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CAPITAL MANAGEMENT

The Truth about Taxes and Your Investments

A Resource Provided by Carlson Capital Management and Zero Alpha Group

One of the biggest factors shaping investment returns overtime also happens to be one of the most misunderstood and ignored. Can you imagine overlooking the cost of gasoline in determining how much it costs to operate an automobile—especially with today's price at the pump? Would you buy a house and leave the cost of insurance or a new roof out of your budget? Unfortunately, many investors make exactly that kind of oversight when they ignore the impact of taxes on their overall investment returns.

The brokerage industry has always focused on gross-investment return, with taxes only coming as an afterthought. In truth, taxes are a huge factor, accounting for what is perhaps the single most easily controlled cost of investing. In their influential position paper on the impact of taxes on investing, the experts Robert H. Jeffrey and Robert D. Arnott summed it up this way: "Taxes matter a lot." Studies have shown that over a 30-year period, the average mutual fund investor can lose over half of their cumulative return to taxes!

In this edition of *A Closer Look*, we will explore ways to reduce the tax "bite" on your investment returns.

LOCATION, LOCATION, LOCATION

You've no doubt heard the expression, "The three most important things for success in real estate investing are location, location, location." This rule of thumb also works for your financial assets. Right now, most of your investments are likely either in tax-deferred accounts (IRAs, 401(k)s, etc.), taxable accounts or Roth IRAs. Most investors' assets are also spread out across equities and fixed income investments.

The *location* of equity holdings is extremely important! An investor must determine whether their equity holdings are better off located inside or outside of tax-deferred accounts. Many investors instinctively concentrate their equity holdings inside their tax-deferred accounts. The logic is that equities have the highest long-term returns, and provide significant long-term growth, and should therefore be concentrated in the most "tax-favored" environment inside long-term retirement accounts.

On the surface, that kind of thinking seems to make sense. However, a closer look reveals a different reality. Returns on equities come from two different sources; (1) appreciation in price (growth) and (2) dividends. If equities are owned in a taxable account, are these two sources of return taxable? The answer: It depends. Appreciation in the price of equities is tax-deferred until the equities are sold; so it's highly controllable. When equities are eventually sold, the tax rate on long-term capital gains is only 15 percent (plus state taxes). The primary source of return on equities over time has been growth (appreciation). Even though dividends are taxable, it is likewise at a very favorable 15 percent rate under the Jobs & Growth Tax Reconciliation Act of 2003.

So, even in a taxable environment, the equity investor automatically has a built-in element of tax-deferral and highly favorable tax rates. In contrast, if equities are owned inside of a tax-deferred account (such as an IRA), the returns are completely and totally tax-deferred. However, there's a catch: When the funds are eventually withdrawn from the IRA, they're taxed at ordinary rates of up to 35 percent rather than the far more favorable capital gains and dividend rates of 15 percent. Without proper planning, some investors (who may think they are doing the smart thing) end up inadvertently doubling their tax rate without even knowing it.

Location truly does make a big difference! And, the convoluted tax laws causes, what at the surface seems like a logical investment location, to actually hurt most investors over time.

WHAT ABOUT MUNIS?

If it makes more sense to hold equities in taxable accounts (when given the choice), does that mean fixed-income investments are the best way to go in taxdeferred accounts? And if so, what about municipal bonds ("munis") and their completely tax-exempt status? These are great questions – and they lead to more answers that may surprise you.

Many investors are well aware that interest income received on municipal bonds is tax exempt. However, there is a "hidden tax cost" associated with municipal bonds. The municipalities that issue the bonds know you don't have to pay tax on the interest earned on their bonds. As such, they know they can get by with paying a lower interest rate than a similar corporate or government bond issuers offer. In most instances, the municipal bond investor accepts a lower yield in exchange for the right to permanently avoid tax on the income. While there's no actual tax, the lower yield has an effect that's-similar to the kind of drag on return that would result-from paying tax.

So what is the best way to beat this "hidden tax"? If the opportunity exists, an investor who owns municipal bonds in a taxable account could increase their yield by switching to corporate or government bonds inside of an IRA. Since IRA ideally should not be used for most equities, they can instead serve as a perfect location for taxable bonds (see above).

ROTH IRAS

What about Roth IRAs? These are unique and offer opportunities not available to either taxable investors or traditional IRA investors. The returns earned in a Roth IRA avoid all taxes, permanently and forever! It sounds too good to be true. And eventually the politicians may figure this out. But, in the meantime, Roth's provide a great opportunity for qualified investors. Whatever you earn inside of a Roth IRA is never taxed, even when withdrawn. Since Roth IRA returns permanently avoid tax, it makes sense to hold the highest-returning and most tax-nasty asset classes in Roth IRA's. Generally, small company stocks or small value stocks have the highest expected returns, combined with higher dividends and realized capital gains. Therefore, these asset classes are most appropriate held in a Roth IRA environment.

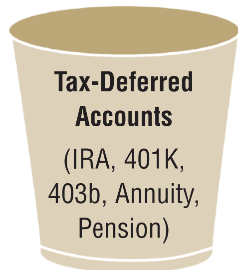
TWO EXPERTS SUMMED IT UP THIS WAY: "TAXES MATTER A LOT." STUDIES HAVE SHOWN THAT OVER A 30-YEAR PERIOD, THE AVERAGE MUTUAL FUND INVESTOR CAN LOSE OVER HALF OF THEIR CUMULATIVE RETURN TO TAXES!

BRINGING IT ALL TOGETHER

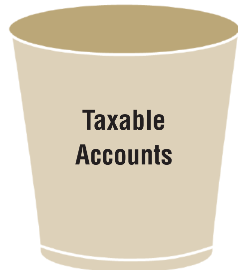
In the quest for maximum tax-efficiency, asset location is almost as important as the actual investments you make. Combining what you've learned so far here, imagine that you hold your portfolio in three different "tax buckets" (tax-deferred accounts, taxable accounts and Roth IRA accounts). The buckets catch and hold the growth in your portfolio each year. However, some of the gains evaporate from the buckets due to taxes. How much evaporates depends upon which investment is held in which bucket. Your advisor can help you minimize your evaporation.

Some people have all their assets in one bucket, although most investors have them spread over two or more buckets. The Roth IRA bucket is often the smallest while taxable and tax-deferred buckets are typically largest. Understanding how, when and at what rates your investments are taxed is essential in deciding which type of investment should be held in which bucket. The suitability of making various investments in the "three buckets" is shown in the table to the right.

Investor Tax Buckets are Taxed at Multiple Tax Rates, Currently and in the Future



Type of Gain	Maximum Current Tax Rate	Maximum Future Tax Rate	Retirement Rate (if below max)
Interest and NQ Dividend	**N/A**	**35 %**	**10–33 %**
Short-Term Capital Gain	**N/A**	**35**	**10–33**
Qualified Dividend	N/A	35	10–33
Long-Term Capital Gain	N/A	35	10–33
IRD (Income Tax at Death)	N/A	35	10–33



Type of Gain	Maximum Current Tax Rate	Maximum Future Tax Rate	Retirement Rate (if below max)
Interest and NQ Dividend	35 %	N/A	N/A
Short-Term Capital Gain	N/A	35 %	10–33 %
Qualified Dividend	**15**	**N/A**	**N/A**
Long-Term Capital Gain	**N/A**	**15**	**0–5**
IRD (Income Tax at Death)	**N/A**	**0**	**0**

Type of Gain	Maximum Current Tax Rate	Maximum Future Tax Rate	Retirement Rate (if below max)
Interest and **NQ Dividend**	**0 %**	**0 %**	**0 %**
Short-Term Capital Gain	**0**	**0**	**0**
Qualified Dividend	**0**	**0**	**0**
Long-Term Capital Gain	**0**	**0**	**0**
IRD (Income Tax at Death)	0	0	0

Type of Investment	Tax-Deferred Accounts	Taxable Accounts	Roth Accounts
TAX-NASTY STOCKS (High Dividend, High Realized Gain)	**Better**	Bad	**Best**
TAX-EFFICIENT STOCKS (Low Dividend, Low Realized Gain)	Bad	**Best**	Better
TAXABLE BONDS (Government, Agency, Corporate)	**Best**	Bad	Fair
TAX-FREE BONDS (Municipal)	Very Bad	**Varies**	Very Bad
CASH (Money Market, T-Bills, Savings, CDs)	Better	Better	Bad

NOTE: IDEAL ASSET LOCATIONS ARE IN BOLD.

CONCULSION

As we have seen, conventional wisdom is often dead wrong when it comes to taxes and investing. Many investors make the mistake of holding long-term investments like stocks in tax-deferred accounts. Though effective tax bucket management is counter-intuitive and complex, the benefit of getting it right can be significant (in terms of bottom-line returns). It can even spell the difference between success and failure of a long-term financial plan.

When it comes to taxes, think of the words of the late entertainer Arthur Godfrey, who said: "I'm proud to be paying taxes in the United States…the only thing is, I could be just as proud for half the money!" With proper tax management of your investments, you literally may end up paying half the money you are now.

Want to know more?

For additional information on this or any other wealth management topic, please contact one of our principals at the locations below or visit our website at www.carlsoncap.com.

ABOUT CARLSON CAPITAL MANAGEMENT

Carlson Capital Management, Inc. is a comprehensive wealth management advisory firm with Minnesota offices in Northfield, Hastings and Rochester. Serving 450 clients in Minnesota and various other states, Carlson Capital Management brings together in one place all of the key disciplines of financial, investment, estate, tax, retirement and philanthropic planning for clients seeking an integrated wealth management experience.

For a complete background summary of the firm, please visit our website at www.carlsoncap.com.

ABOUT ZERO ALPHA GROUP

Carlson Capital Management is a member of the Zero Alpha Group. Founded in 1995, the Zero Alpha Group, which is not an investment advisory firm itself, was created to serve as a nationwide network for eight independent investment advisory firms that manage a total of more than $3.5 billion in assets.

Members of the Zero Alpha Group are committed to providing objective, long-term private wealth management solutions to investors, focusing on asset allocation and a structured, quantitative approach to investing. The eight firms in the Zero Alpha Group network share a common philosophy about investing and client service—a commitment to passive, tax-managed investment strategies while providing an independent financial planning solution for investors.

Visit ZAG online at www.zeroalphagroup.com.

SOURCES

* Savant Capital, Approaching Zero Taxes, 2003.
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