Direct Access Trading
Worldwide

Interactive Brokers
presents

Tax Efficient Trading and Investing

Josh Pohl, Interactive Brokers
jpohl@interactivebrokers.com

Interactive Brokers
The Professional's Gateway to the World's Markets

IRS Circular 230 Notice

- The information in this presentation is provided for informational purposes only, and does not constitute tax advice and cannot be used by the recipient or any other taxpayer to avoid penalties under any federal, state, local or other tax statutes or regulations, or to resolve any tax issue.

Agenda

- ❑ Define Tax Efficiency
- ❑ Holding Periods
- ❑ Tax Efficient Products
- ❑ Using Losses
- ❑ Use of Retirement Accounts to be more Tax Efficient
  - Types of Retirement Accounts and Comparison With other Accounts
  - Tax Attributes of Various Asset Types
  - Strategy to Allocate Assets to Retirement and Non-Retirement Accounts
  - Examples of Tax Efficient Strategy
- ❑ Conclusion and Question & Answer Session

Tax Efficient Trading and Investing

- Reduce tax liability
- Defer tax liability
- No change in nature of investments

Interactive Brokers
The Professional's Gateway to the World's Markets

Tax Efficiency

- ❑ Awareness of Rules and Holding Periods
- ❑ Choice of Products
- ❑ Use of Losses
- ❑ Use of Tax Advantaged Retirement Accounts
  - Primary Focus of This Webinar

Awareness of Rules

- Minimum holding period for long-term gains is one year and one day
- Use Tax Optimizer
- Minimum holding period for qualified dividends is 31 days including the ex-dividend date
- Short sales are almost always short-term
- See IRS Publication 550 Investment Income and Expenses http://www.irs.gov/pub/irs-pdf/p550.pdf

Tax Efficient Products

- Gains on ETF shares and ETF options are generally taxed at short-term rates, unless the holding period exceeds one year
- Gains on index futures contracts are generally taxed as 60% long-term gain and 40% short-term gain regardless of holding period
- For holding periods up to one year, SPX (S&P Index) options are often more tax efficient than SPY options
  - However, gain on SPX options is taxed even if the position remains open at year end

These examples are for illustrative purposes only and are not intended to portray recommendations.

Tax Efficient Products

- Gain on commodities related ETFs and options on ETFs are taxed as short-term capital gains for holding periods of one year or less
- Gain on gold and silver related ETFs may be subject to a 28% rate for long-term gains
- Gains on commodities futures contracts and options on futures contracts are generally taxed as 60% long-term gain and 40% short-term gain
  - Also marked-to-market

These examples are for illustrative purposes only and are not intended to portray recommendations.

Tax Efficient Products

- Interest on US Government bonds is subject to federal tax, but exempt from state and local tax
- Interest on municipal bonds is exempt from federal tax, but may be subject to the Alternative Minimum Tax
- Interest on municipal bonds is exempt from state and local tax in the state where the bond issuer is located

Use of Losses

- Offset current year gains
  - “Tax Loss Harvesting”
- Beware of the Wash Sale Rule
  - Loss is disallowed if you sell for a loss and repurchase within 30 days
- Beware of additional risk
  - Out of market
  - Doubling up
- Carry forward unused losses
  - For life

Retirement Accounts

- Make maximum contributions if possible
- Hold high tax assets in tax-advantaged accounts
- Hold low tax assets in fully taxable accounts

Interactive Brokers
The Professional's Gateway to the World's Markets

Account Types

- Taxable Accounts: Ordinary investment accounts. Subject to current taxation at rates dependent on asset/income type
- Tax-Deferred Accounts: Contributions are often deductible or not included in taxable income. No taxation until withdrawal. Withdrawals subject to taxation as ordinary income. Includes traditional IRA, Sep-IRA
- Roth: Post-tax contributions, untaxed when distributed Includes Roth IRA, Roth 401(k).

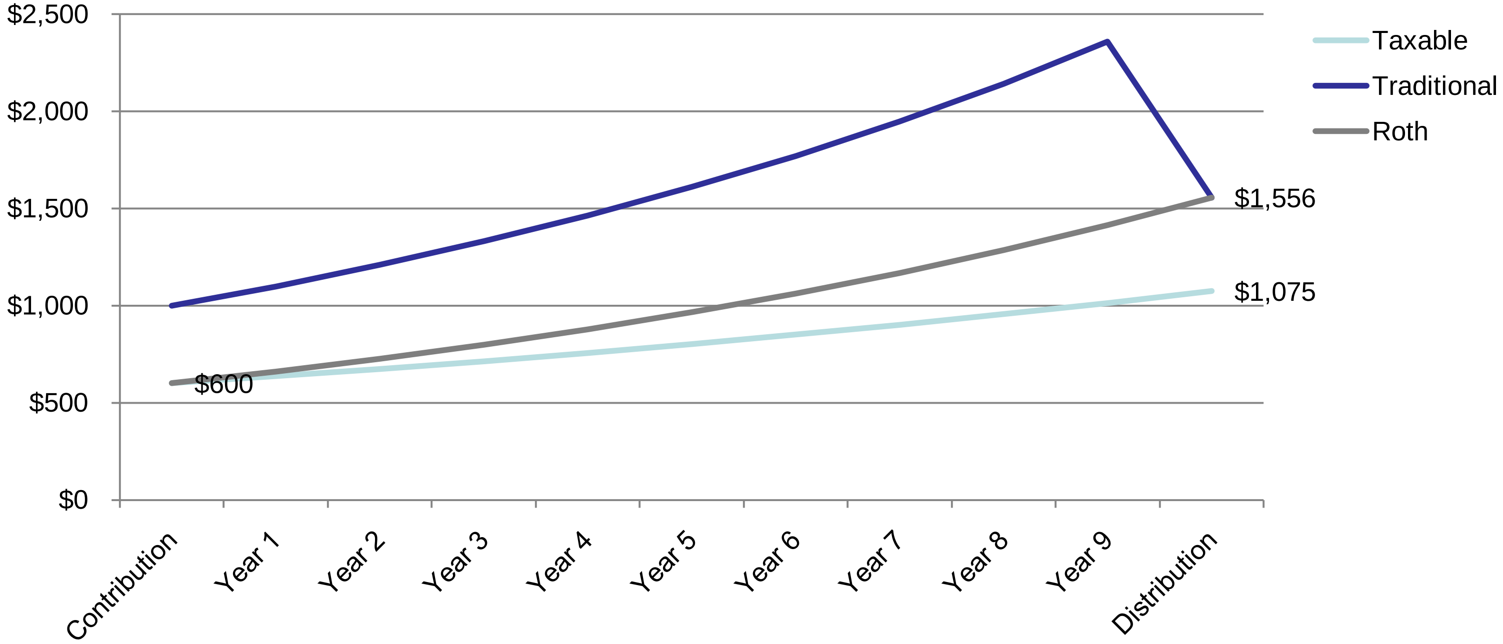
A little bit about IRAs

- The rules that apply to traditional and Roth IRAs are very complex. Publication 590, Individual Retirement Arrangements (IRAs) is useful and available at: http://www.irs.gov/pub/irs-pdf/p590.pdf
- I will only discuss a handful of these rules that are particularly relevant
- I will not address the many important non-tax issues or penalties and taxes applicable to early withdrawals and other prohibited acts

Account Type Comparison

- Hypothetical: Invest a $1,000 bonus in an account for five years then withdraw after-tax total
  - Assume 10% annual return
  - Assume 40% tax rate for all income
- Taxable account
  - Pay 40% taxes at start and 40% taxes after each year
- Traditional IRA
  - Contribute entire bonus to IRA. 40% tax on distribution
- Roth IRA
  - Pay taxes on bonus when earned. Pay no taxes on income/growth of Roth IRA or distributions

After Tax Comparison



- Assumptions:
  - 10% Returns
  - 40% Tax in all cases

Tax Efficient Investing

- This presentation does not distinguish between traditional and Roth retirement accounts
- Not looking to change asset allocation
- Looking to increase tax efficiency over the long-term
- Don't forget non-tax issues

2013 Federal Tax Rates

Filing Status	Taxable Income	Ordinary Income Tax Rate	Long-Term Capital Gains Rate
Single	$0-$8,925	10%	0%
Married Filing Joint	$0-$17,850		
Single	$8,925-$36,250	15%	0%
Married Filing Joint	$17,850-$72,500		
Single	$36,250-$87,850	25%	15%
Married Filing Joint	$72,500-$146,400		
Single	$87,850-$183,250	28%	15%
Married Filing Joint	$146,400-$223,050		
Single	$183,250-$398,350	33%	15%
Married Filing Joint	$223,050-$398,350		
Single	$398,350-$400,000	35%	15%
Married Filing Joint	$398,350-$450,000		
Single	Over $400,000	39.6%	20%
Married Filing Joint	Over $450,000		

Net Investment Income Tax

- Net Investment Income (NII) tax of 3.8% applies to investment income to the extent that taxable income exceeds $250K married filing jointly/$200K individuals
  - Investment income includes, but is not limited to, interest, dividends, capital gains, income from trading securities
  - Does not apply to IRA distributions
  - An additional advantage of retirement accounts
- A married couple filing jointly with $25K Investment Income and $300K total income would pay NII on $25K
- A individual with $50K investment income and $230 total income would pay NII on $30K

Asset Tax Attributes

- Each asset can produce multiple kinds of income
- Each income type may be taxed differently
  - Ordinary income
  - Preferred rate income
  - Special rate income
  - Tax-exempt income
- Capital losses can be used to offset capital gains, but other investment income cannot be offset
- Foreign stocks may provide foreign tax credits that may lower US tax dollar for dollar

Assets Income Pairs

- Bonds
  - Interest: taxable, tax-exempt, partially tax-exempt
  - Capital gains
- Stocks
  - Dividends: qualified, nonqualified
  - Capital gain
- Mutual Funds/ETFs
  - All types of income
    - Look at the specific fund
- Options
  - Capital gain

Ordinary Income

- Not all "Ordinary Income" is the same
- Taxable interest
  - Corporate bonds
  - Account balance interest
- Nonqualified dividends
  - Any dividend with insufficient holding period
  - Foreign stocks in non-treaty countries
- Short-term capital gains
  - Any asset held for up to one year
  - Short positions, Put protected positions
  - Actively managed funds

Ordinary Income Tax Rates

- Marginal rates depend on income level up to a maximum marginal rate of 39.6%
- Maximum AMT rate is 28%, but the effective rate can be higher
- Net Investment Income Tax is an additional 3.8%
  - Does not apply to IRA distributions
- Don’t forget state and local taxes (if applicable)

Preferred Rate Income

- Qualified Dividends
  - US stocks and many foreign stocks
  - Minimum holding period 61 days straddling the ex-dividend date
- Long-term capital gains
  - Most capital assets
  - Minimum holding period 1 year plus 1 day
- Maximum rate is 20% (plus net investment income tax 3.8%)
- Don't forget state and local
- Generally same rates apply under AMT

Special Rates

- Gain on futures contracts is treated as 60% long-term gain and 40% short-term gain.
- Collectibles – including bullion – 28%
  - Includes gains from certain ETFs such as GLD

These examples are for illustrative purposes only and are not intended to portray recommendations.

Other Tax Properties

- Use of losses to offset gains
  - Gains from asset appreciation rather than dividends/interest
  - Loss harvesting
- Foreign tax credits
  - Often you can reduce US tax liability dollar for dollar for any taxes paid on dividends from foreign companies/ADRs

Allocation Technique

- Consider the total value of all accounts
  - Taxable
  - Tax deferred
  - Roth
- Discount tax-deferred accounts by the amount of tax you expect to pay
- Might also discount taxable accounts for built-in gains

Asset Allocation

- Highest Tax Items in Retirement Accounts
  - Corporate Bonds
  - Short-Term Holdings
  - Mutual Funds/ETFs with large amounts of ordinary income
  - US Government Bonds
- Lowest Tax Items in Taxable Account
  - Tax-Exempt Bonds: always
  - Long-term holdings
  - Low dividend stocks
  - Passive/Index Funds
  - Foreign stocks

Overall Asset Allocation

- Spread your assets according to your desired allocation (based on risk tolerance, time frame, etc.)
- Place most highly taxed assets in retirement accounts first until you run out of room
- Place the assets with lowest expected tax liability in taxable accounts

Reallocation Tax Trap

- If you sell an asset for a loss in a taxable account and repurchase the same or substantially similar asset or an option or contract for the purchase of such asset in a non-taxable account
- You do not recognize the loss and lose the benefit forever

Example 1

- Total Portfolio:
  - 200K Taxable Brokerage Account
    - 100K in SPY
    - 100K in HYLD
  - 100K Roth IRA
    - 50K in SPY ETF
    - 50K in HYLD
- Reallocate to:
  - Taxable Brokerage Account:
    - 150K in SPY
    - 50K in HYLD
  - Roth IRA
    - 100K in HYLD

These examples are for illustrative purposes only and are not intended to portray recommendations.

Example 2

- Brokerage Account (250K Total)
  - 100K Diversified Blue Chip Stocks
  - 50K Municipal Bonds
  - 50K Investment Grade Corporate Bonds
  - 50K International Stock Index Fund
- Traditional IRA
  - 100K SPY
- Roth IRA
  - 100K Treasury Inflation Protected Securities

Example 2

- ❑ Total Post Tax Value: 250K(Brokerage) + 50% of 100K (IRA) + $100K Roth = $400K
- ❑ List of assets from the highest expected tax rate to lowest:
  - 50K Investment Grade Corporate Bonds
  - 100K Treasury Inflation Protected Securities
  - 50K International Stock Index Fun
  - 100K SPY
  - 100K Diversified Blue Chip Stock
  - 50K Municipal Bonds

These examples are for illustrative purposes only and are not intended to portray recommendations.

Example 2: Allocate Assets

- Traditional IRA(100K total):
  - 100K Investment Grade Bonds (50K post-tax equivalent)
- Roth IRA(100K Total)
  - 100K TIPS:
- Taxable Brokerage Account(250K total):
  - 50K International Stock Index Fund
  - 50K SPY
  - 100K Diversified Blue Chip Stock
  - 50K Municipal Bonds

These examples are for illustrative purposes only and are not intended to portray recommendations.

Maximize Retirement Accounts

- ❑ Make maximum contributions when possible
- ❑ "Back Door" IRA
  - Roth IRA contributions have income limits, e.g., if you make more than a threshold amount you cannot contribute
  - However, anyone with earned income can make a nondeductible contribution to a traditional IRA
  - Currently, there are no income limits to convert a traditional IRA to a Roth
  - Contribute to a traditional IRA and then convert to a Roth IRA
    - Taxes apply only on the gain in the traditional IRA, not the original non-deductible

General Ideas for Bonds

- Taxable bonds should be the first asset allocated to retirement accounts
- US Government bonds are also a high priority for retirement accounts
- Municipal bonds should never be held in a retirement account
  - Consider holding higher yielding taxable bonds in a retirement account rather than lower yielding munis in a taxable account
- Bond funds distribute gains and losses in addition to interest dividends

General Ideas for Stocks

- Allocate longer-term investments to taxable accounts and shorter-term investments to retirement accounts
- Allocate actively managed funds to retirement accounts and passive/index funds to taxable accounts
- Allocate low dividend/growth stocks to taxable accounts and high dividend/value stocks to retirement accounts
- Allocate domestic stocks to retirement accounts and foreign stocks to taxable accounts

Summary

- ❑ Awareness of Holding Periods
- ❑ Tax Efficient Assets
- ❑ Use of Losses
- ❑ Use of Retirement Accounts
    - Hold high tax assets in retirement accounts

Summary:
Tax Efficient use of Retirement Accounts

1. Determine value of all accounts - retirement plus taxable
2. List assets by tax efficiency
3. Hold the most tax efficient assets in taxable accounts
4. Hold the least tax efficient assets in retirement accounts
5. Don’t forget tax effects of rebalancing and non-tax issues such as liquidity