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Financial Briefs

JUNE 2022

The Downside of Taxes Determining Investment Strategy

While you should always keep the tax consequences of investment decisions in mind, it's a mistake to let them drive those decisions. Why? Because the goals for each are fundamentally different: the goal of investing is to make money over the long run, while the goal of tax planning is to minimize paying taxes in the short run.

Ideally, these goals should complement each other to achieve the maximum long-term growth of your portfolio, given your investment objectives and tolerance for risk. The danger is that by trying to avoid paying taxes today, you will frustrate your efforts to make the money you could have made or need for tomorrow. A few examples of what can go wrong will illustrate the point.

Skewing your asset allocation

Studies have found that the most important factor in determining an investor's long-term rate of return is asset allocation, or how a portfolio is spread out among the different classes of investments: stocks, bonds, cash, real estate, and commodities. When properly structured, your portfolio aims for a given rate of return that's chosen to meet your long-term financial needs.

One way to minimize the absolute dollar amount of the taxes you have to pay is to minimize your returns. You can accomplish that by concentrating in low-return investments like money market funds, savings accounts, certificates of deposits, or bonds. But if your investment goals require the higher rate of return you can only obtain through stocks, this strategy will succeed at minimizing your returns, but fail at meeting your investment goals.

Concentrating investment and credit risk

Municipal bonds are a great way to reduce your exposure to both federal and state taxes. While a municipal bond from any state shelters interest payments from federal taxation, only municipal bonds issued from within the state in which you live will lower your liability for state income taxes. For that reason, investors frequently confine their investments in municipal bonds to in-state issues. The problem with that is you concentrate your exposure to the risk that your home state could run into financial problems that jeopardize your returns.

When it comes to municipal bond portfolios, it can pay to diversify, both away from a single issuer

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Using Portfolio Losses

Capital gains on investments held for one year or less are short-term capital gains taxed at ordinary income tax rates. For investments held over one year, the maximum long-term capital gains tax rate in 2022 is 20%. While the 20% rate is significantly below the maximum ordinary income tax rate of 37%, it still takes a significant chunk out of your investment portfolio.

To help minimize your capital gains tax bill, you should actively harvest any losses in your portfolio. Some strategies to consider include:

Recognize losses to at least offset $3,000 of ordinary income. Keep in mind the tax rules regarding gains and losses — capital losses offset capital gains and an excess of $3,000 of capital losses can be offset against ordinary income. If you are holding stocks with losses in your portfolio, you should probably take advantage of this tax rule.

If you still want to own the stock with the loss, you can sell the stock, recognize the tax loss, and then repurchase the stock. You just have to make sure to avoid the wash sale rules. These rules state that you

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The Downside

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and a single state. That way, you reduce the risk that the market value of your bonds will suffer from a default or credit downgrade.

Holding on to an investment too long

The higher tax rate on short-term capital gains — those realized in less than a year — than on long-term gains encourages some investors to hold on to an investment too long. Stock prices can move quickly, and holding on to a stock just because you want a more favorable tax rate can cause you to lose some or all of your profits or deepen the losses you've already suffered.

Selling an investment too soon

Conversely, investors can be tempted to sell a stock prematurely in an attempt to harvest capital losses to shelter capital gains. While it might be a good idea to exit a stock position before its losses mount, you could regret it if the stock you sold later runs on to big gains. Selling may also leave a hole in your asset allocation strategy and diminish your portfolio's level of risk-reducing diversification.

The proper approach to tax-efficient investing

That doesn't mean that taxes are a good thing, or that you shouldn't try to minimize the taxes your investments trigger. But there's a wrong way to go about it — and a right way. The right way consists of doing the following:

- Taking full advantage of tax-sheltered investment retirement accounts, like IRAs, 401(k) plans, and tax-sheltered annuities.
- Investing in municipal bonds only when they generate a higher after-tax rate of return.
- Selling stocks based on their intrinsic ability to generate gains or losses.
- Prudently culling losing stocks from your portfolio when harvesting capital losses.

Please call if you'd like to discuss this in more detail.

Taxes and Retirement Withdrawals

You may feel more free in retirement than at any other time in your life. Gone are the bosses, deadlines, meetings and to-do lists, but unfortunately you still can't shake the taxes. While you may no longer have to incur payroll taxes and you may be in a lower tax bracket, you will still most likely owe taxes on withdrawals from retirement accounts, capital gains on investments, and pension payments.

As you prepare for retirement, include developing a retirement withdrawal strategy that provides you with the income you need, minimizes the impact of taxes, and keeps your investment mix focused on your goals and personal situation. Here are some strategies to consider:

Withdrawal Order Matters

The order in which you take assets can have an impact on what you pay in taxes. The sequence strategy follows this order:

- Required minimum distributions (RMDs) from retirement accounts
- Taxable accounts
- Tax-deferred retirement accounts, such as a traditional IRAs, 401(k), 403(b), or 457
- Tax-exempt retirement accounts, such as a Roth IRA or Roth 401(k)

RMDs should be taken first if you're older than 72 because if you don't, in most cases, you will pay a penalty that is half the amount of what was not withdrawn.

After the RMDs or if you are not 72, you should take income from your taxable accounts until you've used all of the funds. The reason for this is that tax-advantaged accounts still have the potential to grow on a tax-deferred basis.

On your taxable accounts, you will most likely have to sell investments on which you will pay capital gains on any appreciation, which is from 0% to 20% depending on your tax bracket. The majority of taxpayers pay no more than 15%, since long-term capital gain rates are much lower than income tax rates.

Finally, you should use the assets in your tax-deferred accounts on which you will pay ordinary income tax. If you have Roth accounts, these funds will not be taxed.

Avoid Paying Taxes on Social Security

Up to 85% of your Social Security benefits are taxable if you make more than the income thresholds. If your adjusted gross income, nontaxable interest, and half of your Social Security reaches $25,000 for individuals and $32,000 for couples, you will pay income tax on up to 50% of your Social Security benefits. Additionally, if your retirement income reaches $34,000 for individuals and $44,000 for couples, you will pay income tax on up to 85% of your Social Security payments.

You want to manage your income to reduce the percentage of your Social Security benefits that are taxed. With this strategy, you'll want to make the income threshold the target instead of the income associated with a specific tax bracket.

Take Advantage of Lower Capital Gains Rates

If your taxable income falls into one of the two lowest tax brackets, you can sell stocks that were held longer than a year as a tax-efficient means to generating cash flow. In 2022, taxpayers in the 10% and 12% income brackets will realize long-term capital gains or receive qualified dividends without being taxed. This is a great strategy if you have a high proportion of assets in taxable accounts and a lower amount of recurring income, such as Social Security, a pension, or annuity income.

Please call if you'd like to discuss this in more detail.

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Using Portfolio Losses

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must repurchase the shares at least 31 days before or after you sell your original shares to recognize the loss for tax purposes. That timing can be troublesome. If the stock's price rises substantially before you repurchase it, your tax savings from the loss deduction may not be worth as much as the investment gains during that time period. You can avoid that concern by purchasing the additional shares first and then selling your original shares 31 days later. Another strategy is to purchase a similar stock, perhaps of a competitor, to replace the stock you sold. Since it isn't the same stock, you don't have to wait 31 days to purchase it.

Consider recognizing all, or a substantial portion, of any losses in your portfolio. Realize that no one likes to sell investments at a loss. And since you can only offset an excess of $3,000 of capital losses against ordinary income, you might wonder why you should incur excess losses that can't be used currently, even though you can carry them forward to future years. There are a couple of advantages to this strategy.

First, it gives you an opportunity to totally reevaluate your portfolio. If you are convinced all your investments are good ones, you can sell them, recognize the tax loss, and then repurchase the stocks, being sure to avoid the wash sale rules. But it's probably more likely that you own some investments you wish you didn't or you don't think will recover as quickly as other investments. This is your opportunity to reinvest in stocks you believe have better long-term potential.

Second, it gives you more flexibility when recognizing gains in the future. You may be a little more skittish about letting capital gains ride with the market. Until you use all your capital losses, you can recognize capital gains without worrying about paying taxes. Even if your losses are long term, you can use them to offset short-term capital gains that would be subject to ordinary income taxes.

Use stock losses to offset other capital gains. You don't have to match stock losses with stock gains. If you have capital gains from the sale of another type of asset, such as a business or real estate, stock losses can be used to offset those gains.

Don't gift stocks with losses. If you are planning a large charitable contribution, it makes sense to donate appreciated stock held for over a year. You deduct the fair market value as a charitable contribution, subject to limitations based on a percentage of your adjusted gross income, and avoid paying capital gains taxes on the gain. If the stock has a loss, however, you should first sell it and then send the cash to the charity. That way, you get the charitable deduction and recognize a tax loss on the sale.

If you have losses in your portfolio, you may be able to use them to help reduce your income tax bill. Please call if you'd like to discuss these strategies in more detail.

Tax-Efficient Investment Strategies

During periods of uncertain returns, it becomes even more important to consider other ways to increase your portfolio's value. One of those strategies is to invest in a tax-efficient manner.

Taxes can significantly reduce your portfolio's value. Dividends and interest income from taxable portfolios and distributions from 401(k) plans or individual retirement accounts are taxed in the year received, at ordinary income tax rates of up to 37%. Taxes are not paid on unrealized capital gains in taxable accounts. When the asset is sold from a taxable account, however, you must pay taxes on those capital gains, at a maximum capital gains tax rate of 15% to 20% (0% for individuals under certain income limits) for investments held over one year. Capital gains on investments held for one year or less are short-term capital gains and are taxed at ordinary income tax rates.

Consider the following tax-efficient strategies:

- **Minimize portfolio turnover.** Carefully evaluate your investment choices, selecting those you'll be comfortable owning for a long time. That way, you can let capital gains grow for many years.
- **Place investments that generate ordinary income or that you want to trade frequently in your tax-deferred accounts.** Since income and realized capital gains inside tax-deferred accounts aren't taxed until withdrawn, you defer paying taxes on that income.
- **Analyze the tax consequences before rebalancing your portfolio.** Portfolio rebalancing is a taxable event that may result in a taxable gain or loss. You should generally avoid selling investments for reasons other than poor performance. You can bring your asset allocation back in line through other means. For instance, when choosing investments, only purchase those that are underweighted in your portfolio. Reinvest interest, dividends, and capital gains in underweighted investments. Any withdrawals can be made from overweighted investments. Or rebalance through your tax-deferred accounts.
- **Utilize losses to offset capital gains.** Selling investments at a loss can offset capital gains for that year, reducing your total tax liability. Excess losses may be used to offset up to $3,000 of ordinary income and the unused portion may be carried forward indefinitely. See the article "Using Portfolio Losses" for more details.

Please call if you'd like to discuss this in more detail.

News and Announcements

From the Thurman Household

My son, Levi is preparing for *Grapplers Escape*—a weeklong Jiu Jitsu training camp with world champions. He's teaching children and going various places to learn and meet like-minded athletes. When he's not doing Jiu Jitsu, he's working on his Cryptocurrency mining business. Don't ask. I barely understand it.

My wife, Pati, is preparing for her first marathon. She has run Ultras before, but not a marathon. The marathon is *The Light at the End of the Tunnel* in Seattle. She'll be going with 14 South Oklahoma City runners.

My book, *The All-Weather Retirement Portfolio*, published by Forbes, is out. It's available at local bookstores and on Amazon. If you're a client and would like a copy, sign up here: **https://www.surveymonkey.com/r/ForbesBookRT** or just call our office. I'm currently working on two other books, *The 5 Steps to Finding a Financial Advisor* and a rewrite of *The Richest Man in Babylon.*

June is a challenging month for me in that my mom and dad passed away in June. Let us all embrace life's moments and memories while we can. Remember, as my dad used to say, "Son, it don't take long to live a lifetime."

Make it a great month!

Randy Thurman, CFP®, CPA/PFS

From the Flinton Household

"Do what you can, with what you have, where you are."
~ Theodore Roosevelt

After another whirlwind year of school, dance, tumbling, friends, family, and the like, we are in the full swing of "Summer mode". I can't wait for my daughters Samantha and Emerson to enjoy a summer of down time, as they are continually impressing me with their dedication, determination, and discipline in so many areas of their lives. My daughters have done their own laundry since they were approximately 4-5 years old, they get themselves up and ready for school in the mornings, they make their own lunches, pack their own bags, keep up with their schoolwork and various activities, and have never received an allowance for taking care of their own responsibilities as members of the family. They are incredibly proactive with what they need to accomplish and complete. They are continually showing signs of wisdom beyond their years. We have told them we want them to be incredible adults, not good kids. That requires a paradigm shift in parenting priorities for my wife, Courtney, and I, but we know that it will pay huge dividends as they continue to navigate an ever-changing world.

My daughters are extremely hard working, and they are continually engaged in conversations about customer service, finance, economics, psychology, group dynamics, lifetime learning, and the list goes on. We recognize we only have a short window of receptivity, and continually pray for the wisdom to guide them appropriately, as well as the wisdom to let them fly and fail on their own. As you can see, I'm quite the proud parent, and can't wait to see all that they accomplish in life! Hope you enjoy a wonderful month.

Andrew Flinton, CFP®

From the Bolander Household

Each year, I attend a three-day update on federal regulations for investment advisors. It's usually held somewhere nice because there's got to be something to look forward to! This year was the first one to be held in person since the pandemic and it was in Orlando, Florida. My husband John and son Jake joined me at the end of the week for three days of fun. We got the passes that allow travel between the original Universal Studio Park and the Islands of Adventure Park via the Hogwarts Express train from the *Harry Potter* movies. We discovered that waving a magic wand could cause a skeleton to dance in sync with your own movements, rain to pour from an umbrella and numerous other phenomena.

In addition to boarding the train at the 9¾ platform, there were many entertaining rides throughout both parks with all the special effects of first-rate movies. The rollercoasters were thrilling as we tried to outrun velociraptors or explore the Forbidden Forest. We encountered live movie characters such as Bumblebee from *Transformers* and Captain America from *The Avengers* and enjoyed live show performances. The buildings and grounds transported us to different places and times. With only three days we didn't experience everything, but we had a great family time together. Have a great month!

Brenda C. Bolander, CFP®, CPA/PFS