.

3. **Corporate Bonds** refers to bonds issued by public companies. Interest paid on corporate bonds is fully taxable.

[1] More precisely, for dividends to be "qualified", you must own the stock that generates the dividend for more than 60 days during the 121-day period that began 60 days before the ex-dividend date. For preferred stock that pays annual dividends, you must own the stock for 90 days in a 181-day period that begins 90 days before the ex-dividend date. Are we having fun yet?

[2] Iowa, Illinois, Oklahoma, Utah and Wisconsin tax their residents on locally issued municipal bonds to varying degrees. A description of the types local municipal bonds that are taxable to Wisconsin residents can be found here: https://www.revenue.wi.gov/Pages/faqs/pcs-munifaq.aspx

Generally speaking, taxable bond interest is included in the investor's ordinary income in the year it is received.[3] However, in the case of zero-coupon bonds, which do not pay interest but rather are issued at a discount to their maturity (or "par") value, a pro-rata share of the discount is reported as income by the taxpayer each year until the bond matures.[4]

Tax on Net Investment Income

The "Net Investment Income Tax" ("NIIT") is an additional tax that applies to all forms of investment income (capital gains, dividends and interest). The tax is imposed at a flat 3.8% on all investors whose income exceeds the following thresholds:

Tax Filing Status	NIIT Threshold
Single	$200,000
Married filing jointly or qualifying widow(er)	$250,000
Head of household	$200,000
Married filing separately	$125,000

Strategies to Lessen the Impact of Taxes on Portfolio Performance

The combined impact of the taxes described above can result in you sharing a significant portion of your investment returns with state and federal governments. Compounding serves to magnify the negative impact of taxes on portfolio returns. That's because money pulled from a portfolio to pay taxes cannot be reinvested. This means that not only the money paid to the government is lost to taxes, but also the earnings that would have been generated had those funds been invested. Fortunately, there are a number of steps you can take to lessen the impact of taxes on your investment returns.

1. **Be selective when recognizing capital gains**. All other things being equal, investments that have been held for a year or longer should be sold before those held for less than a year, and investments with a high tax basis should be sold before those with a low tax basis.

2. **Select your investment strategy carefully**. An investment approach that results in a high number of trades has the potential to trigger greater capital gains than one that

[3] The formula for comparing a municipal bond's yield to a taxable bond yield is: Taxable Equivalent Yield = Tax-Free Yield/100 -Your Tax Bracket.
[4] Similarly, if bonds are purchased at a premium (greater than $1,000 per bond), a prorated portion of the amount over par can be deducted yearly on the purchaser's tax return.

trades less frequently, and worse yet, can trigger greater short term capital gains. Accordingly, for taxable accounts, investment strategies that result in fewer trades are preferable to one that is more active. Tax-favored investment accounts, such as qualified plans, IRAs, Roth IRAs, and 529 accounts are better suited to investment strategies that generate frequent trades. Likewise, municipal bonds are best suited to taxable accounts because their tax benefits are wasted if held in a qualified plan, IRA or Roth IRA.

3. **Tax loss harvesting**. Realized capital losses can be subtracted from capital gains, even if those gains are realized years later, provided the same security is not repurchased within 30 days. As a result, "harvesting" capital losses by selling a position at a loss and reinvesting the proceeds in a similar, but not identical, investment can be an effective strategy to lower taxes on current year or future capital gains, without materially affecting the portfolio's returns.

   Example: Penny Wise owns an exchange-traded fund with an unrealized capital loss that tracks the S&P 500 index. Penny could sell this ETF to harvest the loss, and reinvest the sale proceeds in a different ETF that tracks an index that's very similar to the S&P 500 index.

4. **Don't forget about the basis step up at death.** Investments that are includable in a deceased person's estate for estate tax purposes receives a basis adjustment for federal income tax purposes even if the decedent's estate is not large enough to trigger an estate tax. This adjustment results in an heir's income tax basis on inherited investments being either "stepped up" or "stepped down" to the property's fair market value at the date of the decedent's death.[5] As a result, elderly investors who are not leaving their estates to charity should be especially reluctant to recognize capital gains, and should look for opportunities to harvest capital losses.

It is very important to keep in mind the foregoing suggestions assume tax rates remain constant. Changing tax rates could have a major impact on the effectiveness of these suggestions. For example, if tax rates are expected to rise, it may be advantageous to accelerate the recognition of capital gains before the rate hikes take effect, and wait until after the rate hikes take effect to recognize losses.

Supreme Court Justice Learned Hand once said "Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes or a public duty to pay more than the law demands."

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[5] An exception to this rule is "income in respect of a decedent" (or "IRD"), which is earned income that has not yet been taxed (i.e., retirement accounts, IRAs, annuities, deferred compensation, etc.). IRD does not receive a basis adjustment when the owner dies.

Hopefully this post will help you lessen the taxes paid on your investment returns, and thereby make you a better investor. If you are interested in investing and portfolio management I invite you to subscribe to "The Market Commentator" which is my blog on a variety of investment topics. You can do so here: https://themilwaukeecompany.com/blog/

Thank you.

End of Memorandum