What Investors Can Learn From Their Tax Returns

- When managing taxable investment accounts (e.g., individual, joint, and trust accounts), COMPASS Wealth Management, LLC is focused on generating the highest after -tax return for a given level of risk.
- The strategies we employ to reduce the tax consequences of our investment decisions include (1) placing bond and REIT investments in IRAs, where their income is not taxable (also known as the "asset location" decision); (2) employing tax-efficient mutual funds in taxable accounts to minimize taxable distributions; (3) using losses in taxable accounts to offset gains; and (4) rebalancing portfolios within IRAs so that taxable gains are not incurred.

Your 1040 can reveal a lot about your investment habits. Are you withholding too much or too little? Taking advantage of all the credits available to you? Before you stash a copy of your tax return in a drawer, take note of the following line items on your 1040.

Line 8-Interest Income: The raw dollar amounts of your interest income are shown on line 8 of your 1040 form; line 8a shows taxable income and line 8b shows tax-exempt income, generally from municipal bonds. If you have a high level of taxable interest income, pay careful attention to asset location and assess whether taxable bonds, rather than municipals, are truly the better bet once the tax effects are factored in.

Line 9-Dividend Income: Line 9a shows the total amount of ordinary dividends you received last year; dividends on line 9b count as qualified, meaning that they are subject to more favorable tax treatment. As with taxable interest above, take a hard look at any investments, such as REITs, that are paying nonqualified dividends; those investments may be better housed in a tax-sheltered account such as an IRA.

Line 13-Capital Gain (or Loss): Capital gains are often a sign of investment success. But if you see a big number on this line, make sure you're paying due attention to proper tax management. Do you periodically scout around your taxable portfolio for losing positions that you can use to offset gains? If your losses exceed your gains, you can use them to offset up to $3,000 in ordinary income. If one of your fund holdings made a big capital-gain distribution last year, have you considered whether that fund might be a better fit in a tax-sheltered account?

Line 25-Health Savings Account Deduction: Have you evaluated whether a health savings account, used in conjunction with a high-deductible health-care plan, is a good fit for you? For those who are relatively healthy and have cash on hand to cover out-of-pocket expenses that might arise until they hit the maximum for the year, HSAs can serve as supplemental savings vehicles. You'll enjoy tax benefits on your contributions and the money in your HSA will roll over from one year to the next.

Line 32-IRA Deduction: If you are closing in on retirement, haven't saved much, and can deduct your contribution, funding a traditional IRA may be a better bet than putting money into a Roth IRA. If you're not contributing to a company retirement plan, you can deduct your traditional IRA contribution regardless of income level. Individuals earning less than $68,000 in 2012 who are covered by a company retirement plan can make at least a partially deductible contribution to a traditional IRA. Married couples filing jointly can make at least a partially deductible IRA contribution if they earn less than $112,000.

The opinions herein are those of Morningstar, Inc. and should not be viewed as providing investment, tax, or legal advice. Please consult with your financial professional regarding such services. Dividends are not guaranteed. REITs typically provide high dividends plus the potential for moderate, long-term capital appreciation. A REIT must distribute at least 90% of its taxable income to shareholders annually. Real estate investment options are subject to certain risks, such as risks associated with general and local economic conditions, interest rate fluctuation, credit risks, liquidity risks and corporate structure. Municipal bonds may be subject to the alternative minimum tax (AMT) and state and local taxes, and federal taxes would apply to any capital gains distributions. Stocks and REITs are not guaranteed and have been more volatile than bonds. Funds in a regular IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax-free as money withdrawn is not taxed. Penalties may apply for withdrawals prior to the age of 59 1/2.