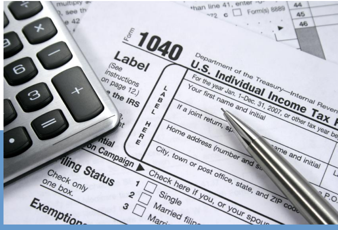

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Investment Tax Planning

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Introduction

Investment planning can be important for several reasons. However, any discussion of investment planning is incomplete without a thorough understanding of the applicable income tax ramifications. Tax planning can help you reduce the tax cost of your investments. Once you've created an investment plan to work toward your various financial goals, you should take advantage of the tax rules to ensure that you maximize the after-tax return on your investments. In other words, your goal is to select tax-favorable investments that are consistent with your overall investment plan.

In order to engage in investment tax planning, you need to understand how investments are taxed (including the concepts of capital gain income and ordinary income) and how to compare different investment vehicles. You also need to know how your own tax situation (i.e., your tax bracket, holding period, and tax basis) affects the taxation of your capital assets.

> **Caution:** Investment choices should not be based on tax considerations alone, but should be based on several factors including your time horizons and risk tolerance.

How does investment tax planning work?

Similar investments may carry substantially different tax costs. It is important to identify the differences and evaluate the costs. Consider the following points:

Investment earnings are taxed in different ways

A myriad of investment vehicles are available to you. For instance, you can invest in stocks, bonds, mutual funds, money market funds, real estate, commodities, or your own business. Investment earnings are taxed in many different ways. Consequently, some investments earn less after tax than others. By taking advantage of these differences, you may save money. In addition, your tax savings can preserve your investments and, as a result, enhance future investment growth.

Investment tax planning can maximize your wealth

Tax investment planning involves maximizing the after-tax return on your investments. This is beneficial because the wealth that remains after you pay your taxes is ultimately more important to you than the value of your investments. It's the after-tax payout that enables you to finance a home, a child's education, a vacation, or your retirement. Thus, one goal of investment tax planning is to maximize future wealth. To do so, you need to know a little bit about taxes. In particular, you need to know the following:

- How your investments are taxed
- The before- and after-tax rates of return on your investments
- How to compare investments in light of after-tax return

How are your investments taxed?

In order to understand how investments are taxed, you first need to become familiar with the following basic concepts:

- Capital gains and losses

- Qualified dividends
- Ordinary (investment) income
- Investment expenses
- Tax-exempt income
- Tax-deferred income

Capital gains and losses

While you hold a capital asset (e.g., your home, stocks, bonds, mutual funds, real estate, collectibles), you will not pay taxes on any increase in value. However, when you sell or exchange the asset, you will realize a capital gain (if you sell it for a profit) or loss (if you sell for less than the asset's cost). If you sell an asset after only a year or less, you will have a short-term capital gain. Short-term capital gains are taxed at ordinary income tax rates (i.e., your marginal income tax rate). If you own an asset for more than a year before you sell it, you will have a long-term capital gain.

Long-term capital gains tax rates are generally more favorable than ordinary income tax rates. Currently, the highest ordinary income tax rate is 35 percent whereas the highest long-term capital gains tax rate (for most assets) is 15 percent (for sales and exchanges on or after may 6, 2003). That's a difference of 20 percent. Thus, holding an asset for long-term growth is a tax-saving strategy.

> **Caution:** The Jobs and Growth Tax Relief Reconciliation Act of 2003 (2003 Tax Act) and the Tax Increase Prevention and Reconciliation Act of 2005 (2005 Tax Act) reduced long-term capital gains tax rates for sales and exchanges made on or after May 6, 2003 and before January 1, 2011. These rates are 15 percent for taxpayers in marginal tax brackets higher than 15 percent, and 5 percent (zero percent in 2008-2010) for taxpayers in the 15 percent and 10 percent marginal tax brackets. In 2011, the rates revert to pre-2003 Tax Act levels--20 percent and 10 percent, respectively. Thus, investors may want to time the sale of highly appreciated assets to take advantage of the lower rates.

You may offset capital gains with capital losses (short-term losses against short-term gains and long-term losses against long-term gains). If you have more losses than gains in a given year, you may offset up to $3,000 of ordinary income ($1,500 if married filing separately). Any remaining losses can be carried forward into future tax years. Thus, timing losses to offset gains is a tax-saving investment strategy.

> **Tip:** You may also elect to include net capital gains from property held for investment as ordinary (investment) income. If you do so, such income will be taxed at ordinary income tax rates, not capital gains tax rates. This may be advantageous if you don't have capital losses, but do have investment interest expenses. Investment interest expense may only be deducted to the extent of investment income (though it can also be carried forward to future years). This election must be specifically made--if you do not make the election, the IRS will classify the income as capital gain income.

Capital gain is computed by subtracting the sale price from the asset's basis. Basis is your cost and includes the price you paid for the assets plus the cost of capital improvements. The higher your basis, the smaller your capital gain and the smaller your tax liability. Thus, you should keep careful records of the basis of an asset. This is especially important if you buy shares of stock in the same company at different times and different prices. This will allow you to control the tax consequences by picking particular shares to sell or hold.

> **Tip:** If you want to sell an asset now but defer the recognition of the gain until later tax years, you may be able to arrange an installment sale with the buyer (but not for stocks or bonds). That way, you report and pay tax on the income as you receive it.

Qualified dividends

Qualified dividends are dividends received during the tax year by an individual shareholder from a domestic corporation or a qualified foreign corporation. Under the 2003 and 2005 Tax Acts, effective for tax years 2003 through 2010, such dividends are taxable at the same rates that apply to long-term capital gains. This tax treatment applies to both regular tax and the alternative minimum tax. Absent further legislative action, dividend tax rates revert to pre-2003 Tax Act levels (i.e., they will be taxed at ordinary income tax rates) beginning in 2011.

Eligible dividends include dividends received directly from a domestic corporation or a qualified foreign corporation as well as qualified dividends passed through to investors by stock mutual funds, other regulated investment companies, partnerships, or real estate investment trusts (REITs). Thus, it may be advantageous to invest in vehicles that pay qualified dividends, especially if you need current income.

Distributions from tax-deferred vehicles, such as IRAs, retirement plans, annuities, and Coverdell education savings plans, do not qualify even if the funds represent dividends from stock. Thus, holding investments that pay qualified dividends within a tax-deferred plan may no longer be desirable.

> **Tip:** Though qualified dividends are taxed at long-term capital gains tax rates, they cannot be offset by capital losses. However, as with capital gains, you can elect to include these dividends in investment income. If you do so, such income will be taxed at ordinary income tax rates, not capital gains tax rates. This may be advantageous if you have investment interest expenses in excess of investment income. Investment interest expense may only be deducted to the extent of investment income (though it can also be carried forward to future years). This election must be specifically made--if you do not make the election, the IRS will classify the income as net capital gain.

Ordinary (investment) income

Ordinary investment income consists of any investment income that is not capital gain income, qualified dividends, or tax-exempt income, and is taxed at ordinary income tax rates. Investment income is generated by investment property such as bonds and bond mutual funds. Examples of ordinary investment income include interest and dividends that are actually interest (and therefore don't qualify for taxation at long-term capital gains tax rates).

Generally, ordinary income tax treatment is not as favorable as long-term capital gains tax treatment.

Investment expenses

If you borrow money to buy investment property, you probably pay investment interest. Investment interest may be used to offset investment income only. Excess investment interest may be carried forward to future years. Other investment expenses (e.g., commissions, fees) are deductible as an itemized deduction on Schedule A and are subject to the 2 percent limit.

Passive income and losses

A passive activity is an investment in a business in which you are not an active participant. Rental real estate and limited partnerships are two common examples. Income generated by a passive activity and gain from the sale or exchange of a passive activity is included in passive income and taxed at ordinary income tax rates. Generally, losses from passive activities may offset income from passive activities only--they cannot be used to offset ordinary income or capital gain income. However, excess losses in a given year can be carried forward into future tax years.

Tax-exempt income

There are a number of tax-exempt investment vehicles. One of the more common vehicles is the municipal bond. Usually, interest paid on municipal bonds is not subject to federal or state tax (at least not in the state of issue). When deciding whether to invest in taxable bonds or tax-exempt bonds, it is important to compare the after-tax rate of return on municipals with that on taxable bonds with similar risk.

Caution: While the interest on municipal bonds is tax exempt, capital gains tax may be imposed when you sell the bonds.

Caution: The interest on U.S. Government bonds is not exempt from federal income tax. However, the interest on federal securities is tax exempt at the state level.

Tip: Roth IRAs, although technically vehicles for holding investments and not truly investments themselves, should be discussed under the heading of tax-exempt income. A Roth IRA is a vehicle in which you can invest a limited amount of money each year for retirement and certain other limited purposes (assuming that you satisfy certain criteria including adjusted gross income (AGI) limits). The income and gains on the account are not taxed at all as long as you follow all applicable rules. Be aware, though, that if all applicable rules are not followed, withdrawals will not only be subject to tax, they may also be subject to a penalty. Tax-free growth is clearly one of the most powerful investment tools available for creating wealth. However, you must use after-tax dollars to make the initial investment and subsequent contributions. No IRA deduction is allowed for contributions to Roth IRAs.

Tax-deferred income

Tax-deferred investments produce earnings that are not taxed until withdrawn. These earnings are reinvested and continue to fuel investment growth. This is one of the most powerful investment tools available. First, there is a time-value of money advantage. The longer you can keep the money in your own pocket and out of the hands of the IRS, the greater the potential benefit will be to you. Second, since our income tax rates are progressive, you may find yourself in a lower tax bracket in the year the earnings are finally taxed. If so, the actual amount of tax paid on those investment earnings will be less. On the other hand, if you find yourself in a higher tax bracket in the year the earnings are finally taxed, the amount of tax paid on the earnings will be higher (assuming all else is equal).

Caution: Many retirement vehicles are designed to provide tax-deferred growth. The downside of this benefit is that all distributions from the retirement plan are taxed at ordinary income rates rather than at capital gains rates. This can result in potentially higher taxation in light of the progressively higher ordinary income tax rates.

What are before- and after-tax rates of return?

To compare investments, you must understand before- and after-tax rates of return. Ultimately, you want to compare the after-tax rate of returns of similar investments. The rate of return is the ratio of the annual amount an investment earns compared to the cost of the investment. Thus, if an investment cost you $10 and earned $1, the rate of return is 10 percent.

Before-tax rate of return

The before-tax rate of return is the annual market-rate of return. For example, a $10 bond that pays $1 per year in interest and is sold for $10 earns a 10 percent before-tax rate of return.

After-tax rate of return

The after-tax rate of return is the ratio of the after-tax income and gain to the amount invested. With the exception of tax-free investments, this rate is always lower than the before-tax or market rate of return. What do you need to know to compute the after-tax rate of return? Generally, you need to know the following:

- What is the tax treatment of your investments (ordinary income, capital gains, tax exempt, tax deferred)?
- What is your tax situation (your marginal tax rate, your holding periods, whether you've invested in tax-deferred retirement accounts)?

How do you comparison shop for investments?

Comparison shopping for investments allows you to compare the after-tax return on two similar investments. In order to effectively make this assessment, you must consider two other issues:

- Tax classification of the investment
- Your tax situation

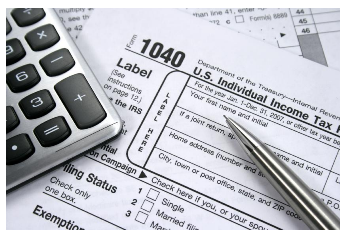
Tax treatment of the investment

You need to know whether the investment vehicle generates capital gains, ordinary income, tax-free, or tax-deferred income. There are two components to the after-tax rate of return: the portion attributable to earnings (such as interest) and the amount derived from a subsequent sale. You also need to know whether any capital gains will be treated as long-term or short-term capital gains.

Special rules can apply to certain kinds of investments such as wash sales, qualifying small business stock, short sales, installment sales, like-kind exchanges, and others. In addition, you may wish to know about market discount rules, anti-conversion rules, and tax shelters.

Your tax treatment

Your investment tax situation depends on several factors. In particular, you'll need to know the adjusted tax basis of your capital assets, the sale price of the assets, the holding period, the amount of the capital gain or loss, the amount of your ordinary investment income or losses, and your marginal tax bracket.



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