Learn about tax-efficient investing

Investor education

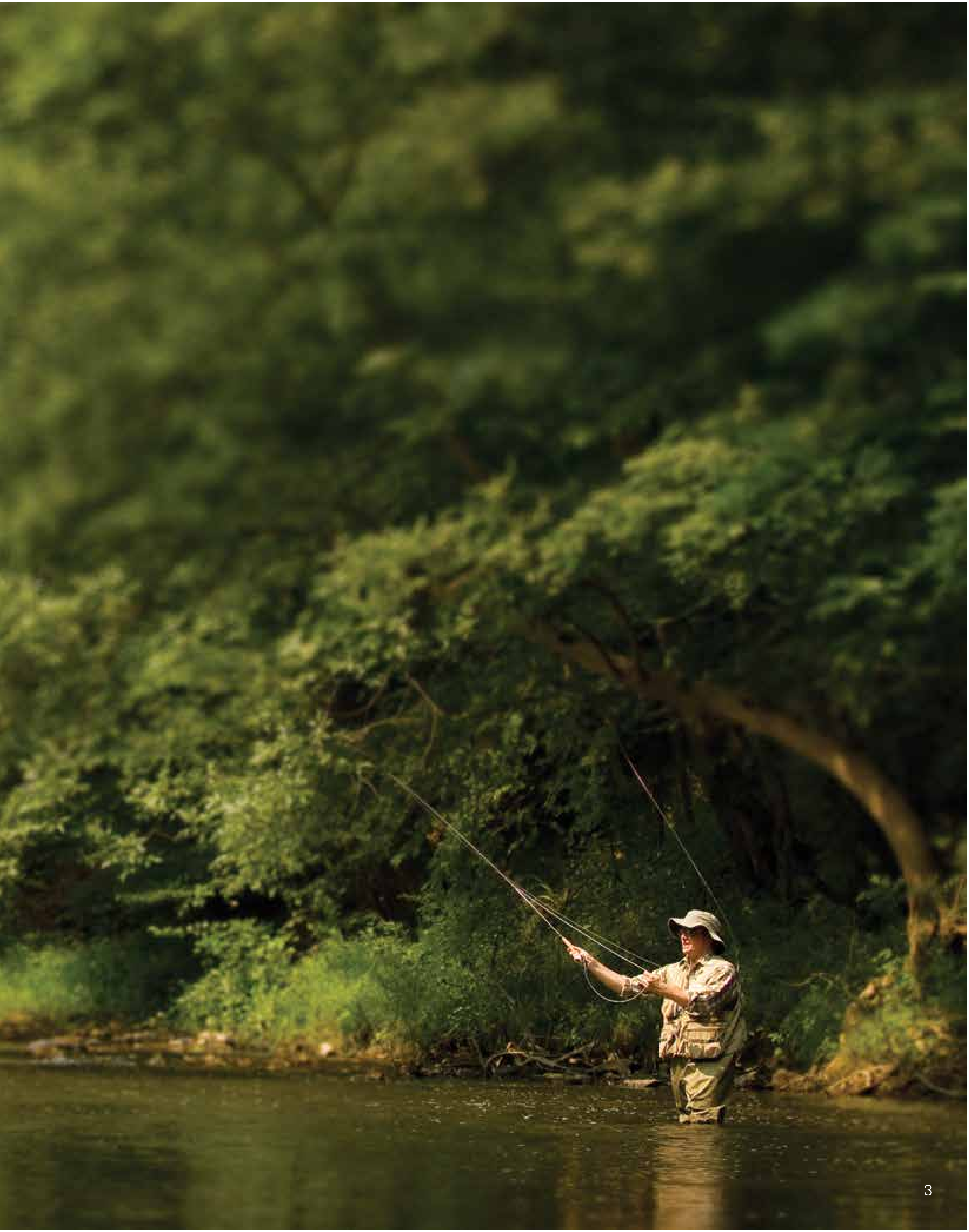
Vanguard®

Be a tax-conscious investor

Of all the expenses investors pay, taxes have the potential for taking the biggest bite out of their total returns. That's why it pays to be sensitive to taxes as you work with your financial advisor to build and manage your investment portfolio.

Use tax-advantaged accounts

One of the most important steps that you and your financial advisor can take to minimize the impact that taxes have on your investments is to tuck away as much money as you can in tax-advantaged accounts, such as employer-sponsored retirement plans and IRAs. Here are some opportunities that may be open to you.



Max out your employer plan

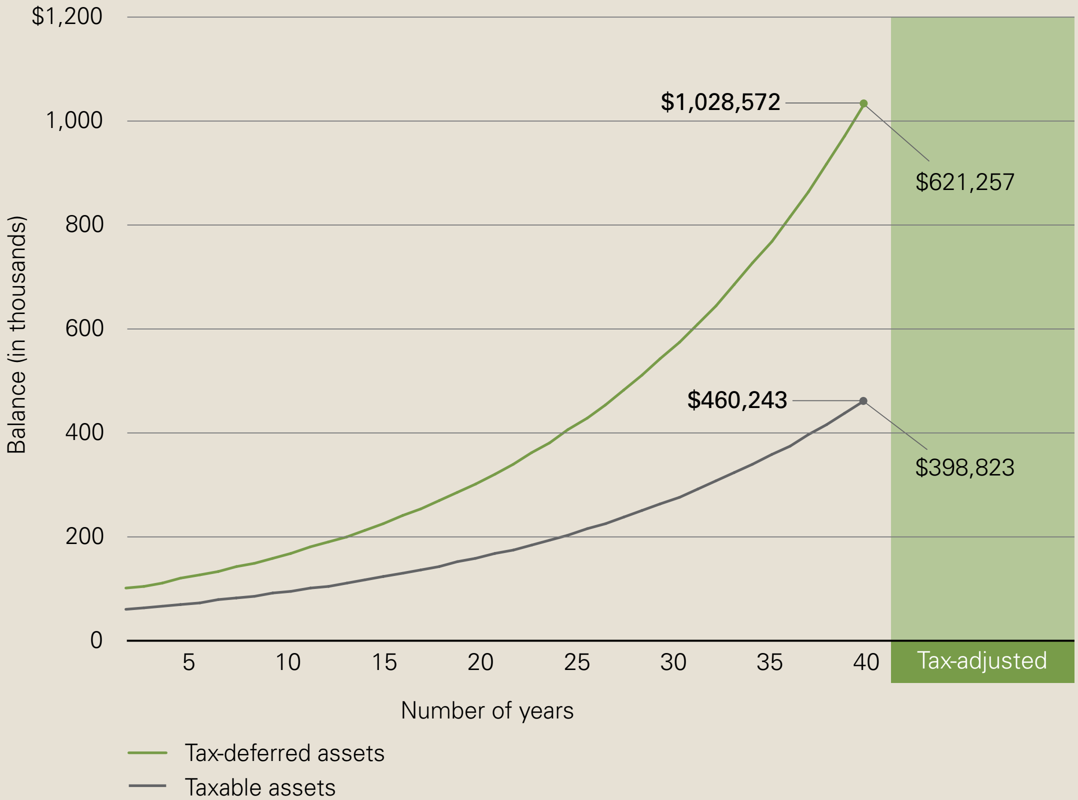
If your employer offers a defined contribution plan, such as a 401(k) or 403(b), sign up for the plan and maximize your contributions as soon as you can. And if your employer matches some or all your contributions, contribute at least enough to get all the matching dollars. It's free money; don't pass it up.

Making pre-tax contributions to an employer plan provides a double bonus. First, Uncle Sam will subsidize your retirement savings by deferring income tax on the amount you save. So for every $1 you contribute to your account (up to an annual limit), your take-home pay may be decreased by only 70 cents or so, depending on your marginal tax rate.

Second, your investments grow tax-deferred. As shown in the graph at right, this deferral can be extremely valuable. By delaying the tax bill, more of your money is working for you over the years. In addition, because the money is taken directly out of your paycheck, you won't be tempted to spend it. This arrangement provides the discipline a lot of investors need to reach their retirement goals.[1]

1 Contributions to a Roth 401(k) or 403(b) plan are made on an after-tax basis, but qualified distributions are tax-free.

The long-term benefit of tax-deferred investing



Taxes can cut deeply into your investment returns. In this example, two people invested in the same mutual fund, but one invested through a 401(k) plan and the other invested through a taxable account. To make the comparison fair, the ending balance in both accounts assumes that the money was withdrawn and taxed at the appropriate tax rate. The ending balance in the taxable account was adjusted for the taxes owed on the growth, using a capital gains rate of 20%; yearly income distributions were taxed as they were realized.

This hypothetical example assumes an initial investment from a $100,000 rollover and a 6% annual total return, 2 percentage points came from income distributions (which were taxed annually at 40% in the taxable account). This example is not representative of any particular investment. The assumed 6% rate of return is not guaranteed. It is an illustrative example of a long-term average return on a balanced investment of stocks and bonds. Market returns are not constant and will fluctuate annually.

If capital gains or income tax rates were lowered in the future, that may make the taxable investment more favorable and the difference between taxable and tax-deferred ending balances less. Any future changes in the tax treatment of investment earnings or a rate of return that is lower than the assumed rate of return may further affect the comparison. Investors should consider their time horizon and current and expected future tax rates before making an investment decision.

If you take withdrawals from a tax-deferred investment before age 59½, you may have to pay ordinary income tax plus a 10% federal penalty tax.

Contribute to an IRA

Similar to a 401(k) plan, an individual retirement account allows you to put aside money for retirement that enjoys favorable tax treatment. There are several types of IRAs, each with its own qualifications and tax benefits.

Traditional IRA

If either you or your spouse has income from work, or if you receive taxable alimony payments, you may be eligible to contribute up to $5,500 per person to an IRA. And if you're age 50 and older, you may be eligible to contribute up to $6,500. Your IRA contributions for you and your spouse can't exceed your earned income, and you must file a joint tax return to make a spousal contribution.

Maximum contributions to IRAs have risen over the past few years, as shown in the table below.

Maximum IRA contributions

When	Under age 50*	Age 50 and older
2018 and later	$5,500	$6,500

*Contribution limits will be indexed for inflation in $500 increments. There is no indexing for inflation on the $1,000 catch-up contribution for age 50 and older.

Everyone who meets the basic criteria for contributing to an IRA can choose a traditional IRA. The only question is whether the contribution is tax-deductible.

Generally, you can deduct all or part of your contribution—even if you (or your spouse, if you're married and filing jointly) participate in an employer-sponsored plan—as long as your modified adjusted gross income doesn't exceed certain limits. Even if you aren't eligible to take an immediate tax deduction, you can still contribute the maximum (if you have the earned income) and benefit from the tax-deferred growth of your investment. Distributions (other than the portion representing a return of nondeductible contributions, if any) will be taxed at your ordinary income tax rate when you withdraw them in retirement.

Roth IRA

No matter what your age, if you meet the basic criteria for contributing to an IRA, you can choose a Roth IRA as long as your modified adjusted gross income doesn't exceed certain levels. (A sliding scale also determines whether you can contribute all or only part of the annual maximum.)

Contributions to a Roth IRA are not tax-deductible, but once you've held the Roth for five years and are over age 59½, your distributions are tax- and penalty-free.

Traditional IRAs and Roth IRAs have different rules for taking distributions, which may affect which one you choose. For example, you must begin taking required minimum distributions (RMDs) from a traditional IRA beginning the year in which you reach age 70½—or face penalties if you don't. You aren't required to take any distribution from your Roth IRA during your lifetime, but there are RMDs for whomever inherits your Roth account.

With a traditional IRA, you may have to pay a 10% federal penalty tax if you make withdrawals before you reach age 59½. With a Roth IRA, you generally have to pay a penalty and/or taxes if you withdraw earnings before age 59½, or if you withdraw earnings and you've held the account for less than five years. However, you can withdraw contributions made to a Roth IRA at any time without incurring a penalty or taxes.

In deciding which type of IRA is right for you, consult with your financial advisor to determine whether you can deduct your contribution and whether you expect your postretirement income tax bracket to be higher than your current tax bracket. If you expect your postretirement tax bracket to be the same or higher than your current tax bracket, a Roth IRA may make more sense.

Open a SEP-IRA if you're self-employed

If you're a sole proprietor or small-business owner, a SEP-IRA is an easy-to-administer plan that permits you to set aside money for retirement in a tax-deferred account.

According to IRS rules, for tax year 2018 you may contribute up to 25% of your compensation or $55,000 to your SEP-IRA, whichever is less. Consult with your tax advisor regarding special rules that apply when determining the maximum deductible contribution.

You also can make employee or personal contributions to your account of up to $5,500 for tax year 2018, plus up to $1,000 in additional contributions if you're age 50 and older. (These are the same limits that apply to traditional and Roth IRAs; note that personal contributions to traditional, Roth, and SEP-IRAs combined cannot exceed these limits.) Personal contributions to a SEP-IRA are treated as traditional IRA contributions and can be either deductible or nondeductible, depending on your income and other factors.

Look to your financial advisor for valuable assistance in determining the best approach to minimizing your taxes.

Contribution and salary-deferral limits for retirement accounts

Provision	Tax year 2018
Maximum annual IRA contribution (under age 50)	$5,500
Maximum annual IRA contribution (age 50 or over)	$6,500
Maximum annual 401(k), 403(b), or 457[1] salary-deferral limit (under age 50)	$18,500
Maximum annual 401(k), 403(b), or 457 salary-deferral limit (age 50 or over)	$24,500
Maximum SIMPLE[2] salary-deferral limit (under age 50)	$12,500
Maximum SIMPLE salary-deferral limit (age 50 or over)	$15,500
Maximum annual additions limit under defined contribution plan (under age 50)	$55,000
Maximum annual additions limit under defined contribution plan (age 50 or over)	$61,000
Maximum includable compensation for computing contributions	$275,000
Minimum annual compensation for determining a "highly compensated" employee (used in 401(k) nondiscrimination tests)	$120,000
Minimum annual compensation amount for SEP participation	$600

1 Additional tax-advantaged contributions can be made under certain circumstances. Consult your financial advisor or tax advisor for details.

2 A SIMPLE plan is similar to a SEP-IRA, but with numerous distinctions, including that your employees can contribute to their accounts in a SIMPLE plan, but not in a SEP-IRA.

Choose the right account types

While tax-advantaged accounts are good for meeting long-term goals, such as retirement, most investors also have money in taxable accounts. But even taxable accounts can be managed with an eye on tax efficiency.

Most investors know that taxes may be due when they sell an investment at a profit. But it's also important to know that you may owe taxes when your investment distributes its earnings as capital gains or dividends. Tax-efficient investments do a better job of keeping those distributions to a minimum.

What makes an investment tax-efficient?

Factors such as the investment approach (active, broad index, narrow index) or methodology can weigh heavily on a fund's tax efficiency. However, certain types of investments are, by their nature, more tax-efficient than others. With stock funds, for example, the amount a fund distributes affects its tax efficiency, of course, but the type of distribution also plays a big role.

One example is capital gains—the money that mutual funds distribute to investors when they earn a profit on the sale of a security. It's also the gain investors realize when they sell a stock or bond for more than they paid for it. In both cases, capital gains are taxed at different rates depending on their classification as short- or long-term gains. It's important to understand that you can owe capital gains on an individual security or a mutual fund, when gains and income are distributed, whether you sold the investment or not. Generally, short-term capital gains on shares held for a year or less are taxed as ordinary income at the investor's marginal tax rate, which can be as high as 37%. Long-term capital gains on shares held more than one year are usually taxed at a rate of 15% or 20%, though the rate

All mutual funds are subject to risk, including the possible loss of the money you invest.

could also be as low as 0% depending on your taxable income or the type of investment involved. Distributions of qualified dividends are taxed at 0%, 15%, or 20% depending on your taxable income.

This significant difference in tax rates means one thing for investors concerned about taxes: Investing money in taxable accounts that distribute high levels of short-term capital gains can be costly.

Taxes can be managed by using tax-efficient investments. Among stock funds, broad-market index funds and tax-managed funds are generally tax-efficient because they typically generate lower levels of capital gains, short- or long-term, although it is possible that the funds will not meet their objective of being tax-efficient. Your financial advisor can help assess your particular situation. Actively managed stock funds, on the other hand, have the potential to generate higher levels of capital gains distributions because they buy and sell securities and realize gains—including short-term capital gains.

Generally, taxable money market and bond funds generate a high proportion of taxable income because most of their total returns come from taxable interest, which, like short-term capital gains, is taxed as ordinary income at the investor's marginal tax rate.

To minimize taxes, your financial advisor will likely suggest placing the most tax-inefficient investments in your tax-advantaged accounts and the most tax-efficient investments in your taxable accounts.

The primary reason to put assets in the "right" type of account or fund is to defer taxes for as long as possible, making the asset location decision more significant for investors with long-term investment horizons.

Tax-inefficient funds

If you and your financial advisor decide that actively managed stock funds are appropriate for your portfolio, they should be placed in tax-advantaged accounts whenever possible. Here's why: Compared with broad-market stock index funds, actively managed stock funds are likely to give up a greater proportion of their return to taxes. In large measure, this is because actively managed funds tend to change their holdings more often than broad-market index funds. This means they may realize more gains and thus generate bigger tax bills for their shareholders. In general, the tax efficiency of actively managed stock funds is unpredictable and highly variable.

The table below suggests whether an investment should be purchased in a tax-advantaged or a taxable account. The column on the right lists the types of investments; the higher on the list, the greater the tax benefit of keeping the investment in the recommended account type. Consult your financial advisor regarding your situation.

An asset location hierarchy

What should go where?	
For tax-advantaged accounts, consider these types of investments:	• Taxable bond funds; bond index funds • Actively managed stock funds • Broad-market stock index funds
For taxable accounts, consider these types of investments:	• Tax-managed stock funds • Broad-market stock index funds • Municipal bond funds (depending on tax bracket) • Taxable bond funds; bond index funds

Tax-efficient funds

Today's investors have more tax-efficient funds to choose from than ever before. Some of these funds are billed as "tax-managed" and focus specifically on maximizing after-tax returns, often by limiting buying and selling of shares (many follow an index strategy) and by instituting policies to discourage investors from frequently moving in and out of the funds.

Tax-exempt funds

Investors who hold a portion of their bond or money market allocation in a taxable account often consider tax-exempt municipal money market and bond funds.

Interest, or income dividends, paid on bonds issued by a state or local political subdivision (that is, municipal bonds) is generally exempt from federal income tax. The interest may also be exempt from state and local income taxes, provided the bonds were issued in the state in which you reside for tax purposes. (Even tax-exempt funds, however, can distribute short- and long-term capital gains, which would be subject to tax. In addition, for some shareholders in tax-exempt funds, a portion of the income may be subject to the alternative minimum tax.)

Because the income dividends from municipal money market and bond funds generally aren't federally taxable, these funds typically have lower yields than taxable money market and bond funds. Even so, if you're in one of the upper marginal tax brackets—and especially if you live in a state or locality that has high income tax rates—municipal money market and bond funds are likely to provide you with higher after-tax income than taxable funds with similar characteristics.

The table at right provides general guidelines for helping you decide if municipal bond funds are right for you. The analysis is not based on a comparison of yields at any particular time, but rather on the historical relationship between the yields available on taxable bonds and municipal bonds. As such, it sets forth helpful rules of thumb (but does not substitute for comparing actual yields of actual funds). Once again, your financial advisor can help determine the municipal bond allocation that's right for you.

As you can see, those in lower tax brackets may be better off investing in taxable bonds, while higher-bracket investors may be better off in municipal bonds. For those in between, municipal bonds may make the most sense for the long-term bond portion of a portfolio. (The difference in yields between taxable and tax-exempt securities is typically wider for longer-term securities than it is for securities with shorter maturities.)

How much in munis?

Allocating municipal bond investments

If you're in this tax bracket ...	you may want to allocate this portion of your bond investments to municipal bonds
10%, 12%	0%
22%	100% of your long-term bonds (your short- and intermediate-term holdings should be taxable bonds)
24%, 32%, 35%, 37%	100%

Portfolio management with an eye on taxes

You're contributing all you can to your tax-deferred accounts, and you and your financial advisor have chosen the right types of accounts for your investments. Now your financial advisor will manage your portfolio with taxes in mind.

There are several tactics that you and your financial advisor can use to help ensure that your portfolio remains tax-efficient.

- Avoid excessive movement into and out of mutual funds and other securities.
- Use tax-efficient strategies when buying and selling investments.
- Consider making charitable contributions using appreciated securities rather than cash.

Don't trade away your tax benefits

You can invest in the most tax-efficient fund in the world, but even if you sell shares as infrequently as every two or three years, you may offset a material portion of the fund's tax benefits. Limiting the sale of appreciated shares in taxable accounts will reduce the capital gains you realize and allow you to defer taxes on a larger proportion of your fund's unrealized gains.

And remember, selling shares that you have held for a year or less will result in short-term capital gains taxed as ordinary income at your marginal income tax rate. By holding on to shares for more than a year, gains will be taxed at rates that are substantially lower. Recent changes in the capital gains rates are outlined in the chart below.

In addition, capital gains income is subject to a 3.8% Medicare tax at or above a certain taxable income threshold.

Rebalancing is important

Of course, minimizing taxes isn't the only goal you and your financial advisor have for your investment program. In fact, it makes good sense to evaluate your program annually and to rebalance your mix of stocks, bonds, and money market funds, if necessary. Your tax-wise financial advisor will first look to rebalance your tax-advantaged accounts, where gains generated by a shift aren't subject to current taxes.

That's not always possible, though, so understand that, at times, these shifts could lead to the realization of gains that would be taxed.

When you do buy and sell mutual fund shares, here are some ways that your financial advisor may be able to lower your tax liability.

Buying

Before investing a large amount in a mutual fund, your financial advisor will examine the realized gains in the fund's portfolio. If they represent a significant portion of the fund's net asset value and the record date of the next capital gains distribution is near, your financial advisor may want to delay your purchase until after the record date. Otherwise, you will "buy the dividend," and that can cost you money in taxes.

2018 capital gains tax rates

Single taxpayer	Married filing jointly	Capital gains tax rate	Section 1411 Medicare surtax	Combined tax rate
\$0–\$38,600	\$0–\$77,200	0%	0%	0%
\$38,601–\$425,800	\$77,201–\$479,000	15%	0%	15%
More than \$425,800	More than \$479,000	20%	3.8%	23.8%

Selling

At some point, you will undoubtedly sell shares from your taxable accounts. You can minimize the tax bite by selling both losers and winners in your portfolio. This strategy can help offset the gains of the winners with the losses of the losers. However, as your financial advisor knows, it's very important not to sell securities or fund shares only for tax purposes.

Donate appreciated securities

Another strategy your financial advisor may suggest is to donate appreciated shares in your portfolio to charity instead of making a cash contribution. For shares held one year, this can have several benefits.

- You can generally take a tax deduction for the full market value of the securities.
- You avoid paying capital gains tax on the amount the securities have appreciated since you acquired them—a tax you would owe if you sold the securities first and then donated the cash proceeds.

Your financial advisor is available to answer your questions about taxes and investing, or any other aspect of your investment program, to ensure that you build and maintain a successful, tax-advantaged portfolio.

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Although the income from a municipal bond fund is exempt from federal tax, you may owe taxes on any capital gains realized through the fund's trading or through your own redemption of shares. For some investors, a portion of the fund's income may be subject to state and local taxes, as well as to the federal Alternative Minimum Tax.

Financial advisors:
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FAEGTXI 102018