Perspectives

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Tax-Advantaged Investments

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On December 17, 2010, Congress approved and the President signed into law a tax bill that extended a number of tax cuts including lower income and capital gain tax rates. While most Americans will benefit from the new law, it is time to plan ahead as we enter the new year. Since most of us like paying as little taxes as possible, this issue of Perspectives looks at a number of tax-advantaged investments and programs that can help keep your taxes low in 2011 and beyond.

Municipal bonds can provide current income, which is typically exempt from federal income tax and may be exempt from state income tax for investors who reside in the state of issue. However, some bonds may be subject to the Alternative Minimum Tax.

Oil and natural gas programs can provide an upfront tax deduction of 85 to 100 percent of the investment amount for intangible drilling costs. These programs subsequently provide income that is based on the underlying price of oil or natural gas. In addition, they may also provide future equipment depreciation deductions. Please note that there are special risks of investing in Limited Partnerships such as lack of liquidity and potential adverse economic and regulatory changes. For this reason, there are minimum suitability standards that must be met. Please ensure you read the prospectus carefully before investing. In addition, an investment in real estate will fluctuate with the value of the underlying properties, and that the price at redemption may be more or less than the original price paid.

Deferred annuities, both fixed and variable, can guarantee the principle, lifetime income and the amount that will ultimately pass to heirs. While the contributions are made with after-tax dollars, the earnings are tax-deferred. These programs may also offer income distribution options to individuals who need current income, at the same time offering certain tax advantages. Any guarantees are based on the claims paying ability of the insurer. Withdrawals may be subject to a contingent deferred sales charge and any withdrawal made prior to age 59½ may be subject to a 10% penalty by the IRS.

Individual retirement accounts (IRAs) may provide an upfront tax deduction, as in the case of a traditional IRA. Roth IRA contributions are not deductible, but the earnings grow tax-deferred in both types of IRAs and may be withdrawn tax-free from Roth IRAs as long as the distributions are qualified distributions. These plans offer a wide range of investment options including stocks, bonds, mutual and exchange-traded funds (ETFs). Please note there are tax implications associated with early withdrawals and surrenders, and the existence of a 10% penalty for withdrawals made prior to age 59½.

Company retirement plans provide an upfront tax deduction to the company and its participating employees. 401(k)s, profit-sharing plans and pension plans are common examples. These plans typically offer mutual fund investment options, although self-directed plans may also offer a wider range of other investment choices. Retirement plan withdrawals may be subject to taxation and penalties when withdrawn early.

529 college savings plans are used to fund higher-education expenses. While the contributions are made with after-tax dollars, the earnings are tax-free as long as the money is used to fund higher-education expenses at an accredited institution. For more complete information about the 529 savings plan, including investment objectives, risks, fees and expenses associated with it, please read the issuer's official statement. The issuer's official statement can be obtained from your financial advisor. Please read it carefully before investing. Remember to consider, before investing, whether your home state offers any state tax or other benefits that are only available for investments in your state's qualified tuition program. Other benefits may include reduced or waived program fees, matching grants, and scholarships to state colleges. Any state-based benefit offered with respect to a particular 529 college savings plan should be one of many appropriately weighted factors to be considered in making an investment decision. You should consult with your financial, tax or other adviser to learn more about how state-based benefits (including any limitations) would apply to your specific circumstances and you also may wish to contact your home state or any other 529 college savings plan to learn more about the features, benefits and limitations of that state's 529 college savings plan.

Tax-efficient mutual funds strive to be tax-neutral by avoiding income-producing assets such as bonds and dividend-paying stocks, keeping turnover low to avoid triggering capital gain tax and using tax loss harvesting to offset capital gains.

Exchange-traded funds (ETFs) are typically more tax-efficient than mutual funds due to the investor's ability to control capital gain recognition. These are typically low-cost, passive investments that mirror an index, industry or sector, geographical region or country. Some ETF's may pay a dividend and one cannot invest directly in an index.

Separately managed accounts (SMAs) are typically more tax-efficient than mutual funds because SMA investors actually own individual securities. This allows money managers to control capital gains recognition, avoid income-producing investments and harvest capital losses to offset capital gains.

Non-qualified deferred compensation plans are typically used to benefit business owners, executives and key employees by allowing these individuals to avoid recognizing the income until the occurrence of a specific triggering event, typically retirement. These plans may also provide an immediate upfront deduction to the company, although not all do. In addition, these plans may enable the employee to spread out the income tax liability when deferred compensation is ultimately received.

By working with your financial and tax advisor and taking advantage of tax-efficient strategies, you may help ease the tax bite, but the time to act is now! Contact your independent financial advisor today to discuss these and other tax-saving opportunities that may be available to you.

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