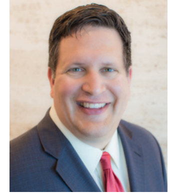
EXPERIENCED ADVISORS HELPING
ACCREDITED ENGINEERS, EXECUTIVES, AND ENTREPRENEURS

SARVER VROOMAN
WEALTH MANAGEMENT GROUP
of Wells Fargo Advisors

1900 Shawnee Mission Parkway, Suite 210 | Mission Woods, KS 66205

7 Strategic Habits of Highly "Tax Aware" Investors

Peter Vrooman, CFA®, CIMA®, CRPC®
First Vice President – Investment Officer
913-267-7170
peter.vrooman@wfadvisors.com



Jonathan Sarver, CPWA®
First Vice President – Investment Officer
913-267-7165
jonathan.sarver@wfadvisors.com

#1

Purchase tax-advantaged municipal bonds.

Investors who purchase municipal bonds in the same state in which they reside may enjoy both Federal and State tax exempt income. The formula for calculating the "taxable equivalent yield" is:

$$\text{Taxable Equivalent Yield} = \frac{\text{Tax-Exempt Yield}}{(1 - \text{Marginal Tax Rate})}$$

As a hypothetical example, if a Missouri resident were to purchase a Missouri municipal bond yielding 3.5% and he was in the 35% Federal tax bracket and 6% state tax bracket, the taxable equivalent yield would be 5.7%:

$$\text{Taxable Equivalent Yield} = \frac{3.5}{1 - (0.35 + 0.06)} = 5.7$$

While the interest income is tax-free, capital gains, if any, will be subject to taxes. Income for some investors may be subject to the federal Alternative Minimum Tax (AMT).

Investing in fixed income securities involves certain risks such as market risk if sold prior to maturity and credit risk especially if investing in high-yield bonds, which have lower ratings and are subject to greater volatility. All fixed income investments may be worth less than original cost upon redemption or maturity. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline of the value of your investment.

#2

Save money for college in "529 college savings" plans.

As long as the money is used for "qualified educational expenses" when it is taken out, the money has the opportunity to grow tax-deferred on both a federal and state tax basis (depending upon which state you reside in) and there are no taxes to pay once the funds are distributed. Depending upon your state of residence, you may qualify for a tax deduction for contributions as well. The availability of such tax or other benefits may be conditioned on meeting certain requirements. Withdrawals of earnings for non-qualified purposes may be subject the ordinary income tax and 10% IRS penalty.

The investment return and principal value of the investment options are subject to market risk and will fluctuate, and when sold, may be worth more or less than the original cost.

College savings plans offered by each state differ significantly in features and benefits. The optimal plan for each investor depends on his or her individual objectives and circumstances. In comparing plans, each investor should consider each plan's investment options, fees and state tax implication.

An investor should consider, before investing, whether the investor's or designated beneficiary's home state offers any state tax or other benefits that are only available for investments in such state's 529 college savings plan.

#3

Gift highly appreciated stock to charity rather than cash.

An investor has invested $2500 in XYZ stock and it doubled in price and is now worth $5000. If he gifts $5000 in cash, he is spending $5000 out of pocket. In contrast, if he gifts his $5000 XYZ position (assuming a 35% federal tax bracket and a long-term capital gain tax rate of 23.8% and a 6% state tax bracket), he will save $745 because:

$$(23.8\% + 6\%) = 29.8\% \times 2500 = \$745$$

#4

Qualified dividends

Dividends from both common stock and preferred stock shares (to which long-term capital gains rates apply) are considered "qualified dividends." Qualified dividends benefit from the long-term capital gains rate of 0%, 15%, or 20% (and sometimes 23.8%), depending upon an investor's tax bracket.

Dividends that do not qualify include dividends from foreign stocks, MLPs, REITS, money market accounts, special dividends, options, and companies that are tax-exempt. This group of non-qualified investments pay "ordinary dividends" and are taxed at ordinary income tax rates.

An investor cannot claim a qualified dividend unless the common stock is held over 60 days during a specific statutory holding period or the preferred stock is held over 90 days during a specific statutory holding period.

#5

Convert your traditional IRA to a Roth IRA after a significant market correction.

This way you are still eliminating future taxes on distributions, but paying taxes on a potentially lesser amount because of depressed prices for stocks and potentially for economically sensitive bonds. It is important to consider how much time you anticipate investing your IRA funds, potential changes in future tax rates, and the liquidity of your holdings that you are using to pay the taxes on the "Roth" conversion.

#6

Pay attention to exceptions to the 10% premature or early distribution penalty for IRA or 401(k) distributions made prior to attaining the age of 59½.

A). Investors may take money out of an IRA prior to attaining the age of 59½ without incurring a 10% early withdrawal penalty if the funds are used for **qualified education expenses.** (Tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible education institution.) If the student is at least a half-time student then room and board is included. Also it is important to reduce your total qualified education expenses by any "tax-free educational assistance" (includes the tax-free portion of distributions from a Coverdell education savings account, tax-free part of scholarships and fellowship grants, Pell Grants, Veterans' educational assistance, employer provided educational assistance, and other tax-free payments received as educational assistance.)

B). If you retire in the same year you turn 55 or older, you can take money out of your 401(k) without incurring the 10% premature distribution penalty.

C). If an investor follows IRS rule 72(t), to avoid the 10% IRS penalty, he can take separate but substantially equal periodic payments from his IRA for a period lasting the greater of 5 years or until the investor reaches the age of 59½ — whichever is longer. The distributions are also based upon several government set calculations and methods of calculation in relation to the investors life expectancy, (or joint life expectancy of the IRA owner and beneficiary). Your tax advisor should be consulted prior to any distributions.

#7

Take advantage of "net unrealized appreciation" (NUA) for highly appreciated employer stock in a 401(k).

NUA is the amount after subtracting the average cost basis from the current market price of employer stock in a 401(k). The NUA is not subject to ordinary income tax and therefore it often makes sense to transfer highly appreciated stock from a 401(k) to a taxable or nonqualified investment account "in-kind," rather than roll it over to an IRA. The investor must pay tax on the cost basis of the highly appreciated employer stock in the year of the distribution. When the shares are eventually sold, the investor will be taxed at the long-term capital gains rate for the NUA and the appropriate capital gains rate for any appreciation since the distribution from the 401(k). NUA typically makes

the most sense when an investor's employer stock is highly appreciated. In addition, the key to adopting the NUA strategy is the difference between the ordinary income tax rate and the capital gains tax rate.

You will have 60 days to roll over the stock or proceeds. This must be a qualified lump-sum distribution. Know your plan and consult with your plan administrator.

Keep in mind if improperly executed, this strategy may subject you to an IRS 10% pre-59½ tax penalty in addition to ordinary income tax. It is important to discuss this with your tax advisor before taking any distributions.

Wells Fargo Advisors does not render tax or legal advice. You should consult your tax and legal advisors for your specific situations. The aforementioned strategies may not be appropriate for your specific circumstances.

Wells Fargo Advisors did not assist in the preparation of this report. Any opinions expressed are those of Jonathan Sarver and Peter Vrooman and may not reflect the views of Wells Fargo Advisors of its affiliates.

Investment and Insurance Products: ▶ NOT FDIC Insured ▶ NO Bank Guarantee ▶ MAY Lose Value

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC, Member SIPC. © 2018 Wells Fargo Clearing Services, LLC 0118-03332 02/18