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A little planning can bring you significant savings

ON INVESTING
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Year end is right around the corner—a time when a young man's fancy lightly turns to thoughts of, well, tax planning.

For most of us, the thought of tax planning is enough to either make us glaze over in a daze of boredom and confusion or send us screaming for the exits as we wait for the annual fleecing by the tax man. However, there are steps you can take to minimize your tithe to Uncle Sam. Some of these can be done at year end, but most strategies are best if applied throughout the year.

The first step is to minimize income. That sounds counterintuitive to those of us who are trying to save and get ahead, but I'm not talking about giving up income, just adjusting the timing and nature of it. There usually isn't much you can do about earned income from your job, apart from making sure you max out your 401(k) plan contribution. However, if you are over age 62, you may be eligible for Social Security benefits. If you are still working, it may be best to defer Social Security at least until after age 66 in order to reduce the amount of taxes you could owe. Deferring until age 70 may be better still.

Similarly, while you can start to draw money from qualified retirement accounts, such as Individual Retirement Accounts, Simplified Employee Pension plans, and 401(k) plans at age 59 1/2 without penalty, you may be better waiting if you have other sources of funds to meet your living expenses. Retirement account withdrawals are generally taxed at ordinary income tax rates; this additional income has the potential to push you into a higher tax bracket. It may be best to wait until age 70 1/2, when required minimum distributions must be taken.

For those relying on investments to meet their living expenses, many investors attempt to maximize the income their portfolio produces through dividends from stocks and interest from bonds. But there's a better way.

Rather than maximizing income, they should think about how best to grow their assets, and then how to access those assets in the most efficient manner.

While it is taboo to suggest spending portfolio principal, that is usually the most tax-efficient way to access your money. I believe drawing principal from a portfolio is fine, as long as the overall portfolio continues to grow. Even taking capital gains is often less costly than drawing dividend and interest income. As of last year, higher tax rates and a new investment tax on those in higher income brackets make tax-smart investing even more important.

Speaking of which, there are ways to structure your portfolio to help minimize the tax bite. Asset location is a strategy that involves using retirement accounts for tax-inefficient investments, such as bonds and real estate investment trusts, and taxable accounts for investments like stocks, which generally produce less income. Holding stocks in your IRA or 401(k) effectively turns investments that could be taxed at lower long-term capital gains rates into investments that are taxed at generally higher ordinary income tax rates. This is so because money eventually withdrawn from IRAs and 401(k) plans is taxed as ordinary income.

Harvesting tax losses is another portfolio strategy that can help reduce the amount you pay on April 15. When the stock market declined a few weeks ago, I took the opportunity to realize as many losses as I could. This may sound absurd, but I like to realize losses when possible. This doesn't mean I like to lose money, but the stock market does go down from time to time.

When that happens, you can sell stocks showing a loss, and immediately repurchase a similar stock. This keeps your portfolio exposure the same, but gives you the economic benefit of a capital loss that you can use to offset a little ordinary income or realized capital gains. If you don't have gains to offset, you can carry the loss forward indefinitely to offset future gains, so I like to bank as many realized losses as possible when they are available.

An interesting counterpoint to this strategy is that you may want to realize capital gains if you are in a low income tax bracket. Let's say you retire early and do not have much taxable income. Social Security will start in a few years, but for now you are in the 15 percent federal income tax bracket. It may make sense to realize capital gains in your investment portfolio, as capital gains for those in the 15 percent tax bracket can often be realized without paying any taxes at all. Even if you simply sell stocks, realize the gain, and buy them right back, you may be able to raise your cost basis, which could save you money in future tax bills.

For those not in a position to realize capital gains without paying taxes on them, a better approach is to reduce the amount of trading you do in your investment portfolio. There is scant evidence that a high level of trading activity adds to long-term investment gains. However, it is all but a certainty that aggressive trading will increase your tax bill over time. So finding investments you can hold for the long haul could go a long way toward helping you keep the investment gains you earn, rather than forfeiting them to the government. This is particularly true for older people who may have low basis stocks that could qualify for stepped-up basis upon their death. In that case, it may be possible to avoid capital gains taxes altogether.

There are a lot of variables when it comes to tax law and some of these strategies can get complicated. Also, tax laws are always changing. It is best to discuss strategies with a financial professional who knows your unique circumstances. But with a little planning, there can be opportunities for significant tax savings.

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