

Improving Your Portfolio's Tax-Efficiency

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Seeing investment values devastated by last year's market performance was hard for investors to take. And some had an even tougher pill to swallow when they saw those same investments generate tax liabilities – in some cases large liabilities – despite their drops in value. While your investment and wealth management strategies shouldn't be driven entirely by tax issues, there are steps you can take now to help make your portfolio more tax efficient for 2009.

What You Should Know:

1. Consider more tax-efficient investment vehicles

Traditional mutual funds can carry hidden tax implications. For example:

- In addition to being taxed on gains on fund shares you own, you will also be taxed on capital gains and dividends earned by the fund itself – events you can't control.
- Mutual funds distribute capital gains to all shareholders as of a particular date – even to those shareholders who didn't own the fund when those gains were earned. "Tax-managed" mutual funds address these concerns by limiting turnover and distributions.

Separately managed accounts, typically available to larger investors, offer more customization and control over taxes.

These investments use pooled money to buy individual securities, with a manager directly purchasing them in your own account to avoid pre-existing gains or losses.

2. Maximize your use of Tax-Deferred Accounts

Because of the different ways investment income is taxed, owning securities in the right types of accounts can help improve the overall tax-efficiency of your portfolio.

- Long-term capital gains and qualified dividends are taxed at a maximum rate of 15%. Investments that generate these types of income typically belong in taxable accounts.
- Interest, ordinary dividends and short-term capital gains are subject to the higher ordinary income tax rates, and may be best kept in tax-deferred accounts such as IRAs and 401(k)s. ▶

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3. Watch your holding periods

How long you hold an investment can make a difference in the amount of taxes you pay.

- Holding investments for more than one year lets you take advantage of the lower long-term capital gains tax rate when it's sold. However, be sure to consider the investment risk of delaying a sale.

4. Be smart about selling and harvesting losses

Capital losses can be used to offset capital gains dollar-for-dollar. You can offset gains from one type of investment, like stocks, with losses from another, like real estate. You can't use realized losses in tax-deferred accounts to offset gains in taxable accounts.

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- If your total losses exceed total gains, up to \$3,000 of your remaining losses can be used to offset ordinary income.

- Losses beyond the \$3,000 limit can be carried over to the next year to offset gains and income, and additional excess losses can be carried over indefinitely.

When harvesting losses, be careful to avoid "wash sales."

- You cannot deduct a capital loss from the sale of a security if you buy a "substantially identical" security within a 61 day period (30 days before and 30 days after the sale).
- You can't use losses from wash sales to offset gains or income in the current tax year; the loss is "deferred" until you sell the replacement property.
- If you sell a security at a loss in your personal account and buy it within the 61-day period in your IRA, the loss is permanently disallowed.

What Should You Do Now:

We recommend contacting your Baird Financial Advisor or tax professional now to talk about how implementation of these strategies might benefit your wealth management plan and help reduce your tax liability in 2009 and beyond. ■

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