

TAX STRATEGY: MASTERING YOUR FINANCIAL FUTURE



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T A X E S

Taxes are the most significant “fee” that most of us will ever pay. The country and state that you live in both rely on tax money to operate. Everything from paving roads to servicing the educational needs of school children relies on taxes levied on things like income, property and sales. Taxes on an investment portfolio can significantly reduce your investment returns by taking a portion of the profits you earn. First, understanding the way that taxes work and then implementing strategies to minimize their impact are two crucial steps in protecting your investment returns. Let’s get started.



Types of Taxes

1. Capital Gains Taxes

- **Short-Term Capital Gains:** If you sell an investment (like stocks or bonds) that you've held for one year or less, the profit is considered a short-term capital gain. These gains are taxed at your ordinary income tax rate, which can be quite high depending on your income bracket.
- **Long-Term Capital Gains:** If you sell an investment after holding it for more than a year, the profit is taxed at a lower, long-term capital gains rate, which is typically lower than your ordinary income tax rate. These rates vary and should be considered when selling.

2. Dividend Taxes

- **Qualified Dividends:** These are dividends from U.S. corporations or qualified foreign corporations that meet specific requirements, and they are taxed at the lower long-term capital gains rate.
- **Ordinary Dividends:** Dividends that don't qualify for the lower rate are taxed as ordinary income, which, depending on your income, can be higher.

3. Interest Income Taxes

- Interest earned from bonds (i.e. corporate bonds), savings accounts, or CDs is typically taxed as ordinary income. This can significantly reduce your net return, especially if you're in a high tax bracket.

Types of Taxes

4. Realized Gains vs. Unrealized Gains

- **Realized Gains:** Taxes are only paid on realized gains, which occur when you sell an investment for a profit. Until you sell, any increase in the investment's value is an unrealized gain, which isn't taxed.
- **Tax-Loss Harvesting:** When investors sell investments that have gone down in value, they are able to offset gains that have been realized on other investments, reducing their overall tax liability.

5. Impact on Compounding

- Taxes reduce the amount of money you have available to reinvest. Over time, this can significantly impact the power of compounding, as you have less capital generating returns.

6. Tax-Advantaged Accounts

- **Retirement Accounts (e.g., 401(k), IRA):** Investments grow tax-deferred, meaning you don't pay taxes on earnings until you withdraw them from the account. Some accounts, like Roth IRAs, offer tax-free withdrawals in retirement, which can protect your returns from future taxes.
- **Health Savings Accounts (HSA):** Contributions can be made pre-tax through a paycheck or can be deducted on your taxes. Investments grow tax free and withdrawals for qualified medical expenses are tax-free.

Lets examine: Example of Tax Impact



Suppose you have a \$10,000 investment that grows to \$15,000. If you sell it within a year, and you're in the 32% tax bracket, you could pay \$1,600 in taxes on the \$5,000 gain. This leaves you with \$13,400 instead of \$15,000. As investment portfolios grow, so do tax bills. Over time, paying such taxes can significantly reduce your overall wealth.



Tax Strategy

Understanding how taxes affect your investments is crucial for effective financial planning. Strategies like holding investments longer to qualify for lower tax rates, using tax-advantaged accounts, or offsetting gains with losses can help minimize the impact of taxes on your returns. It is not only about what you earn, but also about what you get to keep! Minimizing taxes on your investment portfolio involves strategic planning and utilizing various tax-efficient investment strategies.



Taxes & Financial Planning

1. Utilize Tax-Advantaged Accounts

- Retirement Accounts (e.g., 401(k), IRA, Roth IRA):
 - Traditional Accounts: Contributions may be tax-deductible, and investments grow tax-deferred. Withdrawals are taxed as ordinary income in retirement.
 - Roth Accounts: Contributions are made with after-tax dollars, but investments grow tax-free, and qualified withdrawals in retirement are also tax-free.
- Health Savings Accounts (HSA): Contributions are tax-deductible, investments grow tax-free, and withdrawals for qualified medical expenses are tax-free.
- 529 Accounts: If you are saving for private K-12 schools or for college, a 529 grows tax free when distributions are used for qualified educational expenses.

2. Hold Investments Longer to Qualify for Long-Term Capital Gains

- Holding investments for more than a year qualifies you for long-term capital gains tax rates, which are lower than short-term rates.
- The long-term capital gains rates currently are 0%, 15%, or 20%, depending on your income level.



Taxes & Financial Planning

3. Use Tax-Loss Harvesting

- Sell investments that have declined in value to offset gains from other investments. This can reduce your taxable income by offsetting an equal amount of gains realized in a given year.
- You can carry forward unused losses to offset future gains, potentially lowering your tax burden over multiple years.
- Tax losses can also be used to offset the taxes owed each year on up to \$3,000 of earned income.



4. Invest in Tax-Efficient Funds

- Index Funds and ETFs: These tend to be more tax-efficient than actively managed mutual funds because they have lower turnover rates, leading to fewer taxable events.
- Tax-Managed Funds: These funds are designed to minimize capital gains distributions, helping to reduce your tax liability.

5. Asset Location Strategies

- Tax-Deferred Accounts: Hold income-generating assets like bonds and high-dividend stocks in tax-deferred accounts (e.g., 401(k), IRA).
- Taxable Accounts: Hold tax-efficient investments like index funds or ETFs in taxable accounts.

Taxes & Financial Planning

6. Invest in Municipal Bonds

- Interest from municipal bonds is typically exempt from federal income taxes and may also be exempt from state and local taxes if you live in the state where the bonds are issued.
- This can be particularly beneficial if you're in a higher tax bracket.

7. Reinvest Dividends in a Tax-Efficient Manner

- Instead of automatically reinvesting dividends, consider taking them as cash. This gives you more control over when and how they are taxed.
- In a taxable account, you might choose to invest those dividends in tax-efficient funds or assets.

8. Consider a Donor-Advised Fund (DAF)

- If you plan to make charitable donations, consider using a DAF. You can donate appreciated securities, receive an immediate tax deduction, and avoid capital gains taxes on the donated assets.

9. Be Mindful of Capital Gains Distributions

- Before buying mutual funds or ETFs, check for upcoming capital gains distributions, especially near the end of the year. Buying just before a distribution could result in an unexpected tax bill.

10. Optimize Withdrawal Strategies in Retirement

- Roth IRA Withdrawals: Consider withdrawing from Roth IRAs later, as these withdrawals are tax-free.
- Order of Withdrawals: Typically, it's advantageous to withdraw from taxable accounts first, then tax-deferred accounts, and finally Roth accounts to minimize taxes over time.

Taxes & Financial Planning

11. Consider Gifting Appreciated Assets

- Gift appreciated stocks or mutual funds to family members in lower tax brackets. They may pay less or no taxes when they sell the assets.
- Gifts to charities of appreciated assets can also provide you with a charitable deduction and avoid capital gains taxes.

12. Small Business Taxes

- Utilize Pass Through Entity Tax Status if your state permits, paying your state taxes as a business expense will result in a dollar for dollar offset on your Federal income tax return.
- Establish retirement plans like Individual 401K plans, SEP IRAs or even defined benefit plans if appropriate.
- Home office deductions may allow you to reduce some of your normal household expenses. This, however, can be an audit red flag so you must ensure you are precisely following the IRS guidelines.

13. Stay Informed on Tax Law Changes

- Tax laws frequently change, which can impact your investment strategy. Staying informed or consulting with a financial planner or a tax advisor can help you adapt your approach to minimize taxes.

14. Consult a Tax Professional

- A tax advisor or financial planner can help you develop a personalized strategy based on your specific situation, ensuring that you maximize tax efficiency in your investment portfolio.

Conclusion

Implementing these strategies requires careful planning and consideration of your overall financial goals. It's often beneficial to revisit your tax strategy regularly to adapt to changes in your financial situation and tax laws. Successfully executing the strategies outlined above can make a significant difference in your portfolio over your investing career.

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