

## **Tax-Savvy Investing**

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One of the drawbacks to successful investing and building one's wealth is the tax bite that is taken out of profits. Unfortunately for all of us, the government is our "silent-but-monetarily-deadly" partner and always has its hand out for a portion of whatever profits we earn, especially as we earn more of it. Many investors will look with admiration at the nice double-digit returns they have made without taking into account how much of that return may be lost to the IRS (and the state!). For example, if an investor were to trade stocks on a short-term basis successfully and earn an overall return of 30% on his investments by the end of the year, he or she might think they had done quite well. If they were in the 28% tax bracket however, that 30% return may shrink to less than 22%, (as short-term capital gains are taxed at the investor's ordinary income tax bracket), which may be less inspiring. Although there isn't much investors can do about their 2003 taxes by now, investing with an eye on the tax impact for 2004 and onward can help in creating tax-efficient portfolios and keeping more money in their pocket.

Income brackets are possibly the first place to start in understanding how taxes could affect net investment income. Under the recent Jobs and Growth Tax Relief Reconciliation Act of 2003, (JGTRRA), income tax brackets were adjusted downward to the levels of 10%, 15%, 25%, 28%, 33%, and 35%. These new levels were decreased about 2% per bracket. These are important, since short-term capital gains are still taxed at the investor's highest marginal tax bracket, rather than the widely discussed 15% tax on qualified dividends and capital gains. Traders should remember to keep these new brackets in mind when harvesting short-term profits from their positions.

Another reason for being aware of the new tax brackets, (as well as for reducing your taxable dividends and interest where possible), is the increasing impact of the Alternative Minimum Tax. Even though JGTRRA increased the AMT exemption level for MFJ taxpayers from \$49,000 to \$58,000, (\$40,250 for individuals), the new lower tax rate on dividends and long-term capital gains may subject more investors to AMT. This is due to the possible reduction of the investor's overall tax rate to the point where AMT will apply. If this occurs, an investor's large dividend and capital gain income may affect the overall tax picture and cause more tax to be paid as AMT. In addition, if subject to AMT, short-term capital gains, and bond interest income, are taxed at the AMT as well, not the new marginal tax brackets. Until Congress amends the rules and levels regarding AMT to adjust for growing taxpayer incomes, more investors could find themselves paying a higher AMT rather than their regular tax liability, so paying attention to taxable investment income is crucial.

Most investors are aware of the rules regarding capital loss deductions. Generally, you can offset capital gains with capital losses and most look to offset short term gains first to avoid the higher tax rates on these profits. For any remaining losses after offsetting, investors may deduct up to \$3000 in capital losses in a tax year, (\$1500 if married but filing separately), and carry forward any remaining losses to future tax years indefinitely. One little-known rule is that carried-forward losses retain their short-term or long-term character, so if a long-term loss is carried forward, it must first be matched up against a long-term gain before a short-term gain. Also remember about the "wash-sale" rule, which disallows a capital loss if the sold security is repurchased within 31 days of the sale that created the loss.

The new tax law also held some potential confusing criteria for what will be considered eligible long-term capital gains and dividends in 2003. Under the 2003 law, only those long-term capital gains incurred after May 5<sup>th</sup>, 2003, will qualify for the new 15% rate. Some dividends, such as those from preferred stocks, may or may not qualify for the new 15% tax rate and have not yet been defined by the IRS (as of this writing). In addition, to receive the new rate, qualifying dividends must be from stocks held unhedged for at least 60 days during the 120 days holding period that begins 60 days prior to the ex-dividend date.

With the new tax laws and considering the widening net of AMT, investors may want to rethink how they hold their investments within different portfolios. One technique often employed is to have both a tax-deferred account (such as a Traditional, SEP or ROTH IRA) and a taxable account. The reason to have a taxable account at all is because IRA's 401k's, etc. traditionally have yearly contribution limits that necessitate having a taxable account if the investor has more cash than can legally be placed within the tax-deferred vehicle. In addition, it wouldn't make all that much sense in many cases to have a tax-deferred account for those investments, (such as tax-free municipal bonds), that already have tax advantages. While the new LT capital gains rates have potentially diminished some of the advantage of tax deferred accounts, there are still a number of ways an investor may use both tax-deferred and taxable vehicles, balanced together, to create an overall tax-efficient portfolio.

The value of having both accounts may vary for different investors, but the allocation of various types of investments under JGTRRA may now call for closer scrutiny by each investor. As an example, those investments that qualify for the new 15% tax rate may not be as appropriate for a tax-deferred account, because rather than incurring the present 15% tax on gains or dividends, the investor may eventually be paying a higher ordinary income rate in the future on the eventual withdrawals. Taking the new tax rates into consideration, an investor may consider the following for allocating investments between these two accounts:

- Growth-type stocks held long-term (over one year for tax purposes) have been and continue to be best held within the taxable account, as growth stocks traditionally spin off little in the way of dividends and other taxable income. The small amount of dividends that do occur should be those that will qualify for the 15% tax rate. Under the new law, the five year holding period requirement for the 18% tax rate (vs. the 20% rate for shorter holding periods) no longer applies.
- Conversely, there has also been an argument for holding small-cap stocks in a tax-deferred account, because of the higher compounding effect of these potentially higher return, though more volatile and risky) investments. By deferring taxes on these potentially higher returns, investors might realize higher benefits over time. Investors using this technique should make sure, however, they are considering a long time horizon and are aware of the possible tax brackets they will be subject to upon future withdrawals.
- Value-style stocks and so-called 'blue-chip' stocks that will be held for more than one year should also be placed in the taxable account, even though these may pay more in dividends than growth stocks. Like growth stocks however, these dividends could qualify for the 15% tax rate, which could be a better rate for the investor than the eventual ordinary income rate from a tax-deferred account.

- For short-term investing, including trading securities and taking short-term gains, investors may consider using their tax-deferred account. *This does not mean*, however, that an investor should convert their entire retirement account to a short-term trading account. For most investors, accounts designated for retirement, (such as company 401k accounts and large value Rollover IRA accounts), should be diversified and not used for speculative purposes. That said, from a tax standpoint, having short-term gains tax deferred can be a smart strategy. In the case of opening a SEP-IRA for instance, an investor can designate the majority of their annual contribution to a conservative, long-term oriented SEP IRA account and the rest to a separate SEP-IRA for short-term trading purposes, if so desired. One drawback to this technique is that losses cannot be taken as a deduction or carried forward to future tax years.
- Income-producing investments, (such as taxable bonds, preferred stocks, convertibles and mortgage-backed securities), should be held in a tax-deferred account since these securities are generally fully taxable. Preferred stocks should be carefully chosen, however. As of this writing, the IRS has not made a final determination as to whether or which preferred stocks qualify for the new dividend tax rate. If some preferreds do qualify, it might be better to hold these special preferreds in the taxable account.
- Many investors might believe that foreign stocks should be held in the tax-deferred account, since foreign stocks may pay dividends and these may not qualify for the new tax rate treatment. What should be remembered, though, is that foreign taxes on dividends may be withheld by the host country prior to disbursement by the foreign company to the shareholder. The investor receives a 1099 form showing the withheld foreign taxes and then has the option of deducting the withheld tax on Schedule A or claiming a credit for foreign tax paid. If the investor holds the foreign investment within a tax-deferred account though, he/she loses the deduction or credit and the foreign taxes paid are a total loss.
- Municipal bonds, if tax-free, should clearly be in the taxable account.

Many times, the money available for a taxable account will far exceed the annual contribution limits for Roth, Traditional or other IRA accounts. These sums may be through gifts, home sales, inheritances, lawsuits, divorce settlements, or life insurance proceeds, investors may find themselves with a large lump-sum of investible money that cannot be contributed all at once to a tax deferred account. In this case, it may make sense to make sure a portion of taxable account money is contributed each year to an IRA to help build the investable money within the tax-deferred account.

There are also some trading techniques that could be used for tax efficiency. One such technique might be effective to an investor who has a large amount of carry-forward losses, (from the years 2000-2002) and also has some gains from 2003. As an example, if this investor wishes to use up some of those capital losses, but still continues to hold a particular stock, he/she may decide to sell the stock at a gain, offset that gain with an equal amount of carried-forward loss and then repurchase the same stock. This accomplishes two objectives. The investor locks in the gain without tax, (since it was offset by the previous years' losses) and the stock now has a higher cost basis and could be subject to less capital gains tax in the future than it might of otherwise prior to this technique. ("Wash-sale" rules do not apply to stocks sold at gains, only losses).

Similarly, another technique might be used to realize a capital loss while continuing to hold one's position in a stock, yet avoid the wash-sale rule penalty. To illustrate, let's

use an example of an investor who holds a position in a company where the stock price has dropped. The investor thinks well of the company, but would also like to take the capital loss for tax purposes. Instead of selling the stock and waiting 31 days to repurchase, the investor might consider purchasing an equal amount of the stock at the now lower price and then selling his original shares to create the loss. His cost basis is lower, he still has the same number of shares, he has the capital loss for tax purposes and he avoids the wash-sale repurchase delay.

Cost basis in the investment can be another important consideration when looking to sell a portion of long-held stock that has been purchased at different price levels. Even though the capital gains rate might currently be only 15%, an investor might realize significant savings by carefully choosing those particular shares that were purchased at a higher price level (higher basis) and therefore would have less of a capital gains tax impact. Retirees needing to sell long-held investments for income may want to especially pay attention to the cost basis in the shares they want to sell, since the difference between cost basis levels may be significant.

“Swapping” investments is another technique used by experienced investors. Although more commonly used by bond investors, the technique can also be applied to stocks as well. In this technique for bonds, a bond is sold to take advantage of either the capital loss for deduction purposes, or a gain that is offset by other losses. Although that same bond may not be repurchased for 31 days under the “wash-sale” rules, a bond from a different issuer, with similar or the same yield and maturity, can be purchased without jeopardizing the capital loss deduction. This same technique may be applied to stocks, although similar stocks can vary much more considerably in quality and value than bonds. Using companies in the same industry with similar prospects and dividend yields though, the method may be effective.

Over the coming tax return months, investors should also remember to include applicable investment activity deductions on Schedule A (itemized deductions). These may include interest paid on margin loans (used for investment purposes), purchases of investment publications and software, fees paid to an advisor for investment advice and other investment expenses charged to the investor during the year by custodians or investment companies.

Taxes have always been a complicated area of personal finance. Investors would be wise to consult with a tax professional to establish tax-planning strategies that best fit their individual situation. Aside from the satisfaction of (hopefully) realizing good returns from their portfolios, by planning ahead for tax impacts, investors may also know that they are doing their best to keep the government as small a silent partner as possible.

*This article contains generalized tax strategies and should not be considered as tax advice. Readers are strongly advised to consult with their tax professional as to the suitability for their own situation before implementing any of these ideas.*

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