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Smart Money Looks Ahead

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Unravel. That is what is going to happen to a nice perk for high earners. Currently, their tax on dividend income and capital gains is 15%, a modest sum compared to years past. But now, Obama has indicated that taxes for those making $250,000.00 and above will be higher, probably as soon as 2010.

There is no reason to pay unnecessary taxes no matter how rich you are. Smart investors want to make the choice about how they spend their hard earned money rather than giving it to the government to decide. Some proactive steps can go a long way in achieving this goal. This is how.

Do some tax selling in this depressed stock environment to reallocate a portfolio to an asset allocation that better suits your needs. Then, you can use the tax loss later as you have gains in a rising market. For example, let's say you have a portfolio of 20% US based stocks and 20% international stocks plus 60% bonds and cash. You think the US market will rebound before the rest of the world. Then, you might sell some international stock for a loss and replace it with US stock. The wash rule will not affect you as you are buying an entirely different category of stock to replace the one that was sold.*

Another method to reduce taxes is making sure your high dividend earners and non-qualified dividends are in your tax advantaged accounts and vice-versa (the non-qualified dividends don't qualify for favorable tax rates). This is especially true if you aren't near retirement and have a long time horizon. Then, the tax saving will have time to grow.

In that way, you won't have to pay the tax on the dividends now or later when they are increased. For example, the large value Vanguard exchange traded fund (ETF), VGK, pays a 9.81% yield as of 3-13-09. In a tax advantaged account, that yield isn't going to change your taxes. In your taxed account, it makes a difference now and will later when the tax on dividends for higher earners is increased. The wash rule will apply here, though, if you do a direct exchange. By that I mean sell VGK in the taxed account and then buy it in the tax-advantaged account. This is because the same investment is sold in one account and purchased in another, both of which belong to the same person. Nevertheless, the tax savings make this maneuver advantageous with a long time horizon, even though there is not a tax loss.

As for the asset allocation, if you don't know what to do here read some asset allocation material (www.hcplive.com/pmdlive/mymoneymd/03-2008) and/or discuss it with your advisor. The dividend yield can be ferreted out easily by you before you seek help. Go to Yahoo.com and click finance on the left. This will take you to a page that has an option, 'get quotes' on the upper left. Put in the symbol for your holding. For example, use JNJ. Then, click on summary at the top of the left column. The yield is the last figure on the lower right. As of 3-13-09, it yielded 3.80%, a somewhat neutral figure and probably not enough to change it from a taxed to non-taxed. On the other hand, the large Vanguard value ETF, VTV, has a yield of 5.51%, and that would be worth some consideration for a switch.

There is a trend here, as you can tell. The value entities, in general, have a higher dividend yield than the growth. As a rough rule of thumb, they are better suited for tax advantaged portfolios. Also, REITS traditionally pay large dividends so they are usually best in the tax advantaged unless an individual is retired, wants income, and makes less than $250,000.00.

Some people say that high dividend earnings are sexy. If so, growing them in a tax deferred account for a very long time can make them more alluring. Likewise, capital gain losses can look very glamorous when they are paired up with later gains. This ultimately means the high income investor pays less tax and puts more money in her pocket. For the high earning and non-qualified dividend tax deferral to be meaningful, the time horizon should be long. Since these are tax issues, discuss with your accountant/tax attorney to clarify that these maneuvers are right for you. Now, that's smart money.

*The wash rule says that a taxpayer cannot declare a loss on the sale of an investment if that same investment is purchased within 30 days prior or after the sale date.

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