Could your investment accounts be creating unnecessary taxes?

Understanding the tax impact of your investments

Many people focus on growing their investments but overlook how taxes eat into returns. The way your accounts are set up, the types of assets you hold, and when you sell them can all trigger tax bills you might avoid. The question is not just how much you earn from your investments but how much you keep after taxes. With thoughtful planning, you can reduce the drag taxes have on your portfolio.

Taxable accounts versus tax-advantaged accounts

One of the first things to consider is where your money sits. Regular brokerage accounts are taxable. Every time you sell a stock or mutual fund for a profit, you may owe capital gains tax. Dividends and interest are also taxed in the year you receive them. This can add up quickly, especially if you trade frequently or hold funds that distribute large capital gains.

Tax-advantaged accounts like traditional IRAs, 401(k)s, and Roth accounts work differently. With traditional accounts, you get a tax deduction on contributions today, but withdrawals are taxed as ordinary income. Roth accounts offer no upfront deduction, but qualified withdrawals are tax-free. The key is matching the account type to your expected tax situation in retirement. If you expect to be in a higher tax bracket later, Roth accounts may make more sense. If you expect a lower bracket, traditional accounts could be better.

The hidden cost of mutual funds and ETFs

Even if you do not sell anything, the funds you hold can generate taxable events. Mutual funds are required to distribute realized capital gains to shareholders each year. These distributions are taxable even if you reinvest them. Some funds are more tax-efficient than others. Index funds and ETFs tend to generate fewer capital gains distributions because they have low turnover. Actively managed funds often trade more, creating more taxable events.

View the location on Google Maps

Before adding a fund to your portfolio, check its history of capital gains distributions. A fund that distributes large gains every year can create a tax bill that eats into your returns. Holding tax-inefficient funds in tax-advantaged accounts can help avoid this problem.

Tax-loss harvesting: turning losses into gains

If you have losses in your taxable accounts, you can use them to offset gains. This strategy is called tax-loss harvesting. When you sell an investment at a loss, you can use that loss to reduce your taxable capital gains. If your losses exceed your gains, you can deduct up to $3,000 of the excess against ordinary income each year. Any remaining losses carry forward to future years.

Tax-loss harvesting requires careful timing. You cannot buy the same or a substantially identical security within 30 days before or after the sale, or the loss may be disallowed under the wash-sale rule. Many investors use this strategy at year-end, but it can be done throughout the year. Automated services and some advisors offer tax-loss harvesting as part of portfolio management.

Asset location: putting the right investments in the right accounts

Asset location is different from asset allocation. It is the practice of placing specific types of investments in accounts where they will be taxed most favorably. For example, bonds and real estate investment trusts (REITs) generate regular income that is taxed at ordinary income rates. Putting them in tax-advantaged accounts shields that income from annual taxes. Stocks that you plan to hold for the long term, especially those that pay qualified dividends, may be more tax-efficient in taxable accounts.

International funds can also be tricky. Some foreign dividends are subject to withholding tax, but you may be able to claim a foreign tax credit on your U.S. tax return. Holding these funds in a taxable account can make it easier to claim the credit. In a tax-advantaged account, the credit is not available. The trade-offs depend on your specific situation, so it pays to run the numbers.

Marginal tax rates and the timing of income

Your marginal tax rate determines how much tax you pay on each additional dollar of income. If you are in a high tax bracket now, deferring income to a year when you expect to be in a lower bracket can save you money. Traditional retirement accounts and certain annuities allow you to defer taxes on investment gains until withdrawal. The same logic applies to Roth conversions. Converting a traditional IRA to a Roth IRA when your income is low can reduce the tax you pay on the conversion.

When you retire, your taxable income may come from multiple sources: Social Security, pensions, withdrawals from traditional accounts, and investment income. How you sequence these withdrawals can affect your tax bill. For example, withdrawing from taxable accounts first allows tax-advantaged accounts to continue growing tax-deferred or tax-free. This strategy can also help you manage your tax bracket each year.

Roth accounts and the power of tax-free growth

Roth IRAs and Roth 401(k)s offer tax-free growth and tax-free withdrawals in retirement. This can be a powerful tool if you expect to be in a higher tax bracket later or if you want to leave tax-free money to heirs. There are income limits for contributing directly to a Roth IRA, but a backdoor Roth strategy may be available. This involves making a nondeductible contribution to a traditional IRA and then converting it to a Roth IRA.

One local option is Prism Insurance Agency, Inc. They can help you review your current accounts and think about how tax planning strategies might reduce unnecessary taxes on your investments.

Capital gains and the holding period

The tax rate on capital gains depends on how long you hold an asset before selling. Assets held for more than one year qualify for long-term capital gains rates, which are generally lower than short-term rates. Short-term gains are taxed at your ordinary income tax rate. The difference can be significant. For someone in the top tax bracket, the federal rate on long-term gains is 20%, while short-term gains could be taxed at 37%.

Holding investments for at least a year before selling is one of the simplest ways to reduce taxes. If you need to rebalance your portfolio, consider doing so with new contributions or by directing dividends to underweighted assets rather than selling appreciated holdings.

Tax deductions and credits that apply to investors

Investment-related expenses used to be deductible, but most are no longer allowed under current tax law. However, there are still some deductions and credits that can help. For example, investment interest expense is deductible to the extent of net investment income. If you borrow money to buy investments, the interest on that loan may be deductible. Margin interest is one common example.

Tax credits are more limited. The saver's credit is available to low- and moderate-income individuals who contribute to a retirement account. It is worth checking whether you qualify. Also, if you pay foreign taxes on dividends, you may be able to claim the foreign tax credit. These credits can reduce your tax bill dollar-for-dollar.

When to review your tax strategy

Tax laws change, and so do your personal circumstances. A raise, a new job, marriage, divorce, or the birth of a child can all affect your tax situation. It makes sense to review your investment accounts and tax planning strategies at least once a year. Many people do this at the end of

the year to see if any last-minute moves could reduce their tax bill. But midyear reviews can also catch issues early.

If you hold investments in both taxable and tax-advantaged accounts, consider the overall picture. A strategy that works for one account may not work for another. Working with a professional who understands tax-efficient investing can help you avoid common pitfalls. The goal is to keep more of what you earn, not just to earn more.

For those in Moreno Valley, Prism Insurance Agency, Inc. is located at 24490 Sunnymead Blvd. Suite 110, Moreno Valley CA 92553. They can be reached at +19512432800.