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High Class Problems

Volatility and strong markets last year will likely deliver a hefty tax bill come Tax Day. Since paying taxes is only slightly more appealing than incurring large losses for many investors, this may not come as good news to all.

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It's that time of year. Snow is melting, March Madness is approaching, and springtime rains will soon pave the way for May flowers. It's also when most Americans compile endless paperwork, organize receipts, and meet with tax professionals to prepare for Tax Day in mid-April.

For many investors, paying taxes is only slightly more appealing than incurring large losses. Adding to the pain, the volatility and the meteoric rise in many investments last year will likely force several investors to pay more in taxes than ever before. That's likely why there has been increased interest in investment strategies that aim to reduce tax liabilities.

But it's not as easy as picking the most tax friendly investments. There is often a tradeoff between what's best for your tax bill today and financial goals tomorrow. Therefore, let's assess common taxes associated with investment returns and then discuss implications of these taxes over the long run.

Dividends

Companies pay dividends with after-tax profits. Since this pool of capital has already been taxed on the corporate level, these "qualified dividends" receive special tax treatment as long as the company is domiciled in the U.S. or in a country that has a double-taxation treaty with the U.S. The qualified dividend maximum tax rate is currently 20%[1].

Non-qualified dividends are taxed at regular income tax rates and max out at 37%[1]. These tend to be foreign companies that do not pay corporate taxes in the U.S. or dividends paid from interest in a bond mutual fund (since paying interest on debt is not the same as giving cash back to shareholders).

The holding period also matters, but the rules are confusing. The IRS states that an investor can only qualify for preferential tax treatment if they have held shares for at least 61 days during the 121-day period beginning 60 days before the ex-dividend date (the cutoff point for shareholders to be credited a pending stock dividend)[1].

Think about it this way. The IRS wants investors to hold investments for longer. The preferential tax treatment for qualified dividends was done to encourage both companies to reward shareholders with higher dividends and investors to hold these stocks for longer. Any strategy that is short-term in nature is probably going to be viewed less favorably by the IRS.

Interest

The government treats most interest payments as income subject to the marginal tax rate of the investor. One exception is interest on bonds issued by the federal government, U.S. states, and municipalities. U.S. Treasury securities are exempt from state income taxes, and most other municipal debt is exempt from federal taxes.

Furthermore, most states do not tax interest on municipal bonds issued by in-state entities. That means some "muni" bonds generate tax-free income. This is why investors subject to high tax brackets often prefer to own municipal bonds over other forms of income, but it's also why municipalities often pay less interest when compared to similarly rated corporations. High demand for this tax-friendly income stream tends to keep muni bond prices elevated and yields lower.

Capital Gains

Taxes on capital gains almost always depend on the holding period of an investment. Long-term capital gains apply to any investment held for longer than one year, and short-term capital gains for any investment held less than a year. The tax rate on long-term gains is 0%, 15%, or 20% depending on taxable income and filing status[1]. Short-term gains are taxed as ordinary income, which is usually higher.

Taxes on investment funds get more complicated because the actions within the fund pass through to the shareholder. This can often lead to unexpected tax bills. For example, if an investor were to buy a mutual fund late in the tax year, she would be subject to her share of the fund's capital gains tax if she received a year-end distribution (even if she owned the fund for a few days).

Down markets can also create tax bills if shareholders start selling. When mutual fund shares are redeemed, the fund manager often sells positions within the fund to raise enough cash to cover redemptions. If the fund sells positions with large built-in gains, this could lead to net gains within the fund. If so, shareholders will be taxed on the gains – even if the fund's share price went down during the year.

This may sound crazy, but it happens quite regularly during times of extreme market stress. Back in 2008, investors that held mutual funds were shocked to see their investments fall sometimes more than 30%, but what infuriated them was receiving a tax bill at the end of the year.

This phenomenon happened because as panicked investors sold shares, fund managers had to liquidate positions within the fund. Since most managers prefer to sell winners instead of losers, large capital gains were realized in several funds that then were passed on to shareholders. Meaning, not only were investors down in 2008, they got a tax bill because the mutual fund manager decided to sell.

The Bottom Line

One way to potentially lower your annual tax bill is to use tax-deferred vehicles like IRAs and 401(k)s when considering investment strategies with relatively high turnover. Insurance solutions like nonqualified annuities may be another option. These offer tax-deferred income without some of the limitations imposed on investment accounts. However, it's best to consult a tax professional or your financial advisor for specific ideas because the nuances in the tax code often impact investors differently.

But be careful about taking tax minimization too far. I've lost count of the number of times I've met an investor that refused to pay taxes on a homerun that ultimately became a single over time (not all stocks go up forever). Tax considerations have their place, but they should rarely be the primary driver for an investment decision.

Lastly, don't forget why investors pay taxes on investments. It's because they made more money. They took capital that could have been used for consumption in the past, invested it into risky assets, and then realized a gain.

The bottom line is that paying taxes on investment gains is a high-class problem, and it's one that I hope you struggle with every year as you progress towards your financial goals.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer

Sources

1 Internal Revenue Service

Disclosures