DUGAN, SCOTTI & ZOCH, P.A.
Certified Public Accountants
161 McKINLEY STREET • P.O. BOX 576 • CLOSTER, NJ 07624
PHONE: (201) 767-6270 • FAX: (201) 767-0920
www.dszcpa.com

Abstract: When investing for retirement or other long-term goals, people usually prefer tax-advantaged accounts. But traditional taxable accounts may still make more sense for certain investments. This article discusses the difference between "taxable" and "tax-advantaged" and which types of investments tend to work the best where.

Taxable vs. tax-advantaged: Where to hold investments

When investing for retirement or other long-term goals, people usually prefer tax-advantaged accounts, such as IRAs, 401(k)s or 403(b)s. Certain assets are well suited to these accounts, but it may make more sense to hold other investments in taxable accounts.

Know the rules

Some investments, such as fast-growing stocks, can generate substantial capital gains. These gains are recognized and generally taxable when you sell a security for more than you paid for it.

If you've owned that position for over a year, you qualify for the long-term gains rate, generally 15% or 20%. The long-term gains rate also applies to qualified dividends. In contrast, short-term gains, on investments held a year or less, are taxed at your ordinary-income tax rate — which might be as high as 37%. Nonqualified dividends and interest income are also generally subject to your ordinary-income rate. The 3.8% net investment income tax (NIIT) might also apply to capital gains, dividends and interest, depending on your income.

But if an investment is held in a tax-deferred account, like a traditional IRA, 401(k) or 403(b), there's no tax liability until you take distributions from the account. At that time, the distribution is taxed at your ordinary-income tax rate. However, the NIIT doesn't apply to retirement plan distributions.

Choose tax efficiency

Generally, the more tax efficient an investment, the more benefit you'll get from owning it in a taxable account. Conversely, investments that lack tax efficiency normally are best suited to tax-advantaged vehicles.

Consider municipal bonds ("munis"), either held individually or through mutual funds. Munis are attractive to tax-sensitive investors because their income is exempt from federal income taxes and sometimes state and local income taxes. Because you don't get a double benefit when you own an already tax-advantaged security in a tax-advantaged account, holding munis in your 401(k) or IRA would result in a lost opportunity.

Similarly, tax-efficient investments such as passively managed index mutual funds or exchange-traded funds, or long-term stock holdings, are generally appropriate for taxable accounts. These securities are more likely to generate long-term capital gains, which have more favorable tax treatment. Securities that generate more of their total return via capital appreciation or that pay qualified dividends are also better taxable account options.

Take advantage of income

What investments work best for tax-advantaged accounts? Taxable investments that tend to produce much of their return in income. This category includes corporate bonds, especially high-yield bonds, as well as real estate investment trusts (REITs), which are required to pass through most of their earnings as shareholder income. Most REIT dividends are nonqualified and therefore taxed at your ordinary-income rate.

Another tax-advantaged-appropriate investment may be an actively managed mutual fund. Funds with significant turnover — meaning their portfolio managers are actively buying and selling securities — have increased potential to generate short-term gains that ultimately get passed through to you. Because short-term gains are taxed at a higher rate than long-term gains, these funds would be less desirable in a taxable account.

Get specific advice

The above concepts are only general suggestions. Please contact us for specific advice on what may be best for you.