INVESTING TAX SMART

Wolters Kluwer

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Investing involves many considerations, including your personal and financial situation, retirement goals, and risk tolerance or aversion, and – last but by far not least – the tax consequences of the investment vehicles you choose. These considerations are the same whether the economy is experiencing a downturn or performing at its peak. In light of the current economic climate, investing "tax smart" has become even more important.

There are different options with different tax consequences – from stocks, bonds, and mutual funds to 401(k)s and IRAs. The variety of investment options, and their tax consequences, can be complicated and overwhelming.

This booklet provides an overview of the tax treatment of certain investments and how a number of investment vehicles are treated for tax purposes.

WHAT ARE CAPITAL GAINS AND LOSSES?

Any investment strategy must recognize the importance of capital gains taxes. General income tax rates also have a significant impact on what "investment mix" will maximize your after-tax returns. Before investing in stocks, mutual funds, real estate, bonds, or any asset, you have to keep in mind the tax treatment of capital gains and losses.

Comment. Qualified retirement plans typically invest in stocks and other capital assets. But, as a qualified plan, no taxable gains or losses are realized at any time. However, when a retirement account balance is distributed to its owner, it is usually taxed but not at capital gains rates. Rather, the entire distribution is taxed at ordinary income tax rates. On the other hand, if the qualified retirement account is either a Roth IRA or Roth 401(k) plan, no income on any distribution is realized.

Capital gains

Capital gains and losses come about from the sale or exchange of capital assets. A "sale" or "exchange" is the transfer of a capital asset for money or other property. A capital gain is the transfer of property for a profit. If you lose money when you sell an investment asset, that's a capital loss.

Capital gains are taxed at different rates depending on how long you have owned the asset. If you hold onto a capital asset for more than 12 months, then usually any net gain you get from its sale will be taxed as net long-term capital gain.

Net long-term capital gain is taxed at favorable rates, on a sliding depending upon the taxpayer's overall income level. The American Taxpayer Relief Act of 2012 has set current rates as follows:

- zero percent to the extent capital gain when added to all other taxable income does not exceed the top of the 15 percent tax bracket;
- 15 percent to the extent not exceeding the top of the 35 percent tax bracket; and
- 20 percent for any excess.

See the discussion, below, at "CAPITAL GAINS TAX RATES" for a precise explanation of rates that also includes special rates for collectible gain and unrecaptured gain.

The capital gains rates also apply to qualified dividends. Prior to 2003, all dividends were taxed as ordinary income. The American Taxpayer Relief Act of 2012 permanently places qualified dividends within the same rate structure as net long-term capital gains. Nonqualified dividends, however, are taxed as ordinary income.

See the discussion, below, at "DIVIDENDS" for definitions of qualified and non-qualified dividends.

Net short term capital gain is taxed at the same rates as your ordinary income.

Comment. Even in a year in which the stock market has significant losses, a sale of stock may produce capital gains, since gain is measured at the point stock was acquired. For example, if stock is purchased for $5, appreciates to $12, and then is sold for $8, the seller realizes a $3 capital gain, even though the stock has recently lost 1/3 of its value.

Comment. To avoid a capital gains distribution, you may wish to sell mutual fund shares before the specified date for making the distribution, or delay acquiring shares in a mutual fund until after the capital gains distribution date. However, either of these measures subjects you to a market risk that shares will appreciate before you buy or after you sell.

Capital losses

Both long-term and short-term capital losses can always be used to offset capital gains, as well as up to $3,000 of ordinary income. However, an individual can only use $3,000 ($1,500 for married individuals filing separately) of net capital losses to offset ordinary income in any one year.

Despite this limitation, the deduction is nevertheless valuable because it allows the first $3,000 of your net capital losses, if any, to offset any other income you may have for the year, including your "ordinary income" such as wages or interest income that would otherwise be

taxed at a higher rate. Moreover, if your net capital losses exceed the $3,000 deduction limit, you can deduct $3,000 of your losses against ordinary income and carry over the excess loss to the following year. The excess losses that are carried over can then be netted against capital gains in that year with any excess again deductible against ordinary income up to $3,000.

> ***Example.*** In 2013, Janet realizes $30,000 of ordinary income, a net short-term capital loss of $2,000, and a net long-term capital loss of $3,000. Janet's total capital loss deduction is $5,000. She can use $3,000 of her net losses to offset her ordinary income in 2013, and then carry over the remaining $2,000 of net capital losses to be used in 2014 or later, if not used in 2014.

> ***Comment.*** Losses realized on some capital assets, such as small business stock (Code Sec. 1244), are treated as ordinary losses rather than capital losses. Thus, they can fully offset other ordinary income and are not limited by the $3,000 ceiling on deducting capital losses. Upside gains are also treated more favorably, which will be discussed later.

Qualified dividends

While qualified dividends are taxed at the capital gains rate, capital losses cannot offset dividend income, except as ordinary income. For example, say you have net capital losses of $5,000

and dividend income of $4,000. You must pay the full tax on the $4,000 dividend income at capital gains rate, but can use the $5,000 net capital gains to offset $3,000 of ordinary income (or dividend income), and to carry forward $2,000 into the next tax year.

Carryforward losses

Unlike business loss, personal capital losses can only be carried forward. These carryforward rules, however, are tricky and planning can help maximize their benefits. Knowing the rules is critical here.

First, losses are carried forward in the character in which they were realized; that is, short-term or long-term. Second, carryforward losses absorb any remaining capital gains that are not absorbed by similar losses.

For example, say you have a net capital loss carryforward of $6,000, consisting of $4,000 long-term capital losses and

$2,000 short-term capital losses. The next year you have $5,000 in short-term capital gains and $2,000 in long-term capital gains. Your $6,000 carryover losses can offset all of the $2,000 in long-term capital gains and $4,000 in short-term capital gains.

Capital gains strategies

- You should sell capital gain property prior to the end of the year if you have already realized capital losses for the year, which are over any capital gains you have already realized plus $3,000.
- If your gains exceed your losses, you should sell loss property to offset the gain.
- If your other allowable deductions are more than your income, or they push down your tax bracket low enough to be entitled to the zero percent capital gain rate, you should avoid realizing any further capital losses during the year.
- If you experience an unusual spike in regular income for the year that, when gains are added, puts you at the 39.6 percent regular income tax bracket level, consider deferring the recognition of gains until the following year so that they may be taxed at a maximum rate of 15 percent rather than 20 percent

CAPITAL ASSETS

Many possessions you own and use for personal purposes or investment are capital assets. The following are examples of capital assets:

- Stocks and bonds;
- A home owned and occupied by you and your family;
- Household furnishings;
- A car used for pleasure or commuting;
- A coin or stamp collection; and
- Gems and jewelry.

Noncapital assets may include:

- An inventoriable asset;
- Property held primarily for customers in the ordinary course of your trade or business;
- Depreciable business property;
- Real property used in your trade or business;
- A copyright, a literary, musical or artistic composition, a letter or memorandum held by the person who created it; and
- Any hedging transaction that is clearly identified as a hedging transaction by the end of the day on which it was acquired.

BASIS

The amount of your capital gain (or loss) is the difference between your basis in the asset and the amount realized from its sale. Determining the basis of an asset can be complex. Generally, however, the basis of your asset is how much you paid for the asset. Basis can change over the course of time you own the asset. For example, if stock splits, basis also splits. The amount realized is generally the price (less selling expenses) for which you sell the asset.

> ***Comment.*** A broker must file Form 1099-B, Proceeds From Broker and Barter Exchange Transactions, for securities sale. Starting in 2011, every broker must also include the customer's adjusted basis in a covered security and whether any gain or loss regarding the security is long-term or short-term. If your records show a different basis or sales amount, you should contact your broker immediately to request a correction. Otherwise, the IRS computer-matching program may identify your Form 1040, Schedule D for audit.

CAPITAL GAINS TAX RATES

The American Taxpayer Relief Act of 2012 (passed on January 1, 2013) raises the top rate for capital gains and dividends to 20 percent, up from the Bush-era maximum 15 percent rate previously in place for 2003-2012 period. That 20 percent top rate, effective for all sales and dividends on or after January 1, 2013, now applies to the extent that a taxpayer's income exceeds the thresholds set for the 39.6 percent rate ($400,000 for single filers, $450,000 for joint filers and $425,000 for heads of households, for the 2013 tax year; $406,750 for single filers, $457,600 for joint filers and $432,200 for heads of households, for the 2014 tax year).

All other taxpayers will continue to enjoy the capital gains and dividend tax rates that have been in place since 2003. That rate structure calls for a maximum rate of 15 percent, except:

- A zero percent rate applies to the extent gains and dividends when added to other income do not exceed the total income thresholds for the upper range of the 15 percent tax bracket ($72,500 for joint filers and $36,250 for single filers for the 2013 tax year; $73,800 for joint filers and $36,900 for single filers for the 2014 tax year).

- A maximum 28 percent rate applies to long-term gain from collectibles and net gain from small business stock;
- A maximum 25 percent rate applies to unrecaptured Section 1250 gain (defined as gain attributable to excess depreciation on real estate).

Example: Assume in 2013 John and Mary, who file a joint return, realize $425,000 in net capital gain and $200,000 in ordinary income.

- $200,000 ordinary income will be taxed under the regular 2013 income tax schedule = $43,465.50 tax.
- $425,000 capital gain is taxed:
  - $250,000 net capital gain at the 15 percent rate: ($450,000 threshold less $200,000 ordinary income) = $37,500 tax
  - The remainder of the net capital gain of $175,000 at 20 percent = $35,000
- Total tax liability = $43,465.50 on $200,000 ordinary income and $72,500 on $425,000 net capital gain.

Example: Assume in 2013 Ray, a single individual, realizes $20,000 in ordinary taxable income and $35,000 in net capital gain.

- $20,000 ordinary income will be taxed under the regular 2013 income tax schedule = $2,553.75
- $35,000 capital gain is taxed:
  - $16,250 of $35,000 net capital gain @ 0 percent ($36,250 threshold (the top of the 15 percent bracket) less $20,000 ordinary income) = $0
  - The remainder of the net capital gain of $18,750 at 15 percent = $2,812.50
- Total tax liability: $2,553.75 on $20,000 ordinary income and $2,812.50 on $35,000 net capital gain.

Basis information reporting

Brokers reporting gross proceeds from the sale of a security are required to report the adjusted basis and type of gain:

- For most stock acquired on or after January 1, 2011;
- For stock in a mutual fund (RIC) or a dividend reinvestment plan (DRP) acquired on or after January 1, 2012; and
- For other securities and options acquired on or after January 1, 2013.

Stock basis generally is reported using the first-in, first-out (FIFO) or specific identification method. For example, if you buy 10 shares of XYZ Co. on Feb 15, 2013 at $15/share and 5 more shares at $16/share on March 1, 2013, a sale of 5 shares of XYZ Co. on April 1, 2013 at $18/share is deemed sold with a $15/share basis unless you instruct the broker to sell from the later lot. A seller adequately identifies stock by making a designation no later than the settlement date. Taxpayers may select a stock lot by standing order.

Previously, brokers had to furnish statements by January 31; brokers now have

until February 15. The February 15 deadline applies when the broker issues a consolidated statement to the same customer with other forms that ordinarily have to be furnished by January 31, such as Form 1099-DIV. The basis statements for 2012 trades, for example, therefore carried a deadline of February 15, 2013.

Medicare 3.8 percent contribution tax. Starting in 2013, the health care reform package that was passed in 2010 imposes a 3.8 percent Medicare contribution tax on qualified unearned income on higher-income individuals (also commonly known as the net investment income (NII) surtax. The 3.8 percent Medicare tax is imposed on the lesser of:

- an individual's net investment income for the tax year, or
- any excess of modified adjusted gross income (MAGI) in excess of $200,000 (for a single individual). The threshold for married couples filing a joint return and surviving spouses is $250,000 ($125,000 in the case of a married taxpayer filing separately). MAGI for purposes of the 3.8 percent Medicare contribution tax is an individual's AGI for the tax year increased by otherwise excludable foreign earned income or foreign housing costs.

Example. Barbara is single and has $250,000 of wage income and $40,000 of qualified net investment income for 2013 in the form of net capital gains and dividends. She will be liable for the 3.8 percent Medicare contribution tax on the lesser of her qualified net investment income ($40,000) or the difference between her MAGI of $290,000 and the $200,000 threshold ($90,000). In this case, Barbara will be liable for the 3.8 percent Medicare contribution tax on $40,000 because her $40,000 of qualified net investment income is less than her MAGI of $290,000 reduced by her $200,000 threshold amount.

Net investment income for purposes of the 3.8 percent tax is the excess of the sum of the following items less any otherwise allowable deductions properly allocable to such income or gain:

- Gross income from interest, dividends, annuities, royalties and rents unless such income derived is in the ordinary course of any trade or business (for this purpose, income derived in the ordinary course of a trade or business excludes any trade or business that is either a passive activity of the taxpayer, or involves trading in financial instruments and commodities;

- Other gross income from any passive trade or business; and
- Net gain included in computing taxable income that is attributable to the disposition of property other than property held in any trade or business that is not a passive trade or business (most net capital gain is included in this category).

Congress expressly excluded any distribution from qualified employee benefit plans or arrangements. Moreover, interest on tax-exempt bonds is excluded. However, the 3.8 percent Medicare contribution tax also reaches estates and trusts.

Bottom-line tax liability

Although your net capital gains and dividends are taxed at lower rates than your "ordinary" (other) income, they may impact your bottom-line tax liability so as to lower their initial benefit to you. The reason is that capital gains and dividends are added to income in computing adjusted gross income (AGI). Your AGI can work to limit your ability to take itemized deductions.

> ***Example.*** Abby is single and has $100,000 in salary, $100,000 in long-term capital gain income and $40,000 in dividend income. That's $240,000 in adjusted gross income (AGI) on which the 10 percent medical deduction floor, 10 percent casualty deduction floor, and 2 percent miscellaneous itemized deduction floor are computed, as well as any qualification for tax benefits that carry an AGI limit such as access to the education credits.

What's my holding period?

To determine how long you have held an asset for determining whether your capital gain is long term or short term, the holding period starts the day after you acquired the property. The same day of each following month is the start of a new month, disregarding the number of days in the previous month.

> ***Example.*** If you acquire property on February 1, 2013, the holding period starts on February 2, 2013. On March 2, 2013, you will have held onto the property for one month. The date you dispose of the asset is part of the holding period.

Generally, for publicly-traded securities, the holding period starts the day after the "trade date" on which you purchased the securities and ends on the "trade date" on which you sell them. A capital asset must be held "more than 12 months" for realized gain to be classified as long-term capital gain.

> ***Example.*** On November 2, 2012, John purchased 100 shares of Gizmo Inc. for $5,000. On May 8, 2013, John sold the 100 shares for $20,000. John will compute his tax on his $15,000 capital gain by using his ordinary income tax rate for 2013. The ordinary income rates apply because he did not hold the stock more than 12 months.

Gifts. The holding period for gifts of stocks and other investments starts when the person making the gift acquired the property. His or her holding period is then added to the time you hold the asset before selling it.

INHERITED PROPERTY

When you inherit investment property, gain from the sale of the asset is classified as long-term gain and taxed at the long-term capital gains rates whenever you sell it. This rule applies no matter how long or short the holding period was for the decedent. However, your tax basis is generally the asset's fair market value when the decedent died, therefore often significantly lowering the amount of capital gain to be realized.

OFFSETTING GAINS AND LOSSES

In order for you to effectively plan your investment transactions, you have to understand how, under the tax law, you must net or "offset" the various types of capital gains and losses that you experience. The totals for short-term capital gains and losses and the totals for long-term capital gains and losses must be figured separately.

Netting procedure

Under one of the basic netting procedures, your short-term capital losses (losses from property you held for 12 months or less) are applied first against your short-term gains. If you have a net short-term loss at this point, it would be applied against your net long-term gain. If you had a net

short-term gain after you netted against net long-term losses, then your short-term gain would be taxed at your ordinary income tax rate. Given the right mix of gains and losses, therefore, the netting process lets you offset your net long-term capital loss against any net short-term capital gain.

> ***Comment.*** Netting applies to all capital assets. There is no separate netting of stocks with stocks, for example, although many individuals find that stocks are the only capital gains they have each year on a regular basis.

DIVIDENDS

Corporate dividends paid to individuals had long been taxed at ordinary income tax rates prior to the so-called "Bush-era" tax cut starting in 2003. Starting in 2003, qualified dividends began to be taxed at the same favorable rates as net long-term capital gain. The American Taxpayer Relief Act of 2012 (passed on January 1, 2013) permanently continues this treatment. Thus, depending upon income level, qualifying dividends are taxed at zero, 15 or 20 percent.

Eligible dividends. The reduced tax rates apply to "qualifying" dividends, which are dividends received during the tax year from a:

- Domestic corporation; or
- Qualified foreign corporation.

Corporate stock dividends passed through to investors by a mutual fund or other regulated investment company, partnership, or real estate investment trust, or held by a common trust fund are also eligible for the reduced rate, assuming the distribution would otherwise be classified as qualified dividend income.

Dividends ineligible for the reduced tax rates. The reduced dividend rates do not apply to dividends paid by:

- Stock owned for less than 61 days in the 121-day period surrounding the ex-dividend date;
- Stock purchased with borrowed funds if the dividend was included in investment income in claiming an interest deduction;
- Stock with respect to which related payments must be made with respect to substantially similar or related property (through a short sale or otherwise); or
- Specified organizations including credit unions, mutual insurance companies, farmers' cooperatives, or certain employer securities owned by an employee stock ownership plan (ESOP).

Caution. A large number of investors currently receiving "preferred dividends" on "preferred stock" may be ineligible for the reduced dividend tax rate. The most popular preferred equity, hybrid preferred stock, is actually reported as debt by the corporate issuer and pays interest that is deducted by the corporation. Payments on these preferred instruments (hybrid preferred shares) are technically not dividends and are thus ineligible for the reduced dividend rate.

Caution. Investments in tax-deferred retirement vehicles such as regular IRAs, 401(k)s and deferred annuities receive no benefit from the rate reduction. Distributions from these accounts will be taxed at ordinary income tax rates even if the funds represent dividends paid on stocks held in the account.

Dividends paid by foreign corporations. Dividends received from qualified foreign corporations are eligible for the reduced tax rate. Any foreign corporation stock that is traded on an established U.S. securities market is considered qualified. Any corporation incorporated in a U.S. possession is also considered qualified.

Selling stock ex-dividend

The selling of stock "ex-dividend" involves the sale of your stock after a

dividend has been declared but not yet paid out to investors. When a company declares a dividend, it sets a record date which is the date that you must be on the company's books as a shareholder in order to receive the dividend.

Once the record date is set, the company establishes the ex-dividend date. The ex-dividend date is normally set for stocks two business days *before* the record date. If you purchase a stock on its ex-dividend date or after, you will not receive the next dividend payment. If you sell your stock on or after the ex-dividend date or after, you still receive the dividend payment (if you sell before the ex-dividend date, you also sell your right to the dividend).

Interest income

Interest income is compensation for the use of borrowed money, and is generally taxed as ordinary income. Interest income is earned through depositing your money in savings accounts or lending your money; it can be generated from a variety of sources, including:

- Savings accounts;
- Certificates of deposit;
- Life insurance and annuities; and
- Tax-exempt government obligations.

Classification of the type of interest income can determine what interest is

included in gross income, who is to include it, and when it must be included.

Some interest income is improperly referred to as "dividends." Interest must be distinguished from the repayment of principal or from other types of payments, such as a dividend distribution. Dividend distributions are made out of a company's earnings and profits. Qualified dividends are taxed at capital gains rates. Interest income is not.

Investment expenses

Many individuals' portfolios have been hit hard by the economic downturn. As such, investors will want to know what – if any – expenses related to their investment activities are deductible. The IRS distinguishes between expenses that may be deducted by an active trade or business and expenses that may be deducted by an individual investor. Unfortunately for the individual, the IRS favors the former.

Investor deductions. Managing your own investments in stocks and bonds almost never qualifies as a trade or business, although an investor's activities may include buying and selling securities as well as owning the investments for the production of income. An investment club or partnership also is not a trade or business.

Nevertheless, individual investors do have the ability to deduct certain expenses associated with investment in stocks and other securities.

Investment expenses that may be deductible include:

- Fees for services of investment counsel;
- Custodial fees;
- Costs of clerical help;
- Office rent, if investment activities rise to the level of a business; and
- Similar expenses paid or incurred by taxpayers in connection with investments they own.

To be deductible, the expenses must be the taxpayer's own expenses and must be ordinary and necessary and related to the production or collection of taxable income.

Itemized deductions. Investment counsel fees, custodian fees, fees for clerical help, office rent, state and local transfer taxes, and similar expenses that you pay in connection with your taxable investments are deductible as itemized deductions on Schedule A of Form 1040. However, they are subject to a two-percent floor for all these miscellaneous itemized deductions.

> **Caution.** To the extent any expense is attributable to tax-exempt interest, however, it cannot be deducted. Unless an investment advisory fee contains an allocation, the IRS expects you to deduct only the portion of the fee pro-rata in relation to the income you earned.

Overall Itemized Deduction Limitation to Investor Deductions. The American Taxpayer Relief Act of 2012 reinstated the phaseout of itemized deductions for higher-income individuals for tax years beginning on or after January 1, 2013. This itemized deduction limitation, also called the Pease limitation after the member of Congress who introduced the concept used prior to 2010, reduces otherwise allowable itemized deductions of a taxpayer if his or her adjusted gross income exceeds a threshold amount for the tax year.

The applicable threshold amounts beginning in 2013 and 2014 are:

- $300,000 for 2013 and $305,050 for 2014 in the case of married taxpayers filing a joint return or a surviving spouse,

- $275,000 for 2013 and $279,650 for 2014 in the case of a head of household,
- $250,000 for 2013 and $254,200 for 2014 in the case of an unmarried individual who is not a surviving spouse or head of household, and
- one-half of the amount for a joint return or surviving spouse, after any adjustment for inflation, in the case of a married individual filing a separate return ($150,000 for 2013 and $152,525 for 2014).

The threshold amounts will be adjusted for inflation for tax years beginning in calendar years after 2014.

Taxpayers with AGI over the threshold amount must reduce their otherwise allowable itemized deductions by the lesser of:

- three percent of the amount of the taxpayer's AGI in excess of the applicable threshold amount, as adjusted for inflation, or
- 80 percent of the itemized deductions otherwise allowable for the tax year.

Important exceptions. For purposes of the 80-percent limitation, itemized deductions will not include the deduction relating to medical expenses, investment interest expenses, casualty or theft losses, or allowable wagering losses. All other limitations on itemized deductions, including the two-percent floor for miscellaneous itemized deductions, are applied first and then the otherwise allowable total amount of itemized deductions are reduced .

Investment seminars and conventions. Expenses for conventions or seminars related to investments are generally not deductible. Convention and seminar expenses are deductible only if they are incurred in connection with a trade or business.

> ***Comment.*** Subscriptions to newspapers and other professional and investment magazines and books, on the other hand, may be deductible if there is a credible relation between the information and advice gained and the investment activity of the taxpayer.

Short-sale expenses. Amounts paid by investors with respect to ordinary cash dividends on stock that is borrowed to cover a short sale are deductible. Loan premiums paid to a lender in connection with the borrowing of stock to cover short sales also are deductible.

Amounts paid with respect to non-taxable stock dividends or liquidating dividends on stock borrowed incident to a short sale are capital expenses and not deductible.

Fortunately, the tax law does not require you to allocate expenses between those related to ordinary income and long-term capital gain or dividend income. Either generates a full itemized deduction that can be used against any type of income.

Travel expenses. Travel expenses related to the production or collection of income are deductible if you provide proof of the expenses and the necessity for incurring them.

Travel expenses to attend stockholder meetings are permissible deductions only if travel is not for personal reasons and expenses are reasonable in relation to the value of your investment.

As mentioned before, deductions for travel expenses related to attending investment seminars, however, are specifically non-deductible.

Interest expenses. If you take out a loan to carry taxable investment property, you are entitled to an itemized deduction for the interest you pay. The deduction is limited to your net investment income.

The investment interest deduction is not subject to the two-percent floor; you can start with deducting the first dollar of interest paid. Any disallowed interest over the net investment income limit can be carried over to a subsequent tax year.

> ***Caution.*** Net capital gain from the disposition of investment property is not considered investment income. However, you may elect to treat all or any portion of such net capital gain as investment income by paying tax on the elected amounts at your ordinary income rates. This is usually not advisable.

Brokerage commissions. Brokerage commissions related to a particular stock purchase or sale are considered a cost of the sale itself. As such, any commissions paid to buy a stock are added to your tax basis in the shares, which will later determine the amount of taxable gain you have when the property is sold. Any commission on the sale of the shares is netted from the amount you will be considered to realize on that sale.

GIFTS: A METHOD FOR SHIFTING CAPITAL GAINS TAX

Most gifts are not subject to the gift tax. For example, there is usually no tax if you make a gift to your spouse or if your estate goes to your spouse at your death. If you make a gift to someone else, the gift tax does not apply unless the value of the gift you give that person exceeds the annual exclusion for the year in

which you make the gift ($14,000 for 2013 and 2014 or $28,000 if spouses elect to "split" a gift). Furthermore, if you are willing to dip into your unified lifetime gift and estate tax exemption, $5.25 million for 2013 and $5.34 million for 2014, no gift tax usually will be due on amounts higher than the annual exclusion up to the $5.25 million level for 2013 and $5.34 million level for 2014 (but, in many cases, at the expense of higher eventual estate tax).

In addition, you can get large tax savings by making gifts of appreciated stock or mutual funds to children or others who are in a lower tax bracket.

Example 1. Jane owned 100 shares of Yawl Inc. for two years. Her basis is $2,000 and the stock's current fair market value is $10,000. She is in the 39.6 percent tax bracket. Her son is getting married and she sells the stock to give him a $10,000 cash wedding gift. If she sells the stock at the current fair market value, the tax on her $8,000 gain would be $1,600 ($8,000 x 20 percent).

Example 2. Instead of selling the stock, Jane gives the shares to her son as a wedding gift. Her son is in the 15 percent income tax bracket, and sells the stock three weeks later for $10,000. Since the stock was a gift, his basis equals his mother's basis; that is, $2,000. He recognizes gain of $8,000. Because he is in the 15 percent income tax bracket, however, the capital gains tax on the $8,000 gain would be $0 ($8,000 x 0 percent). Because Jane made a gift of the stock rather than selling it and then giving her son a gift of the proceeds, the tax savings was $1,600.

"Kiddie tax" impact

Certain investment income of children is taxed at their parents' presumably higher tax rates. This tax is commonly referred to as "the kiddie tax." The "kiddie tax" stems from the desire to lessen the effectiveness of intra-family transfers of income-producing property. Such transfers involved shifting income produced from such property from the parents' high marginal tax rate to the child's generally lower tax rate, thereby reducing the family's overall income tax liability. The "kiddie tax" applies to children under age 19 and students under age 24. It provides that the first $1,000 of a child's investment income for 2013 and for 2014 (was $950 in 2012) is tax free and the next $1,000 is taxed at his or her own rate. Any net unearned income in excess of $2,000 of a child under age 19 (and under age 24 for students) is

taxed at the parents' presumably higher tax rate.

Parents and grandparents who wish to make transfers of income-producing property to their children or grandchildren must keep in mind, and pay special attention to, the kiddie tax rules.

OTHER SPECIAL CONSIDERATIONS FOR CAPITAL GAINS

Even though it is important that you keep in mind the holding period for long-term capital gains, several other specialized rules also come into play about capital gains.

Collectibles

If you hold certain "collectibles" for over 12 months, any gain is taxed at a maximum 28 percent. Gain would not be taxed as ordinary income unless you hold onto the asset for 12 months or less; or if your ordinary income rate is less than 28 percent.

> ***Example.*** "Collectibles" generally includes items such as works of art, antiques, rugs, gems, stamps, and coins.

Alternative minimum tax

If you have alternative minimum tax (AMT) liability, your AMT will be calculated using the same capital gains rates used to compute your regular income tax. Capital gains do not increase your expoasure to amt, nor do they create a taxable amt preference item

The amount of income that qualifies for the zero percent rate on capital gains was increased through 2010 by the Working Families Tax Relief Act of 2004, thus decreasing the taxpayer's tentative minimum tax liability.

Mutual funds

The capital gains tax rate is applicable to long-term capital gains distributed by certain passthrough entities, such as mutual funds. The entity must inform the taxpayer about the proper classification of distributions (short-term or long-term).

As a passthrough entity, mutual funds must pass along any net realized capital gains to shareholders as dividends. Most fund investors choose to automatically reinvest their dividend distributions in more shares in the fund, instead of receiving cash, through a dividend reinvestment plan.

However, the reinvested amounts must still be reported to the IRS the same way you would report them if you received them in cash. This means that reinvested ordinary dividends and capital gain distributions must generally be reported as income on your Form 1040.

Generally, you will receive a Form 1099-DIV (dividend) from your mutual fund for dividends made or distributions of capital gain.

There is no tax liability if your mutual fund is held via an IRA or 401(k) or other similar tax-deferred retirement. However, if your shares are held in a regular account, the dividends are taxable.

Stock options

If you recognize gain from stock options, Uncle Sam wants some of it. The tax treatment depends on the type of stock option. Two common types are ISOs (incentive stock options) and NSOs (nonqualified stock options).

Gain from the sale of ISOs is usually taxed as capital gain when you sell the stock. Gain from NSOs is calculated differently. The rules are very complex and it is wise to consult with a tax professional to minimize your tax liability.

Interest income: Certificates of deposit

Interest income is taxed at ordinary income tax rates, not at capital gain rates.

> *Comment.* The rationale behind this difference is that the risk taken on an investment that earns interest is minimal to non-existent and, therefore, should not receive the same entrepreneurial encouragement from Congress that equity investments should enjoy.

Interest is defined as payment for the use (or forbearance) of money. Viewed another way, interest is rent paid for the use of your cash. It can be earned on a checking account, money market account, or certificates of deposit (CDs). It can be earned on coupons to corporate bonds (or on government bonds, through which interest may be tax-free on either the federal or state levels). Or you can have interest income on a loan to another person.

Certificates of deposit (CDs) are relatively low-risk investments. However, some CDs may carry more risk than others, impose limits on early withdrawals or lock your money in for longer than you may like.

A CD is a special type of interest-earning time deposit account made with a bank or thrift institution. Generally, CDs offer a higher rate of interest than regular savings accounts. CDs also feature federal deposit insurance, which differentiates them from other investments. However, investors in CDs face some special tax issues regarding the timing of income recognition.

When you purchase a CD, you invest a fixed amount of money for a fixed period of time (for example, six months, one year, five years, or more). In exchange, the issuing bank paid you interest, typically at regular intervals. When you cash in or redeem a CD, you receive the original principal you invested plus any accrued

interest. Interest income is generally not recognized as long as there is a substantial limit on your ability to withdraw it.

Types of CDs. CDs have become more complicated over the years. Now, investors may choose among many types of CDs, from variable rate CDs to long-term CDs and CDs with special redemption features. Make sure you thoroughly understand the features of the CD you select, including its maturity date, any early withdrawal penalties you may have to pay if you cash in your CD before maturity, and any "call feature." The "call" feature allows the issuing bank to terminate (or "call) the CD after a fixed period of time, such as one year.

Accrual-basis taxpayers. In general, accrual-basis taxpayers recognize interest income on a CD as it is earned, regardless of whether it is paid or accrued.

If interest is not paid as it accrues, an appropriate portion of the unpaid interest, based on the effective interest rate of the certificate, must be included in your income each year during the CD's term. In the case of a multi-year deposit that does not pay interest before maturity, the amount of the interest recognized generally increases each year. The rules can get complicated, so consult your tax professional about the income tax consequences.

Cash method taxpayers. Cash method taxpayers (this includes the vast majority of individuals) recognize interest income on a CD based on the terms of the certificate. If the terms require interest to be paid currently (i.e. at least annually), or credited currently and made available to the depositor without penalty, the taxpayer reports interest income as it is received or credited. If your financial institution sends you a Form 1099-INT for the year and you disagree with the amount of taxable interest earned, you should contact the institution immediately for a correction. Otherwise, the interest you report on your return will continue to be subject to IRS computer matching using the orginal Form 1099-INT, which may subject your return to audit.

TIPS

Another investment option you may want to consider, and often overlooked by investors, is Treasury-Inflation Protected Securities (TIPS). TIPS are a variation of traditional Treasury notes and bonds; however unlike other government securities, TIPS are indexed for inflation.

With TIPS, you lend the government money and in addition to repaying your investment plus interest, the government indexes your investment for inflation based on the Consumer Price Index (CPI). Your investment will also be adjusted for deflation and even

decreasing prices, in the event that rare economic phenomenon occurs.

Payments. TIPS pay interest every six months, based on a fixed rate applied to the adjusted principal.

Reporting TIPS. You must generally report the interest income you receive in the year in which the interest is actually received or credited. As such, you must recognize the semi-annual interest payments as income when received.

Taxes. Form 1099-INT and Form 1099-OID are the two tax forms used to report the taxable income you earn from TIPS.

Although you will owe federal income tax, the good news is that you will not owe state or local income tax on TIPS; they are exempt from state and local taxes.

Small business stock

Individuals can elect to roll over, without any immediate tax consequences, capital gain from the sale of qualifying small business stock held for over six months if other small business stock is bought during the 60-day period starting on the date of sale. (see, also qualified small business stock (QSBS), discussed, below, for another small business investment opportunity.

Timing

In many cases, the change of a few days in the timing of when you acquire or sell an asset can have a dramatic difference in the way a transaction will be taxed.

Market economic factors should take precedence over tax considerations. However, you shouldn't completely ignore tax considerations and you should consider tax minimization strategies. You should not hold on to an asset only because you don't want to pay tax on any gain you may realize. On the flip side, you shouldn't sell an asset only to take a tax loss if you believe the asset will increase in value.

Capital gains are fertile areas for planning since you usually have much more control over when you realize income than you have over your salary or business income. You are the one who decides when to sell. However, be aware of the rules governing capital loss deductions.

WASH SALES

You may want to recognize a loss on a security this year without having to abandon your investment. A technique to do this—but with great care to the tax timing rules—is called a "wash sale." This is a transaction whereby you sell the security and later reacquire the same security.

However, you cannot take a deduction for such a loss if you acquire securities that are substantially identical, within a 61-day period starting 30 days before, and ending 30 days after, the sale. As a result, if you need to use a wash sale, you can use the following techniques:

- Wait a minimum of 31 days prior to repurchasing the asset. However, the risk in using this technique is that you forego any gain on the stock that happens during the waiting period.
- "Double up:" Buy a second lot equal to your original holding, wait 31 days, then sell the original lot. By doing this you will recognize the loss. This lets you maintain a continuing interest in the stock, but you would have to tie up more funds for at least 31 days to achieve this and risk is doubled.
- You could sell the stock and reinvest in another company's stock, in the same industry that has historically performed similarly. After 31 days have passed, you could reverse the process for restoring your original holding. In this way, you can minimize your risk during the waiting period.

Caution. If you sell stock at a loss but then buy the same stock within the 61-day period through your IRA, you will not be allowed to deduct the loss.

SMALL BUSINESS INVESTMENTS

A valuable tax incentive is available to encourage people to invest in certain small businesses. This incentive lets investors exclude, from a qualified small business stock (QSBS) sale, 75 percent of the gain they realize. However, you must hold the stock for a minimum of five years and you must also make sure other requirements are met.

The American Taxpayer Relief Act of 2012, together with the earlier 2010 Tax Relief Act, however, temporarily increased the exclusion to 100 percent for stock acquired after September 27, 2010 and before January 1, 2014. A small business cannot have assets over $50 million and must conduct an active trade or business.

Comment. With the 100 percent exclusion, none of the gain on qualifying sales is subject to federal income tax or the AMT.

Small business investment companies

Another major tax advantage is available for investors in common stock or a specialized small business investment company's (SSBIC's) partnership or stock interests. An SSBIC is licensed by the Small Business Administration, with investments that are directed toward businesses that are owned by people who are socially or economically disadvantaged.

Investors who sell publicly-traded stock and use the proceeds to buy an interest in an SSBIC can elect to have tax deferred on any gain. Gain is rolled over into the SSBIC. For SSBIC stock, the investor's basis fails to be reduced for purposes of calculating the gain that is eligible for the 50 percent exclusion now applicable to investments in certain small business stock.

SELLING YOUR HOME

You can generally exclude up to $250,000 of gain realized on the sale or exchange of a principal residence ($500,000 for most married couples filing jointly). To be eligible for the exclusion, you have to have owned the residence and used it as a principal residence for at least two years within the five-year period ending on the date of the sale or exchange.

Nonqualifying use periods. Under the Housing Assistance Tax Act of 2008, which remains the law, gain from the sale of a principal residence is no longer excluded from gross income for periods that the home was not used as a principal residence (i.e. "nonqualifying use"). This income exclusion rule also applies to home sales and exchanges occurring after December 31, 2008. However, under a generous transition rule, this rule also applies only to periods of nonqualified use that begin on or after January 1, 2009. Congress targeted two perceived "abuses" in establishing this rule: (1) vacation home owner who convert their properties into primary residences to exclude all gain under the $250,000/$500,000 home-sale exclusion and (2) owners of rental property who would do the same.

> ***Example.*** Tom buys property on January 1, 2009 for $400,000 and rents it out for two years, claiming $30,000 of depreciation. On January 1, 2011, Tom begins to use the property as his principal residence. On January 1, 2013, Tom moves out of the house and finally sells it for $700,000 on January 1, 2014. The 2009-2010 period is nonqualifying use. The year 2013, after Tom moved out, is treated as qualifying use. Of the $300,000 gain, 40 percent (two years of the five years owned), or $120,000 is not eligible for the exclusion. The balance of the gain, $180,000, can be excluded. The $30,000 gain (of the $120,000) attributable to depreciation must be recaptured as ordinary Code Section 1250 income.

Married couples

Married individuals may use the $500,000 exclusion amount if:

- Either spouse meets the ownership test;
- Both spouses meet the use test;
- Neither spouse is ineligible for the exclusion due to a sale or exchange of a principal residence within the last two years; and
- The couple files a joint return for the year.

Partial exclusion

The IRS has issued regulations on the subject of excluding gain, but with a reduced pro-rata maximum amount, when the seller does not satisfy one of the time-based rules. The tax law provides an exception to the two-year, all-or-nothing rules for use, ownership and claimed exclusion when the primary reason for the sale is health, change in place of employment, or other unforeseen circumstances.

> ***Caution.*** Unforeseen circumstances may include: death; divorce or legal separation; multiple births resulting from the same pregnancy; and condemnation, seizure or other involuntary conversion of the property.

CONCLUSION

Taxes impact your investments when you acquire them and when you sell them. Many people plan the acquisition and disposition of their investments based on the tax consequences. To generate the most tax savings, seek the help of a tax professional to map out the best acquisition or disposition route for you. Careful planning will help to maximize the long-term success of your investment portfolio and minimize your tax liability.