

The Best Investments for Taxable Accounts: Part II

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As discussed in Part I of this article, investors in the U.S. will face significantly higher levels of taxation on all forms of income and capital gains beginning in 2011. As a result, investors in the higher marginal tax brackets and those having substantial taxable investments may wish to explore investment opportunities and portfolio strategies that seek to reduce their tax liabilities. There are two broad categories of investment with some sort of tax preference: tax advantaged and tax deferred. Now let's explore a handful of specific investments, or investment cash flows that might be beneficial to investors concerned with the future tax regime.

Municipal Bonds: Municipal bonds are perhaps the most well-known tax advantaged security available to investors. Generally speaking, interest earned on municipal bonds is exempt from federal income tax, and may be exempt from state and local government taxes as well. Furthermore, long-term municipal bonds have historically traded at market yields that are even high than what their tax-equivalent yields should be, potentially providing additional return to the investor. It should be noted that any capital gains associated with municipal bonds are not exempt from taxation, but are instead subject to the same tax rate as other marketable securities. Finally, some municipal bonds are subject to the Alternative Minimum Tax, so investors need to be selective and ensure that they understand what types of bonds they own.

Master Limited Partnerships: A master limited partnership (MLP) is a publicly-traded partnership structure that may be elected by firms that earn greater than 90% of their income through operations and assets relating to natural resources, commodities or real estate. As a result, most of the MLPs available to investors own and operate assets such as oil pipelines, gas pipelines, treatment and processing facilities, propane distribution systems, etc. To an MLP shareholder (technically called a unit holder) the benefit derives from the fact that limited partnerships have pass-through taxation and thus there is no tax paid by the MLP itself, but the tax liabilities are passed on to the unit holders. Thus, MLPs avoid the double-taxation associated with corporations. Importantly, investors in MLPs receive cash distributions that are not taxed when received, but are classified as reductions in cost basis and therefore the investor generally owes very little taxes until the MLP is ultimately sold. Thus, investors may be able to earn very attractive cash yields and defer the tax liability for many years.

Qualified Dividends: Qualified dividends (as opposed to ordinary dividends) are taxed at lower capital gains tax rates, rather than marginal income tax rates. Most equity dividends are considered to be qualified, and therefore there is a significant tax advantage for investors who receive qualified stock dividends versus income from other sources, such as CDs or corporate bonds. So on a tax-adjusted basis investors may actually be able to earn higher cash yields on equities than on fixed income investments in the current era of low interest rates.

Equities (if held long-term): Long-term capital gains tax rates are applied to any gains generated from the ownership of an asset for more than one year. So, if you own a stock for more than 1 year you will pay a tax rate on any gain that may be less than half of your marginal income tax rate. Also, capital gains taxes are only paid once the gain is recognized, so an investor can both lower and defer their tax liability associated with

stock ownership for many years. This long-term capital gains treatment applies to fixed income securities as well but for most investors any capital gains from bond investments are likely to be small in comparison to the income earned on those bonds, which is of course taxed at the much higher prevailing income tax rates.

Precious metals: The tax treatment of gold and other precious metals is somewhat complicated and varies depending on the method of investment. For assets in taxable accounts the most efficient way to gain exposure to precious metals is through ownership of equities of gold mining companies, in which case you would apply the aforementioned stock and dividend tax rules, as mining stocks are treated just as any other stock investment for tax purposes. You might also consider owning a precious metals ETF, but these funds and others like them are treated as "collectibles" by the IRS and are therefore taxed at a 28% capital gains tax rate, which is one of the highest capital gains tax rates among all investable assets. Of course, if you have a very long time horizon you will defer the payment of the tax liability indefinitely, as gold provides no short-term cash flows such as interest or dividends, therefore creating no liability for as long as you hold the investment.

It should be understood that this article does not cover all of the possible tax consequences resulting from investment in any of the securities or assets described herein, and it is not intended to constitute tax advice but is provided solely for informational purposes. Investors should work with their advisors to understand these investments and their suitability in a particular portfolio management strategy, but some or all of these opportunities may certainly assist those in the highest tax brackets (which are going higher) and those having large portfolios of investable assets held outside of retirement accounts.

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