

# thePLAN

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## What to Learn From Your Tax Return

*Your 1040 can help you identify financial planning opportunities—so don't file it away just yet.* By ISMAT SARAH MANGLA

WHETHER YOU EAGERLY completed your taxes in late January or will just slip in under the April 15 deadline, savor the relief you feel once your return is finally in Uncle Sam's hands. But before filing that 1040 away for good, make a copy for your financial adviser—or just take a closer look yourself.

Some smart scanning of this document can help you plan for the future. And that doesn't just refer to the standard advice →

of adjusting your withholding if your refund is particularly fat or catching missed deduction opportunities. New York City financial planner Karen Altfest says the tax return is “one of the most valuable pieces of information” she uses to help clients determine the best uses of their money, what investments go in what vehicles, and whether to make portfolio changes. Here are a few planning opportunities your 1040 can present.

**YOU COULD BE KEEPING MORE OF WHAT YOUR PORTFOLIO IS THROWING OFF**

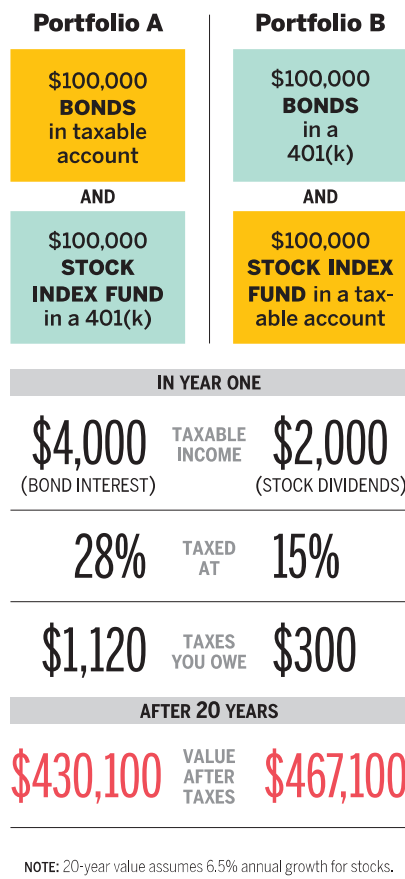
**What to look for:** More than \$1,000 in taxable interest (on line 8a) or more than \$1,000 in “unqualified” dividends (line 9a minus line 9b). **What it means:** Either of those is a sign that you might want to relocate some holdings into tax-deferred accounts, says Colorado Springs financial planner Allan Roth. As is, you might be paying more taxes than you need to on certain assets.

People often keep their fixed-income holdings outside their IRAs and 401(k)s, but tax-wise, that doesn't make sense. Interest from CDs and bonds is taxed at your ordinary income rate, and the same is true for dividends earned on REITs. So you're better off sheltering these highly taxed investments in tax-advantaged accounts (with the exception of the dough you plan to tap in the short term or have earmarked for emergencies).

As for how to invest taxable money, consider a stock index fund that covers the total U.S. or international markets. Such funds don't trade holdings frequently, so they don't generate many capital gains. While they may pay qualified dividends, those will be taxed by the feds at only 15% for now. And the yields tend to

**AN OPPORTUNITY FOR TAX EFFICIENCY**

*Placing stock index funds in taxable accounts and bonds in 401(k)s nets more than the opposite strategy, as shown below. Both portfolios earn 2% dividends on stock funds and 4% annual interest on bonds, and belong to a couple in the 28% tax bracket.*



be low. So even with President Obama's proposal to shift dividends to a 20% rate for couples making more than \$250,000, a stock index fund would still make sense.

The graphic above illustrates the benefit, on a yearly basis and over time, of having stock index funds in taxable accounts and fixed-income investments in 401(k)s for a couple

in the 28% federal tax bracket. However, actually selling out of funds to re-orient your portfolio in this way may not be wise, if by doing so you will incur large capital gains. But you can use these strategies to guide you on money that you're newly investing.

**YOUR MUTUAL FUNDS MAY BE COSTING YOU**

**What to look for:** Significant net short-term capital gains (line 7 of Schedule D). **What it means:** Short-term capital gains are taxed at your ordinary income rate as well. And if you have a lot of them, it's probably because you're in an actively managed fund that makes a lot of investment changes (or you're a day trader, in which case you're reading the wrong magazine). You might consider switching out such funds for actively managed funds with low turnover, such as those on our MONEY 70 list, on page 106. Bonus: Funds that buy and sell less frequently actually end up producing higher returns than their heavily trading counterparts. Alternatively, you could buy into index funds, which, as noted earlier, are particularly tax-efficient.

**YOU HAVE A CHANCE TO FIX YOUR PORTFOLIO, TAX-FREE**

**What to look for:** Capital losses that you're able to carry forward to future years (line 16 minus line 21 of Schedule D).

**What it means:** You can use capital losses to offset capital gains—meaning this could be your chance to make some of the investment changes discussed earlier without incurring a tax bill, says Altfest.

Other reasons you might want to sell an investment that's gained in value: You need to rebalance the taxable portion of your portfolio or you have some high-fee mutual

funds that you'd like to trade in for funds with lower expenses. But don't bother making changes just for the sake of using up the losses, because you can also use \$3,000 each year to reduce your taxable income.

**YOU MAY WANT TO PAY OFF YOUR MORTGAGE**

**What to look for:** Total itemized deductions that are not much above the standard deduction—which was \$11,400 for a married couple filing jointly in 2009 (line 40a).

**What it means:** If you are a homeowner still paying off your house, a small gap between the standard deduction and the itemized deduction means that you're not benefiting much from the mortgage interest

write-off. Paying off your mortgage, if you're in a position to do so, might save you more than itemizing.

Say you and your spouse took out a \$200,000 30-year mortgage at a fixed rate of 5% in 1990. Last year you paid \$5,400 in interest. If your other itemized deductions equaled \$8,000, your total deduction comes out to \$13,400. So you really benefited from only \$2,000 of the mortgage interest—a savings of just \$560 for a couple in the 28% tax bracket, says Gordon Bernhardt, a financial planner in McLean, Va. That benefit will continue to decrease as the years progress, because you'll be paying less interest and more principal on the mortgage.

With \$102,520 left on your mort-

gage at this point, you could pay it off and invest what you would have paid over the next 10 years—\$1,073 a month—in a bond fund yielding 4%. At the end of 10 years, you'd have about \$5,700 more than you would if you'd left that \$102,520 in the same bond fund and continued to pay off your mortgage in increments. Besides reducing your debt load—especially important as you head into retirement—paying off your mortgage also nets you more in the long run, says Bernhardt.

“But you have to do the math in every case,” he adds. “What's greater? The after-tax payment on your mortgage or the after-tax earnings on the portfolio?” If the mortgage bill is higher, it'll pay to wipe out that loan. ■

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