12 Ways to Simplify Your Taxable Investing Account

I received a long email recently about taxable investing accounts which basically boiled down to this question:

Q.

We max out all available tax-protected accounts including 401(k), 457, Backdoor Roth(s) and a 529 for our child. We also invest about $4K a month in taxable. In order to keep things simple, we have chosen four very tax-efficient mutual funds and invest $500 in each of them every two weeks.

However, I'm just now realizing, as I recently wanted to tax-loss harvest, that I have a ton of different tax lots to keep track of and that tax-loss harvesting is going to require me to own even more funds, with even more tax lots. Any advice for a guy who wants to keep things as simple as possible?

A.

It is easy to see the dilemma. You want to have tax-efficient investing. You want to manage your own investments. You want to keep things as simple as possible, including your tax return. But you also don't want to leave free money on the table and everyone says you should be tax-loss harvesting.

There is unlikely to be any perfect solution, but there are a couple of options and certainly some general principles to keep in mind.

Option # 1 Hire someone else to manage your taxable account

Some roboadvisors, such as Betterment, have shown they can do a great job managing a taxable account in a very tax-efficient way, and perhaps even get more tax losses than you can get on your own. There is a cost, of course, at 0.15-0.30% of AUM.

There is some argument as to whether their ability to tax-loss harvest can actually make up that cost. But there is no doubt if you highly value removing this hassle from your plate that 15 basis points is a very low price to pay to do that.

You could also hire a regular, full-service advisor. Managing your own investments can be a very profitable hobby, but if it's not a hobby you're interested in, you won't be tax-loss harvesting like you should.

Option # 2 Do it yourself but balance investing simplicity with tax simplicity

You're actually doing pretty great and already following some good principles. However, there are a number of principles of simplification you are NOT following, which you could apply relatively easily to your taxable investing account.

12 Principles for Simplifying Your Taxable Investing Account

Principle # 1 Max out tax-protected

accounts

Whether you choose tax-free (Roth) or tax-deferred (most retirement accounts,) both are almost always better than taxable in the long run, from an investing return standpoint, a tax standpoint, an asset protection standpoint, and a simplicity standpoint. Far too many doctors are investing in taxable simply because they don't know about all the accounts available to them, such as individual 401(k)s, defined benefit/cash balance plans, backdoor Roth IRAs, and stealth IRAs (Health Savings Accounts.)

Principle # 2 Follow a regular savings and investing plan

You have a written asset allocation, are saving an adequate amount, and are following your plan. In the long run, that matters far more than a few bucks in taxes and how much hassle your account requires.

Principle # 3 Use tax-efficient funds in the taxable account

Although there is significant debate about asset location, whether you choose to hold bonds, stocks, or both in taxable, it is best to choose very tax-efficient funds there. That means broadly diversified stock index funds and muni bond funds. While individual bonds are also tax-efficient and reasonable to use, they certainly introduce additional hassle and are expensive to tax-loss harvest.

Principle # 4 Simplify holdings at every opportunity possible

As you go through the years, there are often ways to simplify and consolidate your various tax lots. Take advantage as you go along. Tax-loss harvesting is one of the best ways to do this.

For example, imagine if you have 8 lots of shares of an index fund, and in a bear market, the price of that fund falls below the price of the lowest tax lot. Just sell all 8 of them, and consolidate them into one tax lot as you tax loss harvest. If you have mistakenly bought investments you really don't want for the long term, and you have a taxable loss in them, here's your chance! You may wish to do this even if your shares have small gains, just for the sake of simplicity.

One simplifying idea that is probably NOT worth doing is waiting 30 days to reinvest. I think it is better to find a tax-loss "partner" and buy it at the same time you sell the shares with the loss. That way if the market takes off on you in the next month, as it often does, you're not selling low and buying high.

Principle # 5 Donate appreciated shares

One of the best ways to simplify things, if you give regularly to charity anyway, is to simply donate appreciated shares to the charity instead of cash. Not only do you get the itemized deduction, but neither you nor the charity has to pay the capital gains taxes.

You can then turn around and use the cash you would have donated to buy those shares back immediately with a higher tax basis. You get to flush those taxable gains right out of your portfolio. Plus, it gives you another opportunity to simplify holdings. By giving some tax lots (or investments you didn't want to hold for the long run) away, you have fewer tax lots.

Watching your kids sumo wrestle is way more fun than tax-loss harvesting.

Principle # 6 Save regularly but invest less frequently

Just because you pull money out of your pay every two weeks to invest, doesn't mean you have to buy funds with it. You can just stick the money into a high-yield savings account and invest once a month, or even once a quarter. If you're buying 4 times a year instead of 24 times a year, you're going to have a lot fewer tax lots.

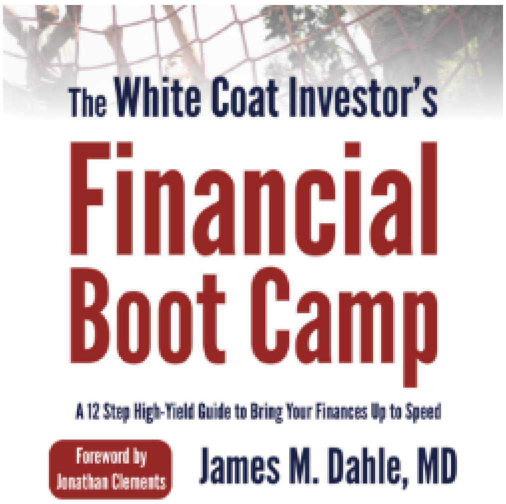
Principle # 7 Buy one investment at a time

Along those same lines, if you have $2000 to invest (or maybe $12,000 if you decide to do it once a quarter), you can just put that entire $12,000 into the same fund instead of into all four funds. Sure, your asset allocation will be a little off, but that doesn't matter much, especially as the years go by and new contributions become tiny compared to the size of your portfolio.

Each quarter just choose the holding whose asset allocation is the lowest compared to the target allocation, and lump sum the whole contribution into that fund. There will be fewer opportunities to tax loss harvest, but you won't have to watch hundreds of tax lots over the years. You may also save commissions depending on your brokerage and investments.

Principle # 8 Hold bonds in taxable

Wherever you fall in the bonds vs stocks in taxable debate, there is no doubt that you can worry a lot less about tax-loss harvesting if you just hold muni bond funds in taxable. Consider the Vanguard Intermediate tax-exempt fund. The current price is $14.43. Over the last fifteen years, the price has basically stayed between $13 and $14.50 (except for one very brief excursion down to $12.11 in the 2008 bear market.) So basically, you only had a significant opportunity to tax loss harvest one time in 15 years, and that was only an 8% drop. That's not so bad.



Equity funds, on the other hand, are far more volatile. You get 8% drops a couple of times a year for most years. Again, you're balancing a desire for simplicity with maximizing the benefits of investing in a taxable account where Uncle Sam will share in your losses. All bonds in taxable give you maximum simplicity. All stocks in taxable give you maximum opportunities for tax-loss harvesting.

Principle # 9 Don’t tax loss harvest tiny losses

As a general rule, unless you’re exchanging from a less-preferred fund to a more-preferred fund, wait until you have a significant loss to tax loss harvest – as defined by dollar amount, not a percentage amount. There are costs to buying and selling, even if you’re not paying commissions.

ETFs are particularly handy for tax-loss harvesting (since you can capture intra-day losses). When you buy and sell ETFs there are bid-ask spreads you eat every time you make a transaction. While a fund doesn’t see that, there may be other fees associated with the transaction.

If you have a bunch of $500 lots, you’re not going to want to harvest 8% drops, much less 4% drops. But on a $15K lot, a 4% drop is $600, and probably $300 off this year’s tax bill. That’s worthwhile to me. And a 10% drop on a $40K lot? That a $4000 loss and $2000 off my taxes. That’s definitely worth a bid-ask spread.

Principle # 10 Use ETFs, especially if commission-free

As mentioned above, you can capture intra-day losses with ETFs. It’s more of a pain to have to put in the buy and sell orders manually, but probably worth it in the long run. If the asset class you’re interested in has a good ETF, might as well use it. ETFs, by virtue of their structure, can be slightly more tax-efficient than even a highly-tax efficient index fund, although the Vanguard funds with ETF share classes get that free ride too.

I prefer traditional mutual funds in tax-protected accounts, but I like ETFs in taxable. On a related note, use only high volume ETFs with tiny bid-ask spreads. I've seen spreads as high as 2%. That's not something you want in taxable when you can get ETFs with spreads of 1 or 2 basis points.

Principle # 11 Don't reinvest dividends in taxable

Want to create a big tax pain? Reinvest your dividends in taxable. Now every quarter every holding you have has another tiny little tax lot. Better to just direct them all into your sweep account and throw them into your next big transaction. Yes, it will be time out of the market for those dollars, but I think it's worth it to save the hassle. That's just one more way in which taxable investing is inferior to tax-protected investing.

Principle # 12 Remember tax loss harvesting is done in the beginning

After you have held a fund for a year or two, chances are good it is NEVER going back below the price you bought it at. So typically, you're only tax loss harvesting tax lots you bought in the last year. Maybe in a big bear market you might sell something you bought three or four years ago. But if you're not flushing out gains with charitable donations, you will likely end up with tax lots you bought a decade or three ago. Eventually, you are just spending distributions and holding on until your heirs get the step-up in basis at death. If you need to sell shares, you'll be selling shares purchased more recently anyway. So the point is, even if you have dozens or hundreds of tax lots, you don't have to watch them all.

Applying these principles should allow you to tax loss harvest while still being able to keep your portfolio as simple as possible. The main principle is that if you don't want to manage a large number of tax lots, don't buy a large number of tax lots and consolidate the ones you have at every opportunity either through tax-loss harvesting or donation of shares to charity.

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What do you think? How do you manage your taxable account? ETFs or traditional mutual funds in taxable? How much do you let your asset allocation drift from month to month in order to avoid tax hassle? Comment below!