Q&A: Tax-Efficient Investing

Q. How are investment returns taxed in an ordinary brokerage account, compared with 403(b)s and IRAs?

A. Ordinary brokerage account returns are taxable. You'll pay tax each year on any investment income these accounts produce, such as bond interest and stock dividends. You'll also owe taxes on any appreciation during the year if you (or your fund) sold investments for a gain.

IRAs and workplace retirement accounts, such as 403(b)s, shield investment income and realized gains from taxes. Instead, you generally pay tax when you make either withdrawals (traditional retirement accounts) or contributions (Roth accounts). Investment earnings from both Traditional and Roth IRAs are taxed and subject to a 10% penalty if you make a withdrawal before age 59½.

Q. Which types of investments should I hold in retirement accounts rather than in brokerage accounts?

A. You can use retirement accounts to hold investments that have the potential to produce large tax bills in a brokerage account. These may include:

- Stocks you might sell within a year (in an IRA)
- Corporate bonds and mutual funds that hold them
- Funds that trade frequently.

Q. Which types of investments are best for taxable accounts?

A. Consider using ordinary brokerage accounts to hold assets that generate minimal tax. These may include:

- Municipal bonds, exempt from federal taxes
- Stocks you'll hold longer than a year
- Funds designed to be tax-efficient, such as index funds or exchange traded funds (ETFs).