How to Keep More of Your Money

A GUIDE TO:

Tax-Savvy Investing

EDUCATION GUIDE

THE Vanguard GROUP®

Become a Tax-Savvy Investor

Of all the expenses investors pay, taxes can take the biggest bite out of total returns. That is why it is important to understand investment taxes as you work with your financial advisor to build and manage a successful portfolio.

This guide outlines three important steps you can take to become a tax-savvy investor.

Step 1: Use tax-advantaged accounts.

Step 2: Choose appropriate account types.

Step 3: Manage with an eye on taxes.

Step 1 Use Tax-Advantaged Accounts

One of the best ways to help minimize investment taxes is to put as much money as possible into tax-advantaged accounts which don't require tax payment until you make withdrawals—usually when you're in retirement and in a lower tax bracket. Here are some key options:

Maximize Your Employer-Sponsored Retirement Plan Contributions

If your employer offers a defined contribution plan, such as a 401(k) or 403(b), sign up and maximize your contribution. Contributing to an employer plan provides a double bonus.

- The federal government will subsidize your savings by deferring income tax on the amount you save. For every $1 you contribute to your retirement plan, your take-home pay may be reduced by only about $0.70.
- Your investments grow tax-deferred. By delaying your tax bill, more of your money is working for you over the years.

In addition, because the money you invest is taken directly from your paycheck, there is less temptation to spend it. This arrangement provides the added discipline many investors need to help reach their retirement goals.

Maximum Allowable 401(k) and 403(b) Contributions

When	For Those Under Age 50	For Those Age 50 or Above
2004	$13,000	$16,000
2005	$14,000	$18,000
2006 and later	$15,000	$20,000

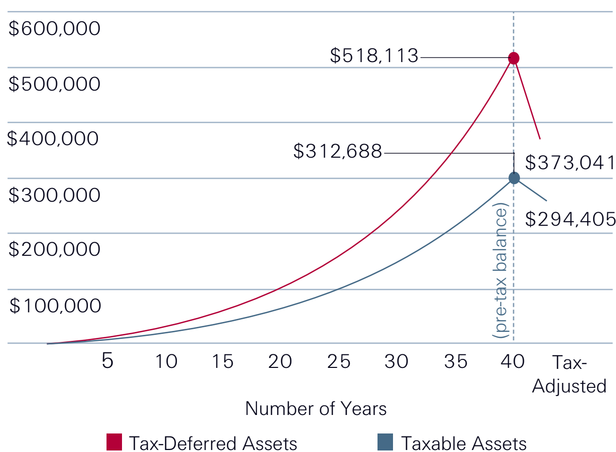
Contribute to an IRA

Generally, you're eligible to contribute up to $3,000 annually to an individual retirement account (IRA). If you are at least 50 years old, you can contribute up to $3,500 each year. Maximum IRA contribution limits also will increase over the next several years.

Traditional IRAs

IRAs may allow for an annual tax-deductible contribution for each eligible income earner. Contributions are fully tax-deductible for those who do not have access to an employer-sponsored retirement plan, or for those within certain income ranges.

The Benefits 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 tax-deferred account and the other invested in 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 taxable account was adjusted for the taxes owed on the growth—the capital gains rate of 15%; yearly distributions were taxed as they were realized.

This hypothetical example assumes an annual contribution of $2,000 (adjusted to $1,440 for the taxable account), an 8% annual total return, 3% of which came from income (and was taxed annually at 28% in the taxable account). It is not representative of any particular investment. Lower minimum tax rates on capital gains and dividends could make the return on the taxable investment more favorable, thereby reducing the difference in performance between the two accounts shown. Consider your personal investment horizon, as well as your current and anticipated income tax rate, when making an investment decision.

Investor Tip

If you expect your post-retirement income tax bracket to be the same or higher than your current tax bracket, investing in a Roth IRA may be more appropriate. Your financial advisor can help you determine which type of IRA is right for you.

Roth IRAs

A Roth IRA can offer tax-free investing. Although Roth contributions are not tax-deductible, you pay no taxes on withdrawals after you reach age 59 ½ if you've owned the Roth for at least five years. You are never required to make withdrawals, so your assets can continue to grow tax-free.

Some Basic IRA Rules

Traditional IRAs and Roth IRAs have different distribution rules which may affect which type you choose.

- *Traditional IRAs* require that you begin taking distributions by the year you reach age 70½. You generally have to pay a penalty if you make withdrawals before age 59½, if you contribute more than the allowable limit for any year, or if you don't withdraw enough after reaching age 70½.

- *Roth IRAs* may require you to pay a penalty if you withdraw earnings before age 59½, if you have held the account for less than five years, or if you contribute more than the allowable amount each year. Otherwise, Roth IRA contributions can be withdrawn at any time without penalty.

Maximum IRA Contribution

When	For Those Under Age 50	For Those Age 50 or Above
2004	$3,000	$3,500
2005	$4,000	$4,500
2006—2007	$4,000	$5,000
2008 and later	$5,000	$6,000

Self-Employed? Open a SEP–IRA

If you're a sole proprietor or small business owner, a Simplified Employee Pension individual retirement account (SEP–IRA) allows you to set aside money in a tax-deferred retirement account.

Contribution Limits

Sole proprietors may contribute up to the lesser of 20% of profits from self-employment (net profit minus one-half of self-employment tax) or $41,000 in 2004.

If your business is incorporated and your compensation is reported on IRS Form W-2, you may contribute up to the lesser of 25% of your annual income or $41,000 in 2004.

Note: Withdrawing money from tax-deferred accounts before age 59½ may result in income taxes and penalty taxes.

Step 2 Choose Appropriate Account Types

One of the simplest ways to help minimize investment taxes is to place tax-inefficient investments in tax-advantaged accounts and tax-efficient investments in taxable accounts.

The primary reason to put assets in the right type of account is to defer taxes for as long as possible, making the asset location decision most significant for long-term investors.

Understanding Tax Efficiency

A number of factors work to make investments tax-efficient or tax-inefficient, including the investment approach (active, passive, broad index, narrow index), the amount a fund distributes, and the type of distribution the fund makes.

Certain types of investments are, by their nature, more tax-efficient than others. Among stock mutual funds, broad market index funds and tax-managed funds are generally tax-efficient because they typically don't generate a high level of capital gains. Actively managed stock mutual funds have historically generated higher capital gains, making them less tax-efficient.

Taxable money market and bond funds can also generate a high proportion of taxable income because most of their total returns come from taxable interest. Like short-term capital gains, these returns are taxed as ordinary income.

Investor Tip

A capital gain is realized—and taxable—when a fund sells a security that has increased in value. Investors also can generate realized gains by selling fund shares for more than they paid for them. Avoid making a tax-efficient strategy tax-inefficient by selling funds and realizing gains that might better be deferred.

When to Use Tax-Advantaged Accounts

As discussed earlier, tax-advantaged accounts, such as employer-sponsored retirement plans and IRAs, are sensible locations for tax-inefficient mutual funds because you don't pay taxes on these types of accounts until you make withdrawals.

The Importance of Taxable Accounts

Taxable accounts play an important part in many investors' portfolios. When choosing investments for these accounts, your financial advisor will likely recommend tax-efficient and tax-exempt mutual funds.

What Should Go Where?

For tax-advantaged accounts, consider these types of investments:	1. Actively managed stock funds. 2. Taxable bond funds. 3. Bond index funds. 4. Treasury inflation-protected securities.
For taxable accounts, consider these types of investments:	1. Tax-managed stock funds. 2. Broad-market stock index funds. 3. Exchange-traded funds. 4. Municipal bond funds (depending on tax bracket), taxable bond funds, bond index funds.

Tax-Efficient Funds

These days, investors have more tax-efficient mutual fund choices than ever, including:

- *Tax-managed funds* that focus on maximizing after-tax returns by limiting the buying and selling of shares and by discouraging investors from moving in and out of the fund.
- *Broad-market stock index funds* that have a low level of securities turnover and, therefore, generate lower capital gains.
- *Exchange-traded funds (ETFs)* that share the buy-and-hold nature of traditional indexing in an effort to reduce capital gains.

Tax-Exempt Funds

Tax-exempt municipal bond and money market funds are extremely efficient investment options. Both offer interest or income that is generally exempt from federal income tax. Interest on the bonds can also be exempt from state and local taxes, if they were issued in the state in which you live. Keep in mind, however, that these funds typically have lower yields than their taxable counterparts.

Investors in tax-exempt municipal bond and money market funds should be aware that both vehicles can distribute short- or long-term capital gains that could be subject to taxes. In addition, for some shareholders, a portion of the income may be subject to the alternative minimum tax.

How Much Should You Invest in Municipal Bonds?

If you're in this tax bracket . . .	this portion of your bond investments should be in municipal bonds . . .
10%, 15%	0%
25%	100% of your long-term bonds (your short- and intermediate-term holdings should be taxable bonds)
28%, 33%, 35%	100%

Step 3 Manage With an Eye on Taxes

The first two steps in this guide explained the importance of contributing all you can to your tax-deferred accounts and choosing the right types of accounts for your investments. Step three discusses how to manage your portfolio with taxes in mind. Here's how:

Don't Trade Away Your Tax Benefits

Even trading as infrequently as every two or three years can offset most of your tax benefits. So limiting your sale of appreciated fund shares in taxable accounts will reduce the capital gains you realize and allow you to keep a higher proportion of your fund's after-tax return.

Should You Hold or Sell?

It may make sense to hold your investment and pay tax on the fund's distribution instead of selling your shares and paying tax on your capital gain.

If an investor . . .	the taxable distribution or long-term capital gain is . . .	at the maximum 15% capital gains rate, the tax owed is . . .
Holds shares	$1,000	$150
Sells shares	$2,000	$300

Investor Tip

Calculating the cost basis of your investments is the best way to avoid paying taxes twice. Your financial advisor can explain how cost-basis accounting helps preserve your portfolio's tax efficiency.

Buy and Sell Carefully

Work with your financial advisor to evaluate your investment program periodically and, if necessary, rebalance your investments. Look first to rebalance your tax-advantaged accounts, where gains generated by a shift are not subject to current taxes.

Other Ways to Remain Tax-Efficient

Take Advantage of Tax-Loss Harvesting

Tax-loss harvesting is the process of offsetting or reducing taxable gains by selling securities that have lost value at the same time as selling securities that have increased in value. The key to tax-loss harvesting is that tax-related objectives, not performance, influence the sale of securities.

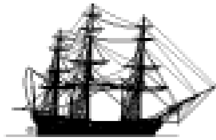
Donate Appreciated Securities

When making charitable contributions, consider donating shares of mutual funds or individual stocks or bonds that have appreciated in value and that you've held for longer than a year. You'll enjoy tax savings in two ways:

- 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—an amount you would owe if you sold the securities first and then donated the cash proceeds.

Work With Your Financial Advisor to Make Tax-Savvy Investing Easy

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 a successful, tax-advantaged portfolio.



Intermediary Services
Valley Forge, PA 19482-2900

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