



TAX EFFICIENT INVESTING

Keep more of what you earn

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Investing inherently involves risks, many of which are beyond an investor's control. Therefore, it is essential to leverage every controllable strategy to enhance your after-tax returns. This guide offers practical strategies for improving tax efficiency in your portfolio.

Understanding Investment Distribution Taxation

A fundamental understanding of how different types of investment distributions are taxed is the first step toward tax-efficient investing. This section offers a high-level overview of the tax treatment for interest, dividends, and capital gains.

Interest, Dividends, and Capital Gains

Interest Income

Interest income generally receives the least favorable tax treatment, as it is taxed at **ordinary income tax rates**. Sources of interest include savings accounts, money market accounts, Certificates of Deposit (CDs), and many types of bonds (e.g., corporate bonds).

- For those in the highest income brackets, the federal ordinary income tax rate can reach **37% in 2025**.
- The **Net Investment Income Tax (NIIT)** may apply, adding an additional **3.8%** (see NIIT section below), potentially bringing the total marginal federal tax rate to **40.8%**.

Dividends

Dividends are categorized based on their tax treatment:

- **Qualified Dividends:** These are taxed at the same favorable rates as long-term capital gains: **0%, 15%, or 20%**, depending on your taxable income and filing status.
 - **Criteria for Qualification:**
 - Must be from a U.S. corporation or a qualified foreign corporation.
 - The investor must have held the stock for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date.
- **Ordinary Dividends:** These are taxed at your standard federal **ordinary income tax rate**, which is generally higher than the qualified dividend rate. Common sources include:
 - Most distributions from Real Estate Investment Trusts (REITs).

- Dividends from master limited partnerships (MLPs).
- Dividends from stock not held for the required qualified period.
- Dividends from money market accounts.

Capital Gains Tax

Capital gains—the profit from selling an investment—are taxed based on the holding period of the asset.

- **Short-Term Capital Gains:** Defined as profits from assets held for **one year or less**. These gains are taxed at your **ordinary income tax rates**.
- **Long-Term Capital Gains:** Defined as profits from assets held for **more than one year**. In 2025, these gains are taxed at favorable rates of **0%, 15%, or 20%**, based on your taxable income.

Filing Status	0% Tax Rate (Income Threshold)	15% Tax Rate (Income Threshold)	20% Tax Rate (Income Threshold)
Single	Up to \$48,350	\$48,351 to \$200,000	Over \$200,000
Married Filing Jointly	Up to \$96,700	\$96,701 to \$600,050	Over \$600,050

Net Investment Income Tax (NIIT)

The NIIT is a **3.8% tax** levied on certain investment income for individuals, estates, and trusts whose income exceeds specific thresholds.

- **Individuals Subject to NIIT:** You are subject to the NIIT if you have net investment income and your Modified Adjusted Gross Income (MAGI) exceeds the following thresholds:
 - Married Filing Jointly or Qualifying Widow(er): **\$250,000**
 - Single or Head of Household: **\$200,000**
 - Married Filing Separately: **\$125,000**

- **Income Considered Net Investment Income (NII):**
 - Interest, dividends, and capital gains.
 - Rental and royalty income.
 - Passive income from investments.
 - Taxable portion of non-qualified annuities.

- **Income *Not* Considered NII:**
 - Wages, salaries, and self-employment income.
 - Social Security benefits and unemployment compensation.
 - Distributions from qualified retirement plans (e.g., 401(k)s, IRAs).
 - Tax-exempt interest from municipal bonds.

Tax Implications of Investment Types

Having reviewed how various distributions are taxed, the next step is to understand the tax characteristics of different investment vehicles.

Investment Type	Potential Tax Implications	Key Tax Consideration
Individual Stocks	Highly tax-efficient. Capital gains are taxed based on the holding period (short-term vs. long-term). Dividends are taxed as ordinary or qualified.	Focus on holding periods to secure long-term capital gains rates and maximizing qualified dividends.
Corporate Bonds	Interest income is generally taxed at ordinary federal income tax rates.	Least tax-efficient for high-bracket investors.
U.S. Treasury Securities	Interest is exempt from state and local income tax but is taxed at ordinary federal income tax rates.	State tax exemption is a key benefit, but federal tax remains.

Investment Type	Potential Tax Implications	Key Tax Consideration
Municipal Bonds (Munis)	Interest can be exempt from federal, state, and local taxes, depending on the type and issuing state.	Ideal for high-tax-bracket investors. Must calculate Tax-Equivalent Yield (TEY).

Tax-Equivalent Yield (TEY) Calculation for Municipal Bonds:

TEY is used to compare the tax-free yield of a muni bond to the pre-tax yield of a taxable bond.

TEY= Tax Free Yield divided by 1 minus Marginal Tax Rate

- **Rule of Thumb:** Municipal bonds often offer a competitive TEY for investors in the **35% tax bracket and higher**.

Mutual Funds and Exchange-Traded Funds (ETFs)

Funds can hold any combination of the securities listed above. Generally, funds pass dividends and interest to shareholders with the same tax treatment as if the investor held the underlying assets directly.

- **The Disadvantage of Funds:** Fund managers make buy/sell decisions, which can trigger capital gains distributions for shareholders at potentially inopportune times.
- **Active vs. Passive (Index) Funds:** **Actively managed funds** typically have a higher portfolio **turnover rate** than passively managed index funds, which can result in higher realized capital gains distributions.
- **Embedded Gains:** Look for a fund's *embedded gains* (or unrealized gains). While not a guarantee, high embedded gains indicate the potential for significant capital gains distributions if the fund liquidates underlying holdings.

Alternative Investments (MLPs, Private Credit, Private Equity)

Many income-seeking investors purchase alternative investments, such as Master Limited Partnerships (MLPs).

- **Tax Complexity:** It is crucial to understand the tax implications of these investments, as their distributions are often reported on a **Schedule K-1** form, rather than the standard Form 1099.

- **Filing Impact:** Holding these investments in a taxable account necessitates filing the K-1 with your tax return, which can incur additional preparation costs. K-1 reporting delays (common with MLPs) may also require filing a tax extension, which can postpone any potential refund.
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Tax-Efficient Investment Strategy

A successful tax strategy begins by aligning investment decisions with goals and time horizons. While paying taxes is a natural result of earning profits, a strategic approach can potentially mitigate unnecessary tax burden.

1. Asset Location

Asset location is the practice of placing specific asset classes (or investments) into the type of account—taxable, tax-deferred, or tax-free—where they will be most tax-efficiently held.

- **Goal:** Maximize overall after-tax returns by shielding the *least* tax-efficient investments from immediate taxation.
- **Strategy (Example for a 70% Equity / 30% Fixed Income Allocation):**
 - **Tax-Deferred/Tax-Exempt Accounts (e.g., Traditional IRA, 401(k), Roth IRA):** Prioritize holding the least tax-efficient assets here.
 - **Traditional IRA/401(k):** Ideal for assets that generate frequent ordinary income, such as **bonds** (corporate and Treasury), **REITs**, and high-turnover **actively managed funds**.
 - **Roth IRA:** Use for assets with the highest potential long-term growth (e.g., highly volatile or aggressive stocks/funds) or those generating qualified dividends, as all withdrawals in retirement are tax-free.
 - **Taxable Brokerage Account:** Allocate the most tax-efficient assets here.
 - **Municipal Bonds:** Their tax-free interest makes them a priority for taxable accounts.
 - **Low-Turnover Index Funds/ETFs:** These generally distribute fewer capital gains.
 - **Individual Stocks:** Especially those paying qualified dividends or held for long-term capital gains.

2. Tax-Loss Harvesting (TLH)

Tax-loss harvesting involves selling an investment that has declined in value to **offset realized capital gains** and potentially up to **\$3,000 of ordinary income** in a taxable brokerage account.

- **Cost Basis Method:** When opening a brokerage account, selecting the **Specific Share Identification (SpecID)** cost basis method is highly recommended.
 - **Benefit:** SpecID allows you to selectively sell only the specific tax lots (shares purchased at a particular time and price) that are at a loss, maximizing opportunities for tax-loss harvesting while retaining low-cost basis shares for future growth.
- **The Wash Sale Rule:** Investors must be cautious of the wash sale rule, which prohibits claiming a loss if the investor, or a related party, buys a "substantially identical" security within 30 days before or after the sale.

For more detailed information on the wash sale rules, see IRS Publication 550

3. Resetting gains

When you are temporarily in the **0% capital gains tax bracket**, consider **realizing investment gains** up to the limit of this bracket. Immediately repurchasing the investment *outside* of the wash-sale rule period will **increase your cost basis**. This strategic move effectively "resets" the cost basis higher, which can **reduce future capital gains tax liability**.

4. Direct Indexing

Unlike a fund with direct indexing, you own the individual stocks. This allows for the possibility of TLH at the individual stock level, rather than the entire basket level. For example, if you own Exxon Mobil (XOM) in an ETF and it is at a loss, but your ETF shares are at a gain, you cannot simply sell Exxon Mobil to harvest the loss. By owning the individual shares of Exxon Mobil, you can sell just the individual share or lots of Exxon Mobil at a loss.

You can use direct indexing for a portion of your portfolio, such as a large-cap blend, and build around the index with funds to balance out your overall portfolio.

Using the above strategies can help possibly increase your after-tax returns, allowing you to keep more of what you earn.

To review your strategy, visit our website at synergywm.net/contact and fill out Contact us form.

Source. The source for this guide is IRS Publication 550.

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