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Investment Tax Planning

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Investment Tax Planning

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.

Tax Basis of Investments

What is the tax basis of your investments?

The tax basis of your investment is the base figure you use when determining whether you have recognized capital gain or loss on the sale of an investment. (Gain or loss on the sale of your investments equals the difference between your adjusted tax basis and the amount you realize upon the sale of the investment.) In many cases, your taxable gain or loss will equal the difference between what you initially paid for the investment and the sale price. In other words, your adjusted tax basis often equals your cost. However, in many circumstances, your adjusted tax basis will not equal the cost of the investment.

Determining tax basis when you acquire your investment

When you acquire an investment, your initial tax basis is normally your cost. However, if you did not purchase your investment (for example, if you received the investment as a gift, as an inheritance, or in a tax-free distribution), then your initial tax basis will be based on a figure other than cost. Details about these acquisitions will be discussed later.

Adjusting tax basis when you own your investment

In some cases, you will need to increase or decrease the initial tax basis of your investment. For example, if your investment produces depreciation deductions, these deductions reduce your tax basis in the investment. However, if you make additional investments or improve your investment property, you may be able to increase your tax basis in the property. Basis adjustments may also be necessary if your investment is divided or consolidated into a different number of units or shares.

Determining tax basis when you sell your investment

You may sell less than all of your shares in an investment. If you purchased these shares at different times and prices, you may have different tax bases for different shares. There are three different methods for determining tax basis of the shares sold in this case: (1) specific identification, (2) first in, first out (FIFO), or (3) average cost.

How do you determine tax basis when you acquire your investment?

Your initial tax basis in an asset will depend on how you acquired the asset. Depending on the method of acquisition, your initial tax basis may be equal to your cost, the basis of the transferor in the asset, the fair market value (FMV) of the asset at the time of acquisition, or the basis of property you exchanged to acquire the asset.

Cost basis

If an asset has a cost basis, this means that the initial tax basis of the asset equals the amount you paid for the asset. Thus, if you purchase shares of stock for \$10,000, then your initial tax basis in those shares will be \$10,000.

Transferred basis

If an asset has a transferred basis this means that your initial tax basis in the asset will be the tax basis of the person who transferred the asset to you. There are two situations where this is likely to occur: with gifts and with certain partnership transactions. When you receive a gift, the gift is not included in your gross income. However, you take the donor's basis in the property. This is for the purpose of determining gain. (You cannot use this basis for the purpose of determining a loss.)

Example(s): Say your father gives you X stock worth \$1,000. He purchased the stock for \$500. Your basis in the stock, for the purpose of determining gain on the sale of the stock, is \$500.

Example(s): Now assume that the stock is only worth \$200 at the time of the gift and you sell it after receiving it. You do not pay tax on the sale of the stock. You do not recognize a loss either. In this case, your father should have sold the stock (and recognized the loss) and then transferred the sales proceeds to you as a gift. (You are not permitted to transfer losses.)

In a tax-free distribution of an asset from a partnership to a partner, the partner takes the partnership's basis in the asset.

Example(s): Assume your partnership distributes a building to you worth \$100,000. The building was purchased for \$80,000. The partnership took \$30,000 of depreciation deductions on the building. What is your basis in the building? It equals the partnership's basis before the distribution, which was \$50,000 (\$80,000 less \$30,000). If you sold the building immediately after the distribution, you would have a \$50,000 gain (\$30,000 of this gain would likely be recaptured as ordinary income).

Fair market value (FMV) basis

You generally receive an initial basis in an asset equal to the asset's FMV in two situations. The first is when you receive the asset via inheritance. The FMV is established on the date of death or on an alternate valuation date six months after death. The second situation where you would receive an initial basis in an asset equal to FMV is when the value of the consideration paid for the investment is not readily determinable. (This is not a factor with assets acquired in exchange for marketable securities.) For example, if you trade one tangible investment asset for another in an arm's-length transaction, there is an assumption that the values of the assets exchanged are equal. Therefore, assuming that the exchange is not a tax-free transaction, you need to determine the FMV of the transferred property in order to determine your gain or loss on the transferred property and the tax basis of the new property.

Exchanged basis

An exchanged basis means that you determine your basis in new property from property previously owned by you. This occurs with property acquired in a tax-free transaction.

Example(s): Assume you contribute land to a business in a tax-free transaction in which you receive one share of stock. The land and the stock are both worth \$1,000. Your basis in the land was \$500. Therefore, your basis in the stock is also \$500. This is an exchanged basis. This often occurs in tax-free business formations. It also occurs when you exchange like-kind property in a tax-free transaction.

Tip: Note that in the above example the business's basis in the land is also \$500 (this is a transferred basis).

How do you adjust tax basis?

You may be required to increase or decrease your tax basis under certain circumstances. In particular, this may happen if you take certain deductions with respect to your investment, or if you reinvest or improve the investment, or receive investment units in a stock split or consolidation.

How depreciation impacts your tax basis

Investments in tangible property (such as buildings) are often depreciable. This means that you get a deduction against current ordinary income for the estimated wear and tear on the asset. These deductions reduce your tax basis.

Example(s): Assume you invest in a machine for \$100,000 and that you are permitted a deduction for depreciation equal to \$20,000 per year for five years. You sell the investment for \$40,000 in year six. You took a total of \$100,000 in deductions on this asset. What is your basis in the year of the sale? It is your cost basis adjusted for deductions--in this case, \$100,000 less \$100,000. Thus, your basis equals zero, and your gain is \$40,000.

How reinvestment impacts your tax basis

In certain cases, you may reinvest your earnings. If taxable earnings are reinvested without a change in your investment shares or investment units, then your basis in those shares or units increases. Likewise, you may make capital improvements to land, buildings, or tangible property or to a business you own. These contributions of capital increase your tax basis in the investment.

How splits, stock dividends, stock rights, or consolidations impact your tax basis

A stock split involves a division of your stock into more units of the same stock. In theory, the aggregate value of the old and new shares should be the same.

Example(s): Assume Corporation X declares a 2-for-1 stock split. You own 100 shares that you purchased two years ago at \$5 per share and are currently worth \$10 per share (or \$1,000) before the split. After the stock split, you own 200 shares. These are worth \$5 per share (or \$1,000). There is no gain on receipt of the additional shares.

A stock dividend is a proportionate distribution of stock to all the shareholders. Similar to a stock split, it essentially subdivides the stock.

Example(s): Assume Corporation X declares a proportionate 10 percent stock dividend. You own 100 shares that you purchased two years ago at \$5 per share and are currently worth \$10 per share (or \$1,000) before the split. After the stock split, you own 110 shares. These are worth approximately \$9.09 per share (or \$1,000). There is no gain on the distribution.

Your gain (or loss) on a subsequent sale is the difference between your cost basis and the sale price. How do you determine basis on your shares? You allocate the basis of the old stock proportionally between your original shares and the shares received in the stock dividend or stock split. If you purchased several blocks of stock at different times, you must allocate the basis proportionally.

In the preceding scenario, the \$500 basis is allocated among the 200 shares. Thus, the basis per share is \$2.50. In the second example, the \$500 basis is allocated among the 110 shares. Thus, the basis per share is approximately \$4.55 per share.

The holding period in stock received from a stock split or a stock dividend is the same as the holding period for the original shares. If you purchased several blocks of stock at different times, you must allocate the holding period proportionally.

In the preceding examples, the holding period is two years for all the stock.

From time to time, a corporation may distribute rights to purchase its stock to its shareholders. If the value of stock rights distributed to you in a tax-free transaction exceeds 15 percent of the value of your stock, then you must allocate the basis in your stock between the stock and the rights based on their relative FMVs on the date of distribution. If the value of the stock rights is less than 15 percent, you may elect to allocate the basis proportionally based on value or treat the basis in the distributed rights as zero. You may wish to make the allocation when you expect to sell the rights but not the stock. You may prefer a zero basis in the rights when you expect to sell the stock but not the rights.

How do you determine tax basis when you sell your investment?

There are occasions when you might sell only part of your holdings in an investment in securities.

Example(s): Assume you own 100 shares of X stock. You acquired the stock by purchasing 10 shares per year for 10 years. The purchase price for each block of shares differed. You decide to sell 50 shares. What is the tax basis of these shares?

For most investments, the IRS permits you to use one of the following methods:

1. Specific identification method
2. FIFO method
3. Average cost method

Specific identification method

The specific identification method lets you pick and choose which securities you sell. Of course, the advantage to this is that you can pick the securities, the sale of which will result in the smallest tax liability. This may involve the selection of securities with a high tax basis and/or built-in-losses. It may result in the sale of securities with longer holding periods. It may even include the selection of securities which will produce short-term gain when adequate losses are available to offset such gain.

To use the specific identification method, you must be able to adequately identify the securities being sold. You are likely to hold your investments in one of two forms: in your broker's name or in your name.

- Securities held in your broker's name--Most people hold securities in their investment accounts. For practical reasons, the securities are generally not registered in your name but are registered in the broker's name and credited to your account. An adequate identification is made if, at the time of the sale, you specifically identify which shares you want your broker to sell. You need to get a written confirmation from your broker regarding your selection. You should also identify the stock by the purchase date and price.
- Securities held in your name--The securities sold are the securities that are delivered or transferred. This is true even if you instructed your broker to sell from a different lot. In some cases, you will sell fewer shares than are represented by the stock certificate.

Example(s): Assume you sell 50 shares but have only a 100-share certificate. The certificate will be transferred, and you are credited with the remaining odd lot. If you purchased the 100 shares at different times and prices, you can specify which shares you wish to sell. As long as you identify these shares by purchase date and price and you get a written confirmation, you have satisfied the adequate identification requirement. This is true even though the actual certificate representing all 100 shares is transferred.

Tip: The specific identification method is applicable to all of your marketable investments.

First in, first out (FIFO) method

The FIFO method requires you to treat the first share purchased as the first sold. This is beneficial from a long-term capital gain distinction, but it may have negative consequences in terms of tax basis if the market value of the securities has increased over time.

Tip: The FIFO method is applicable to all of your marketable investments (such as stocks, bonds, and mutual funds), and is the rule which generally applies when the specific identification method is not applicable.

Average cost method

When you sell shares in an open-end mutual fund, you are entitled to use the average cost method to determine the basis of the shares sold. If you use the average cost method, you have two options.

The first option is referred to as the average-cost single category method. This allows you to average the basis of all mutual fund shares regardless of how long you have owned the shares. The actual holding period is determined under the FIFO method. Thus, where shares are increasing in value, you are likely to get a more favorable tax basis as well as a longer holding period.

The second option is called the average-cost double category method. This requires you to calculate separate average cost bases for long- and short-term capital gain shares. You may then choose which shares you wish to

sell. This provides you with greater flexibility in selecting your tax treatment.

To take advantage of the average cost methods, you must make an election on your tax return. Once this election is made, you are not permitted to switch to another method without approval from the IRS. In addition, if you use the double category method, you must also inform the mutual fund custodian whether the shares sold are treated as long- or short-term.

Sale of Investments and Investment Property

What is the sale of investments and investment property?

The sale of investments and investment property can create either ordinary income or loss, or capital gain income or loss. It is important to understand the difference between ordinary tax treatment and capital tax treatment because the rates are different. Because there are a variety of investment vehicles available (e.g., cash alternatives, stocks, bonds, pass-through investments), you need to know how specific investments are taxed. This involves several concepts including tax basis, holding period, after-tax rate of return, computation of capital gain or loss, and netting of losses. In addition, you should be aware of special tax rules that apply to wash sales, short sales, installment sales, and other investment transactions.

What is the difference between the capital gain tax and ordinary income tax rates?

Long-term capital gains are accorded special tax treatment. Currently, the top long-term capital gains tax rate is 15 percent (for most assets), whereas the top ordinary income tax rate is 35 percent--that's a difference of 20 percent.

Tip: Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 and the Tax Increase Prevention and Reconciliation Act of 2005, long-term capital gains tax rates (for most assets) are 15 percent for taxpayers in tax brackets higher than 15 percent, and 5 percent (zero percent in 2008-2010) for taxpayers in the 15 percent and 10 percent tax brackets. These rates apply to sales and exchanges made on or after May 6, 2003 and before January 1, 2011. The tax rates in effect prior to May 6, 2003 are 20 percent and 10 percent, respectively. Beginning in 2011, long-term capital gains tax rates will revert to these pre-2003 Tax Act levels.

Capital gains and losses in a given year are netted or used to offset one another in a prescribed manner. Unused losses can be carried forward to the next tax year, in most cases. The concept of "holding period" also comes into play in determining whether capital gains and losses are long-term capital gains and losses.

Ordinary income tax rates can sometimes apply to investment income. In particular, ordinary rates apply to interest earnings on investment assets. In addition, ordinary rates can apply if you fail to hold your investment assets for more than one year or if you receive dividends that don't qualify for taxation at long-term capital gains tax rates.

Does tax treatment differ depending on the type of investment you sell?

Tax treatment can differ depending on the type of investment you sell. If you plan on selling a particular type of investment, it is important to gain a comprehensive understanding of the applicable tax rules.

Why is tax basis important?

If you sell or exchange a capital asset for more or less than your adjusted tax basis in the asset, the result is a capital gain or loss. Therefore, you need to know which assets are treated as capital assets, what basis means, how to calculate it, and how to adjust basis when necessary.

What about special tax rules?

Special tax rules can apply if you engage in a wash sale, short sale, installment sale, like-kind exchange, or other unusual transaction. In addition, you may need to know about qualified small business stock, market discount rules, or anti-conversion rules.

Common Types of Mutual Funds

Stock or Equity Funds	Balanced Funds (Stocks or Bonds)	Bond Funds
<p>Categorized by objective:</p> <ul style="list-style-type: none"> • Aggressive growth • Growth • Value • Blend / core (growth + value) <p>Categorized by size (capitalization) of companies invested in:</p> <ul style="list-style-type: none"> • Large cap • Midcap • Small cap • Microcap <p>Other types:</p> <ul style="list-style-type: none"> • Index • International (global, foreign, emerging market, single country or geographic region) • Nondiversified (focused) • Sector • Inverse • Socially responsible • Tax-efficient 	<ul style="list-style-type: none"> • Growth and income/equity-income • Asset allocation • Lifecycle/target date • Income replacement/distribution • Fund of funds 	<p>By Issuer:</p> <ul style="list-style-type: none"> • Government (federal) • Municipal (state and local government) • Corporate (investment grade) <p>By duration:</p> <ul style="list-style-type: none"> • Short-term • Intermediate • Long-term <p>By focus:</p> <ul style="list-style-type: none"> • High yield (junk) • TIPS

Before investing in a mutual fund, carefully consider its investment objectives, risks, fees, and expenses, which can be found in the prospectus available from the fund. Read it carefully before investing.

Exchange Traded Funds and Index Mutual Funds Compared

As they become more widely known, exchange traded funds (ETFs) are growing in popularity with investors. ETFs offer investors the ability to invest in a large and growing number of market indexes or sectors. While ETFs and index mutual funds have many similarities, they also have a number of important differences.

Feature	ETFs	Index Mutual Funds
Intra-day trading	Yes	No, orders placed during the day are executed at the close of trading
Diversification across a number of securities	Yes	Yes
Tracks index or sector	Yes	Yes
Buy on margin	Yes	No
Sell short	Yes	No
Expenses	Brokerage fees are incurred with each transaction, and there is a spread between bid and ask prices	May have any or all of the following: <ul style="list-style-type: none"> • management fees • 12b-1 fees • redemption fees • sales loads
Tax considerations	ETFs typically make fewer capital gains distributions	Must distribute any capital gains and dividends annually to investors, which may create a taxable event
Redemptions	Must be sold through a broker	Shares may be redeemed directly with fund company

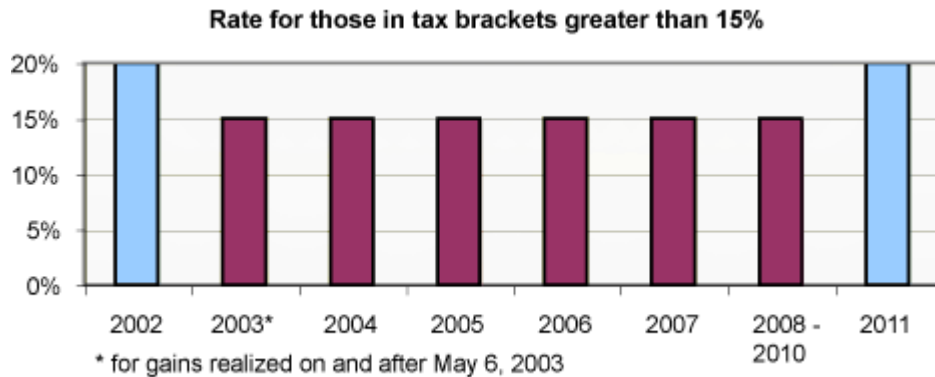
Before investing in a mutual fund, carefully consider its investment objectives, risks, fees, and expenses, which can be found in the prospectus available from the fund. Read it carefully before investing.

Capital Gains and Dividends Tax Relief

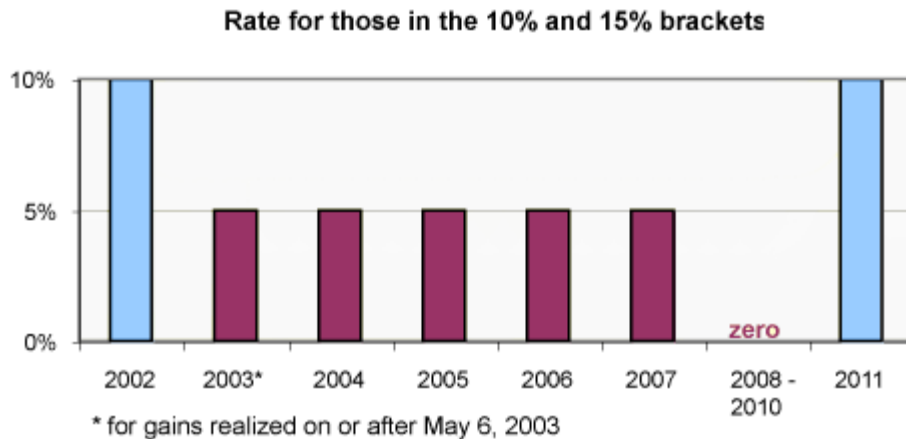
Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 and the Tax Increase Prevention and Reconciliation Act of 2005

Tax on long-term capital gains

These two acts set the maximum tax rate on long-term capital gains (gains on the sale of assets held for more than one year) at 15 percent through 2010.



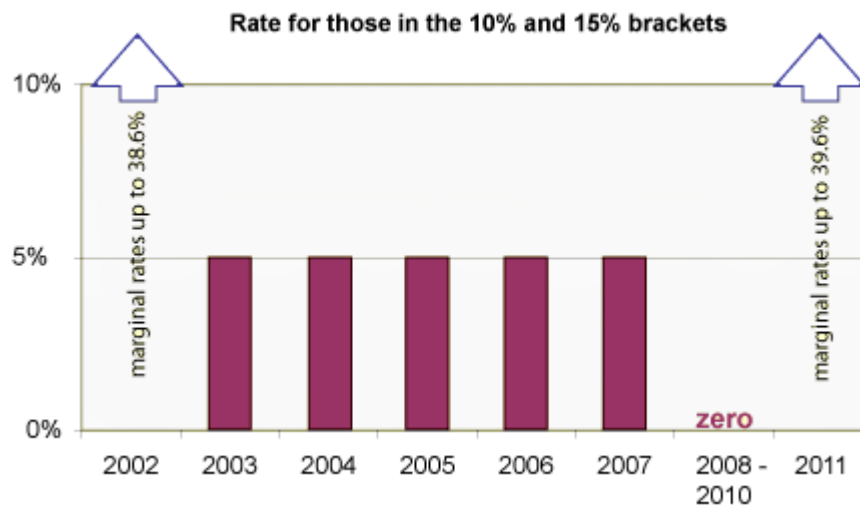
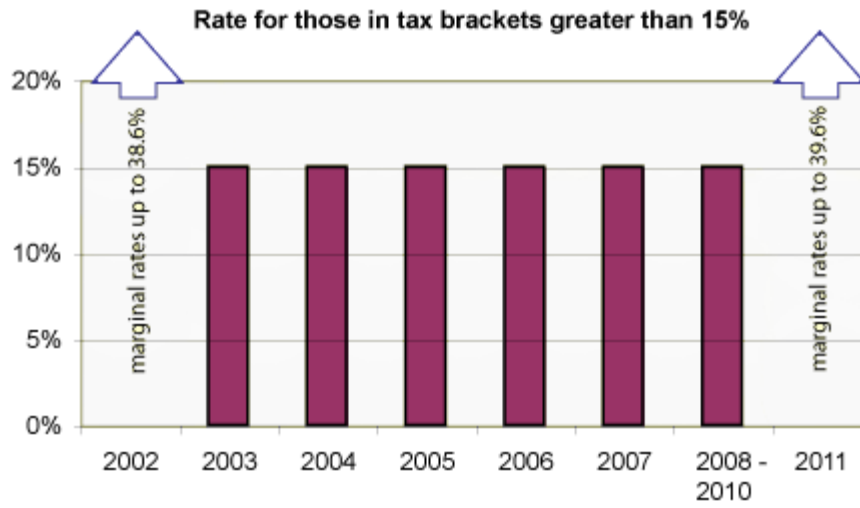
For individuals in the 10 percent and 15 percent marginal tax brackets, the rate is 5 percent, except for tax years 2008 through 2010, when the rate will be zero.



Tax on dividends

Taxpayers who receive corporate dividend payments also benefit from these rates. Dividends received from U.S. and qualified foreign corporations are generally taxed at the long-term capital gains rates. Prior to 2003, dividends were taxed as

ordinary income. The following charts illustrate this change, which is effective for dividends received in 2003 through 2010.



Taxation of Investments

It's nice to own stocks, bonds, and other investments. Nice, that is, until it's time to fill out your federal income tax return. At that point, you may be left scratching your head. Just how do you report your investments and how are they taxed?

Is it ordinary income or a capital gain?

To determine how an investment vehicle is taxed in a given year, first ask yourself what went on with the investment that year. Did it generate income, such as interest? If so, the income is probably considered ordinary. Did you sell the investment? If so, a capital gain or loss is probably involved. (Certain investments can generate both ordinary income and capital gain income, but we won't get into that here.)

If you receive dividend income, it may be taxed either as ordinary income or capital gain income. Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 and the Tax Increase Prevention and Reconciliation Act of 2005, dividends paid to an individual shareholder from a domestic corporation or qualified foreign corporation are generally taxed at the same rates that apply to long-term capital gains. These rates are 15 percent for an individual in a marginal tax rate bracket that is greater than 15 percent or 0 percent (in 2008-2010) for an individual in the 10 or 15 percent marginal tax rate bracket. But special rules and exclusions apply, and some dividends (such as those from money market mutual funds) continue to be treated as ordinary income.

The distinction between ordinary income and capital gain income is important because different tax rates may apply and different reporting procedures may be involved. Here are some of the things you need to know.

Categorizing your ordinary income

Investments often produce ordinary income. Examples of ordinary income include interest and rent. Many investments--including savings accounts, certificates of deposit, money market accounts, annuities, bonds, and some preferred stock--can generate ordinary income. Ordinary income is taxed at ordinary (as opposed to capital gains) tax rates.

But not all ordinary income is taxable--and even if it is taxable, it may not be taxed immediately. If you receive ordinary income, you must categorize it as taxable, tax exempt, or tax deferred.

- **Taxable income:** This is income that's not tax exempt or tax deferred. If you receive ordinary taxable income from your investments, you'll report it on your federal income tax return. In some cases, you may have to detail your investments and income on Schedule B.
- **Tax-exempt income:** This is income that's free from federal and/or state income tax, depending on the type of investment vehicle and the state of issue. Municipal bonds and U.S. securities are typical examples of investments that generate tax-exempt income.
- **Tax-deferred income:** This is income whose taxation is postponed until the future. For example, with a 401(k) retirement plan, earnings are reinvested and taxed only when you take money out of the plan. The income earned in the 401(k) plan is tax deferred.

A quick word about ordinary losses: It's possible for an investment to generate an ordinary loss, rather than ordinary income. In general, ordinary losses reduce ordinary income.

Understanding what basis means

Let's move on to what happens when you sell an investment vehicle. Before getting into capital gains and losses, though, you need to understand an important term--basis. Generally speaking, basis refers to the amount of your investment in an asset. To calculate the capital gain or loss when you sell or exchange an asset, you must know

how to determine both your initial basis and adjusted basis in the asset.

First, initial basis. Usually, your initial basis equals your cost--what you paid for the asset. For example, if you purchased one share of stock for \$10,000, your initial basis in the stock is \$10,000. However, your initial basis can differ from the cost if you did not purchase an asset but rather received it as a gift or inheritance, or in a tax-free exchange.

Next, adjusted basis. Your initial basis in an asset can increase or decrease over time in certain circumstances. For example, if you buy a house for \$100,000, your initial basis in the house will be \$100,000. If you later improve your home by installing a \$5,000 deck, your adjusted basis in the house may be \$105,000. You should be aware of which items increase the basis of your asset, and which items decrease the basis of your asset. See IRS Publication 551 for details.

Calculating your capital gain or loss

If you sell stocks, bonds, or other capital assets, you'll end up with a capital gain or loss. Special capital gains tax rates may apply. These rates may be lower than ordinary income tax rates.

Basically, capital gain (or loss) equals the amount that you realize on the sale of your asset (i.e., the amount of cash and/or the value of any property you receive) less your adjusted basis in the asset. If you sell an asset for more than your adjusted basis in the asset, you'll have a capital gain. For example, assume you had an adjusted basis in stock of \$10,000. If you sell the stock for \$15,000, your capital gain will be \$5,000. If you sell an asset for less than your adjusted basis in the asset, you'll have a capital loss. For example, assume you had an adjusted basis in stock of \$10,000. If you sell the stock for \$8,000, your capital loss will be \$2,000.

Schedule D of your income tax return is where you'll calculate your short-term and long-term capital gains and losses, and figure the tax due, if any. You'll need to know not only your adjusted basis and the amount realized from each sale, but also your holding period, your marginal income tax bracket, and the type of asset(s) involved. See IRS Publication 544 for details.

- **Holding period:** Generally, the holding period refers to how long you owned an asset. A capital gain is classified as short term if the asset was held for a year or less, and long term if the asset was held for more than one year. The tax rates applied to long-term capital gain income are generally lower than those applied to short-term capital gain income. Short-term capital gains are taxed at the same rate as your ordinary income.
- **Marginal income tax bracket:** Marginal income tax brackets are expressed by their marginal tax rate (e.g., 15 percent, 25 percent). Your marginal tax bracket depends on your filing status and the level of your taxable income. When you sell an asset, the capital gains tax rate that applies to the gain will depend on your marginal income tax bracket. Generally, a 0 percent long-term capital gains tax rate applies to individuals in the 10 or 15 percent tax bracket (in 2008-2010), while the long-term capital gains of individuals in the other tax brackets are subject to a 15 percent rate.
- **Type of asset:** The type of asset that you sell will dictate the capital gain rate that applies, and possibly the steps that you should take to calculate the capital gain (or loss). For instance, the sale of an antique is taxed at the maximum tax rate of 28 percent even if you held the antique for more than 12 months.

Using capital losses to reduce your tax liability

You can use capital losses from one investment to reduce the capital gains from other investments. You can also use a capital loss against up to \$3,000 of ordinary income this year (\$1,500 for married persons filing separately). Losses not used this year can offset future capital gains. Schedule D of your federal income tax return can lead you through this process.

Getting help when things get too complicated

The sale of some assets are more difficult to calculate and report than others, so you may need to consult an IRS publication or other tax references to properly calculate your capital gain or loss. Also, remember that you can always seek the assistance of an accountant or other tax professional.

Tax Planning for Annuities

Favorable tax treatment is one of the main reasons for buying an annuity. But what exactly are the tax benefits? And are there any drawbacks? It's important to know the answers to these questions before deciding whether to purchase an annuity.

Of course, any information pertaining to taxes is complex, full of exceptions, and subject to change. This discussion deals with the general rules for taxation of annuities--you should consult a tax advisor for more specific information before you take any action.

Taxation of premiums

Annuities are typically funded with after-tax dollars. So, the money you pay into an annuity (in the form of premiums) is nondeductible. By placing funds in an annuity, you will not realize any current income tax savings, unlike putting money into a traditional IRA, 401(k) plan, or other employer-sponsored retirement plan.

Tax-deferred growth

Unlike most investments, an increase in the value of an annuity from interest is not currently taxable. Generally, annuity funds are allowed to grow tax deferred until they're distributed, at which time the owner will pay ordinary income tax on all gains.

Taxation of premature withdrawals

Withdrawals taken before age 59½ may be subject to a 10 percent IRS penalty tax unless an exception applies. When you make a withdrawal from an annuity, the IRS assumes that earnings are withdrawn first. The 10 percent penalty applies to the earnings portion of a withdrawal. So, early withdrawals are costly from a tax standpoint.

For example, if your annuity has grown by \$1,000 since you purchased it, a \$500 withdrawal would be considered 100 percent interest and would be subject to the 10 percent penalty--in this case, \$50. In addition, because the entire withdrawal represents earnings, it would be subject to ordinary income tax. If you are in the 25 percent tax bracket, your income tax liability on the withdrawal would be \$125. Adding this to the early withdrawal penalty, \$175 of your \$500 withdrawal would end up in the IRS's pocket.

Taxation of scheduled distributions

If you choose an annuitization option, you will begin receiving regular distributions from your annuity over a predetermined period of time. Each distribution consists of two components: principal (a return of the money you paid into the annuity) and earnings. The percentages of principal and earnings of each distribution will depend on the annuitization option chosen. Again, the earnings portion of each distribution will be treated as ordinary income. Also, depending on the annuitization option chosen, the 10 percent penalty rule may not apply.

Note: Annuity guarantees are subject to the claims-paying ability of the annuity issuer.

Taxation of lump-sum distributions

Taking a lump-sum distribution of your annuity funds can have many consequences. If you make this election within the first few years after purchasing your annuity, you may be subject to surrender charges imposed by the issuer. In any case, the earnings portion of the distribution will be treated as ordinary income in the year you take the distribution. Also, keep in mind that a large lump-sum distribution could actually push you into a higher tax bracket, dramatically increasing your tax liability.

Income Tax Planning and 529 Plans

The income tax benefits offered by 529 plans make these plans attractive to parents (and others) interested in saving for college. Qualified withdrawals from a 529 plan are tax free at the federal level, and some states also offer tax breaks to their residents. It's important to evaluate the federal and state tax consequences of plan withdrawals and contributions before you invest in a 529 plan.

Federal income tax treatment of qualified withdrawals

There are two types of 529 plans--college savings plans and prepaid tuition plans. The federal income tax treatment of these plans is identical. Your contributions to college savings plans and prepaid tuition plans are tax deferred. This means that you don't pay income taxes on the plan's earnings each year.

Then, if you take out money and use it to pay for qualified education expenses, the earnings portion of your withdrawal is free from federal income tax. This presents a significant opportunity to help you accumulate funds for college.

Qualified education expenses include tuition, fees, and books for college and graduate school. Room-and-board expenses are also considered qualified if the beneficiary is attending college or graduate school on at least a half-time basis.

State income tax treatment of qualified withdrawals

States differ in the 529 plan tax benefits they offer to their residents. For example, some states may offer no tax benefits, while others may exempt earnings on qualified withdrawals from state income tax and/or offer a deduction for contributions. However, keep in mind that states may limit their tax benefits to individuals who participate in the in-state 529 plan.

You should look to your own state's laws to determine the income tax treatment of withdrawals (and deductions). In general, you won't be required to pay income taxes to another state simply because you opened a 529 account in that state. But you'll probably be taxed in your state of residency on the earnings distributed by your 529 plan (whatever state sponsored it) unless your state grants a specific exemption. Also, make sure you understand your state's definition of "qualified education expenses," since it may differ from the federal definition.

Income tax treatment of nonqualified withdrawals (federal and state)

If you make a nonqualified withdrawal (i.e., one not used for qualified education expenses), the earnings portion of the distribution will usually be taxable on your federal (and probably state) income tax return in the year of the distribution. The earnings are usually taxed at the rate of the person who receives the distribution (known as the distributee). In most cases, the account owner will be the distributee. Some plans specify who the distributee is, while others may allow you (as the account owner) to determine the recipient of a nonqualified withdrawal.

You'll also pay a federal 10 percent penalty on the taxable amount of the nonqualified withdrawal (usually, that means on the earnings). There are a couple of exceptions, though. The penalty is usually not charged if you terminate the 529 account because the beneficiary has died or become disabled, or if you withdraw funds not needed for college because the beneficiary has received a scholarship. A state penalty may also apply.

Deducting your contributions to a 529 plan

Unfortunately, you can't claim a federal income tax deduction for your contributions to a 529 plan. Depending on where you live, though, you may qualify for a deduction on your state income tax return. A number of states now allow a state income tax deduction for contributions to a 529 plan, and several other states are considering such a measure. Again, keep in mind that most states let you claim an income tax deduction on your state tax return

only if you contribute to your own state's 529 plan.

Most of the states that provide a deduction for contributions impose a deduction cap, or limitation, on the amount of the deduction. For example, if you contribute \$10,000 to your son's 529 plan this year, your state might allow you to deduct only \$4,000 on your state income tax return. Check the details of your 529 plan and the tax laws of your state to learn whether your state imposes a deduction cap.

Also, if you're planning to claim a state income tax deduction for your contributions, you should learn whether your state applies income recapture rules to 529 plans. Income recapture means that deductions allowed in one year may be required to be reported as taxable income if you make a nonqualified withdrawal from the 529 plan in a later year. Again, check the laws of your state for details.

Coordination with the Coverdell education savings account and education tax credits

You can fund a Coverdell education savings account and a 529 account in the same year for the same beneficiary without triggering a penalty.

You can also claim an education tax credit in the same year you withdraw funds from a 529 plan to pay for qualified education expenses. But your 529 plan withdrawal will not be completely tax free on your federal income tax return if it's used for the same higher education expenses for which you're claiming a credit. (When calculating the amount of your qualified higher education expenses for purposes of your Section 529 withdrawal, you'll have to reduce your qualified expenses figure by any expenses used to compute the education tax credit.)

Note: Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about specific 529 plans is available in the issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.

Investing in Stocks

Businesses sell shares of stock to investors as a way to raise money to finance expansion, pay off debt, and provide operating capital. Each share of stock represents a proportional share of ownership in the company. As a stockholder, you share in a portion of any profits and growth of the company. Dividends from earnings are paid to shareholders, and growth is realized by the increase in value of the stock.

Stock ownership also generally gives you the right to vote on management issues. Company executives work for the shareholders, who are represented by an elected board of directors. The goal of management is to increase the value of the corporation's equity. If shareholders are dissatisfied with the corporation's performance, they can vote for a change in management.

Why invest in stocks?

The main reason that investors buy stock is to seek capital appreciation and growth. Although past performance is no guarantee of future results, stocks have historically provided a higher average annual rate of return over time than other investments, including bonds and cash alternatives. Correspondingly, though, stocks are generally considered to have more volatility than bonds or cash alternatives.

Can you lose money?

Yes, you can. There are no assurances that a stock will increase in value. Several factors can affect the value of your stocks:

- **Actions of investors:** If a large number of investors believe that the nation is entering a recession, their actions can affect the direction of the stock market
- **Business conditions:** A new patent, an increase in profits, a pending merger, or litigation could affect investor interest and stock prices
- **Economic conditions:** Employment, inflation, inventory, and consumer spending influence the potential profit of a company and its stock price
- **Government actions:** Decisions on interest rates, taxes, trade policy, antitrust litigation, and the budget impact stock prices
- **Global economy:** Changes in foreign exchange rates, tariffs, or diplomatic relations can cause stocks to go up or down

Understanding these factors can help you make sound investment decisions and keep losses to a minimum.

What are the different classifications of stocks?

Stocks are often classified in the following ways:

- **Growth stocks** have earnings that are increasing at a faster rate than the market average. These are usually in new or fast-growing industries and have the potential to give shareholders returns greater than those offered by the stocks of companies in older, more established industries. Growth stocks are the most volatile class of stock, however, and may be just as likely to go down in price.
- **Value stocks** are those of companies with good earnings and growth potential that are currently selling at a low price relative to their intrinsic value. Due to some problem that may be only temporary in nature, investors are ignoring these stocks. Since it can take quite some time for their true value to be reflected by their price, value stocks are usually purchased for the long term.

- Income stocks are generally not expected to appreciate greatly in share price, but typically pay steady dividends. Utilities are an example of companies that have historically been considered income-oriented.
- Blue chip stocks are the stocks of large, well-known companies with good reputations and strong records of profit growth. They also generally pay dividends.
- Penny stocks are very risky speculative stocks issued by companies with short or erratic performance histories. These stocks are so named because they sell for under \$5 per share. Their low price appeals to investors willing to assume a total loss in exchange for the potential for explosive growth.

It is usually best to diversify among the different classifications and not own stock in just one or two companies or industries (though diversification alone cannot guarantee a profit or ensure against a loss).

How are stocks bought and sold?

During an initial public offering (IPO), new issues of stock are sold on the basis of a prospectus (a document that gives details about a company's operation) that is distributed to interested parties. Investment bankers or brokerage houses buy large quantities of the stock from the company and sell them to investors. After the IPO, the stock may trade on a stock exchange or over the counter.

Normally, stock is purchased through a brokerage account. The buy order you place will be directed to the appropriate stock exchange. When someone who owns the stock is willing to sell at the price you are willing to pay, the sale takes place. A commission or fee is charged on your transaction.

Stock certificates may be transferred from one owner to another since they are negotiable instruments. The certificates are issued in the buyer's name or, more typically, held by the brokerage house in street name (i.e., the brokerage firm's name) on behalf of the investor. The advantage of a street-name registration is that if you decide to sell, you do not have to sign and deliver the stock certificates before the sale can be completed. And you don't have to worry about losing the stock certificates.

How do you set up a brokerage account?

You will need to complete a new account agreement and make three important decisions:

Who will make the investment decisions? You will--unless you give discretionary power to your broker or agent. Discretionary power allows a broker or agent to make decisions based on what he or she believes is best for you. Unless you limit the broker's or agent's discretion, this may be done without consulting you about the type of security and number of shares involved, or about the time and price at which to buy or sell. Do not give discretionary power to your broker or agent without seriously considering if it is right for you.

How will you pay for the stock? A cash account requires you to pay for each stock purchase in full at the time you buy it. A margin account allows you to borrow money from the brokerage firm. Securities that you own are held as collateral, and interest is charged on the loan. If the account value falls below the specified amount required to maintain the loan (even as the result of a one-day market decline), you must pay down the loan balance to an amount determined in relation to your new account balance. This is known as a margin call and can potentially require the payment of a sizable amount of money.

What level of risk can you handle? You will be asked to specify your investment goals in terms of risk. Choices such as income, growth, or aggressive growth may be given. Make sure you understand the meaning of each term, and be certain that the level of risk you choose truly reflects your ability to handle risk. Any investment your broker or agent recommends should be based on the category of risk you selected.

Read the account agreement

Keep good records of:

- Documents you sign
- Documents outlining the details of an account or investment
- Periodic account statements
- Transaction confirmations
- Documents verifying an account error was corrected
- Correspondence with your broker or agent

Review these as soon as you receive them. Discuss any discrepancies you find with your broker or agent at once, and follow up on any actions taken until you are satisfied. Never allow your broker or agent to mail statements and transaction confirmations to someone other than you. It's important that you check the accuracy of your own accounts.

Be patient

Some stock investors have made money quickly. But they are the exception rather than the rule. Investing in stocks requires a long-term outlook. Read books, attend seminars, and take advantage of professional advice. Education, good judgment, common sense, and above all, patience increase your chances of achieving your goals.

Investing in Bonds

Bonds may not be as glamorous as stocks or commodities, but they are a significant component of most investment portfolios. Bonds are traded in huge volumes every day, but their full usefulness is often underappreciated and underestimated.

Why invest in bonds?

Bonds can help diversify your investment portfolio. Interest payments from bonds can act as a hedge against the relative volatility of stocks, real estate, or precious metals. Those interest payments also can provide you with a steady stream of income.

How bonds work

When you buy a bond, you are essentially loaning money to a bond issuer in need of cash to finance a venture or fund a program, such as a corporation or government agency. In return for your investment, you receive interest payments at regular intervals, usually based on a fixed annual rate (coupon rate). You are also paid the bond's full face amount at its stated maturity date.

You can purchase bonds in denominations as low as \$100 (though individual brokers may have a higher minimum purchase). Some are backed by tangible assets, such as mortgage contracts, buildings, or equipment. In many other cases, you simply rely on the issuer's ability to pay. You can buy or sell bonds in the open market in the same manner as stocks and other securities. Therefore, bonds fluctuate in price, selling at a premium (above) or discount (below) to the face value (par value). Generally, the longer a bond's duration to maturity, the more volatile its price swings. These factors expose bonds to certain inherent risks.

Bond risk factors

Although many bonds are conservative, lower-risk investments, many others are not, and all carry some risk. Because bonds are traded in the securities markets, there is always the chance that your bonds can lose favor and drop in price due to market risk. Much of this volatility in prices is tied to interest-rate fluctuations. For example, if you pay \$1,000 for a 10 percent bond, that same \$1,000 might buy you an 11 percent bond the following month, if interest rates rise. Consequently, your old 10 percent bond may be worth only about \$900 to current investors.

Since bonds typically pay a fixed rate of interest, they are open to inflation risk. As consumer prices generally rise, the purchasing power of all fixed investments is reduced. Also, there is a chance that the issuer will be unable to make its interest payments or to repay its bonds' face value at maturity. This is known as credit or financial risk. To help minimize this risk, compare the relative strength of companies or bonds through a ratings service such as Moody's, Standard & Poor's, A. M. Best, or Fitch. Finally, bonds also involve reinvestment risk: the risk that when a bond matures, you may not be able to get the same return when you reinvest that money.

Corporate bonds

Bonds issued by private corporations vary in risk from typically super-steady utility bonds to highly volatile, high-interest junk bonds. Also, many corporate bonds are callable, meaning that the debt can be paid off by the issuing company and redeemed on a fixed date. The company pays back your principal along with accrued interest, plus an additional amount for calling the bond before maturity.

Some corporate bonds are convertible and can be exchanged for shares of the company's stock on a fixed date. You can also purchase zero-coupon bonds, which are issued at a discount to (below) face value. No interest is paid, but at maturity you receive the face value of the bond. For example, you pay \$600 for a 5-year, \$1,000 zero-coupon bond. At the end of 5 years, you receive \$1,000. Corporate bonds have maturity dates ranging from

one day to 40 years or more and generally make fixed interest payments every six months.

U.S. government securities

The securities backed by the full faith and credit of the U.S. government carry minimal risk. United States Treasury bills (T-bills) are issued for terms from a few days to 52 weeks. They are sold at a discount and are redeemed for their full face value at maturity. Other Treasury securities include Treasury notes, which have terms from 2 to 10 years, Treasury Inflation Protected Securities (TIPS), which have terms from 5 to 20 years, and Treasury bonds, which have a term of 30 years. Although the interest earned on these securities is subject to federal taxation, it is not subject to state or local taxes.

Various federal agencies also issue bonds. As with any investment, these bonds carry some risk. However, because the U.S. government guarantees timely payment of principal and interest on them, they are considered very safe. Some of these bonds use mortgages as collateral. Most mortgage-backed securities pay monthly interest to bondholders.

Municipal bonds

Municipal bonds (munis) are issued by states, counties, or municipalities, and are free from federal taxation (with some exceptions). Some may be completely tax free if you are a resident of the state, county, or municipality of issuance. Though municipal bonds generally offer lower interest payments compared with taxable bonds, their overall return may be higher because of their tax-reduced (or tax-free) status.

Munis come in two types: general obligation (GO) bonds and revenue bonds. GO bonds are backed by the taxing authority of the issuing state or local government. For this reason, they are considered less risky but have a lower coupon rate. Revenue bonds are supported by money raised from the bridge, toll road, or other facility that the bonds were issued to fund. They pay a higher interest rate and are considered riskier. Therefore, research the project being funded to the extent possible before you invest, to make sure that it will generate sufficient income to make payments.

How to begin investing in bonds

Thousands of books, newsletters, and websites can provide you with investment information that can help you evaluate and choose bonds. The major bond-rating services offer concise letter grades regarding the relative strength of a corporation or bond.

However, if you don't want to go it alone, a brokerage firm or financial advisor can evaluate and recommend choices for you. Keep in mind that brokers or advisors may charge a fee for this service.

You can buy bonds from a broker, from a commercial bank, over the Internet, or (for Treasury securities) directly from the U.S. Treasury. Shares in bond funds can be purchased through a mutual fund or bond trust.

Monitoring your bond portfolio

Of course, you'll want to keep an eye on your bond portfolio, as you should with all of your investments. Although other factors may affect them, bond prices are often closely tied to interest rates. When rates go up, the market price of your bonds tend to go down; when interest rates fall, your bonds generally rise in value.

Interest rates also tend to affect a bond's current yield, which measures the coupon rate of your bond in relation to its current price. The current yield rises with a corresponding drop in the price of a bond, and vice versa. In addition, inflation, corporate finances, and government fiscal policy can affect bond prices.

Mutual Fund Basics

A mutual fund pools the money of many investors to purchase securities. The fund's manager buys securities to pursue a stated investment strategy. By investing in the fund, you'll own a piece of the total portfolio of securities, which could be anywhere from a few dozen to hundreds of stocks. This provides you with a convenient way to obtain instant diversification that would be harder to achieve on your own.

Types of mutual funds

There are many mutual funds to choose from. The two most common types are stock mutual funds and bond mutual funds. A stock fund invests in common stocks issued by U.S. and/or international companies. Funds are often named and classified according to investment style or objective, which can be stated in various ways. For example, some stock mutual funds buy stocks in companies believed to have potential for long-term growth in share price. Other stock mutual funds look for current income by focusing on companies that pay dividends. Sector funds buy stocks in a particular sector, such as technology or health care. Still other mutual funds may purchase stocks based on the size of the company (e.g., stocks of large, midsize, or small companies).

Although the name of a stock mutual fund generally offers insight into its investment style and objective, it is important not to rely on the name alone in determining whether a particular fund is what you want. The fund prospectus is like an owner's manual and contains information about the kind of investment style that the manager(s) employ, and the kinds of stocks that the fund will buy.

Note: *Before investing in any mutual fund, carefully consider its investment objectives, risks, fees, and expenses, which are discussed in the prospectus available from the fund. Read the prospectus carefully before investing.*

A bond fund is made up of debt instruments that governments or corporations issue to raise capital. They are designed to provide investors with interest income in the form of regularly scheduled dividends. If you bought individual bonds, you would need to concern yourself with their maturity dates and the reinvestment of your funds. Buying shares of a bond fund relieves you of these concerns; the fund manager handles them for you.

Bond funds are primarily classified according to the issuers of the bonds in the fund's portfolio and/or to the term of the bonds. For example, municipal bond funds buy bonds issued by municipalities. The income from these is free from federal tax (however, a portion of the income may be subject to the federal alternative minimum tax) and may be free from state and local taxes. Similarly, some funds invest only in U.S. Treasury debt instruments (e.g., bonds, bills, and notes) or high-grade (or low-grade) corporate bonds. Some bond funds, from all types of issuers, limit themselves to bonds maturing in the short, intermediate, or long term.

There are other types of mutual funds that you will encounter. Funds that invest in both stocks and bonds (or stocks, bonds, and cash alternatives) are often known as balanced funds. A money market fund buys extremely short-term debt instruments and is often used as a place to put cash, short term, until it is needed elsewhere. (Though a money market fund attempts to maintain a \$1 per share value, there is no guarantee it will always do so, and it is possible to lose money investing in a money market fund.) Index funds attempt to duplicate a standardized, broad-based index such as the Standard & Poor's 500 (S&P 500) stock index or Moody's bond index by holding a portfolio of the same securities used by the index in an attempt to match the index's performance as closely as possible.

What are the benefits of investing in a mutual fund?

Diversification: Most mutual funds own dozens or even hundreds of securities. The managers often spread the fund's assets over more than one type of investment (e.g., both stocks and bonds, or stocks from a variety of industries). This exposes you to less potential risk than buying just a few individual securities. If some of the fund's holdings perform poorly, they may be offset by others doing well, (though diversification cannot guarantee a profit or ensure against a loss).

Professional money management: When you buy shares in an actively managed mutual fund, part of what you pay for is the fund manager's expertise. The manager analyzes hundreds of securities (both current and contemplated holdings) and makes decisions on what and when to buy and sell.

Small investment amounts: Depending on fund rules, you can open an account and make subsequent contributions with a very small initial investment. You can even set up automatic investments through a transfer of funds from your bank account.

Liquidity: You can convert your mutual fund investment into cash (i.e., redeem your shares) by making a request to the fund company in writing, over the phone, or on the Internet on any business day.

Of course, mutual funds are not guaranteed investments. The price of all mutual fund shares can change daily, and you'll receive the current value of your shares when you sell--which may be more or less than you paid.

Choosing a fund

Choosing a mutual fund to invest in requires more than picking a fund from the Top 10 list of the best past performers. Choosing a mutual fund requires careful thinking about numerous factors. The most important of these to consider include your investment objectives, risk tolerance, and time horizon.

Spend some time considering these factors, then do as much research as you can. Many financial magazines and websites are good sources of information to use in an initial screen for suitable mutual funds. Review the fund prospectus. It provides a great deal of information that you'll want to know about the fund, such as the fund's investment objective and style, and the fund's expenses. To get a prospectus, contact the mutual fund company directly, or go on-line to the company's website to download one.

Sales charge and other costs

All mutual funds have expenses that investors must pay for, but the sales charge, or load, is probably the most significant and varied among funds. These sales charges are generally paid as commissions to stockbrokers, financial advisors, and insurance agents. The sales charge may be deducted at the time you purchase shares of the mutual fund (front-end load), leaving less to work for you, or it may be charged at the point of redemption (back-end load). Some mutual funds, known as no-load funds, have no sales charges.

Pay attention to a mutual fund's other fees and expenses, as well. Look at a fund's expense ratio, which is calculated by dividing the fund's annual expenses by the fund's average net assets. Expenses affect a fund's net return. The higher the expense ratio, the less money is being put to work for you.

Turnover ratio

Portfolio turnover reflects the value of a fund's trades during a year compared to the total value of its assets, and is often used as an indicator of how actively a fund manager trades. If the value of a fund's trades equals that of its entire portfolio, its turnover ratio would be 100 percent.

Aggressively managed funds generally have higher portfolio turnover ratios than do conservative funds, which buy and hold for the long term. High turnover generally adds to the expenses of a fund because of the brokerage commissions paid for each transaction.

More important, however, is that when the fund sells stock at a gain, the gain must be distributed to shareholders. You will then be liable for income tax on your portion of the gain, even if the gain was reinvested, and even if your fund's share value actually decreased that year.

A tax-efficient approach minimizes the tax impact of its trades by implementing strategies such as offsetting gains by selling other stocks at a loss, or holding stocks for long periods. Note that if you own a mutual fund in an individual retirement account (IRA) or a qualified retirement plan at work (e.g., a 401(k)), tax efficiency is not as important. This is because no tax is immediately paid on realized gains in these retirement accounts and plans;

tax is deferred until the money is withdrawn.

Past performance

Although past performance is no guarantee of future results, a fund's track record over the past 3, 5, and 10 years is certainly worth considering. How does it compare with its peers--funds with similar risk and investment strategies? Apples-to-apples comparisons of funds are difficult, so a variety of broad market indexes are used as comparison benchmarks. For example, the S&P 500 is often used as a proxy for the U.S. stock market as a whole. Examine how well the fund that you are looking at has performed in both good and bad years relative to the most appropriate benchmark index.

Fund managers

One of the advantages of purchasing shares in an actively managed mutual fund shares is professional money management. The past performance of the fund is a reflection of the fund manager's ability to effectively manage its assets. You should research the current manager's history with the fund; was the fund's performance his or her achievement? If the fund has a new manager, make sure that individual's investment style matches your expectations.

Other Investments

A well-diversified investment portfolio contains a mix of stocks, bonds, short-term cash investments, and savings accounts that is tailored to your investment goals and risk tolerance. If you want to diversify your investment portfolio further, you can look to other investment possibilities. Here are a few of these, with brief explanations of what they are, how they can be used, and what the risks and potential rewards may be.

Precious metals

Some investors purchase silver or gold as a hedge against inflation or currency fluctuations.

In general, as inflation rises, the value of the dollar normally goes down. Historically, when a significant drop in the dollar occurred, gold and silver (and platinum to a lesser extent) went up in value. Precious metals such as gold had a tendency to retain their purchasing power no matter how badly the currency declined. Precious metals have intrinsic value, while currency can literally become worth less than the paper it is printed on, as was the case with the German mark after World War I. Keep in mind, though, that past performance is no guarantee of future results, and there can be no assurance that an investment will ever be profitable.

As with any other investment, risks are involved when investing in gold. These include certain risks uncommon to other types of investments, such as monetary policy changes and currency devaluations. Investors should discuss the risks of investing in gold with their financial professional.

Some options for investing in precious metals include actually purchasing the asset (i.e., gold bullion or coins), buying shares of mining companies, investing in a fund that concentrates its portfolio in the securities of issuers principally engaged in gold-related activities, buying futures or options contracts (see below) or investing in an exchange-traded fund that holds bullion.

Options

Options give the owner the right, but not the obligation, to buy or sell an underlying asset at a set price (strike price) before a certain date (expiration date). The underlying asset can be (to name some of the more popular ones) currency, a stock, an index, a bond, or a Treasury bill. A call option is the right to buy the underlying asset, and a put option is the right to sell the underlying asset. The price paid for the option is called the premium.

An investor purchases an option to control a specific number of shares for a limited period of time. An investor might purchase a call option because he or she believes that the price of the stock will go up during that period. Similarly, an investor might purchase a put option because he or she believes that the price will go down during that period. If the investor has guessed wrong, the option expires worthless and he or she could lose the total premium paid for the option.

An investor may sell an option for income on an underlying security that he or she owns. The income is the premium that an option buyer pays to purchase the option. If the underlying security moves in favor of the option buyer, the buyer may exercise the option, and the option seller may be required to sell the underlying security. If the underlying security moves in favor of the seller, the buyer normally will not exercise the option, and the seller keeps both the premium and the underlying asset.

These are just two strategies in which an investor uses options. Although there are many benefits in using them, options are risky and not suitable for all investors. For example, selling an option is done in a margin account, subjecting the seller to interest costs and margin calls. Before attempting to buy or sell options, it is important to discuss the role they can play in your portfolio with a financial professional.

Futures

A futures contract is a promise to buy or sell a commodity for a certain price on a future date. Commodities include oil, natural gas, lumber, and base metals, as well as many agricultural products such as farm grains, beef, pork, coffee, and cocoa. In addition to commodities, investors can trade futures on foreign currencies, interest rate products such as Treasury bills, precious metals, and market indexes such as the S&P 500.

Investors purchase futures contracts either as a hedge against price fluctuations or for speculation purposes. Hedging is the primary purpose of futures contracts. The purchaser of the futures contract establishes a price now for a purchase or sale that will take place in the future. Speculators buy and sell futures contracts based on whether they expect prices to move up or down; they hope to profit from the price changes that hedgers try to avoid, and rarely take delivery of the underlying commodity itself.

Futures contracts are extremely high-risk investments. They should be considered only by experienced investors and professionals.

Real estate investment trusts

A real estate investment trust (REIT) is a corporation (or business trust) that invests in real estate or provides financing for real estate. REITs own and, in most instances, manage income-producing real estate such as offices, shopping centers, apartments, and warehouses. REITs derive their income from rents and capital gains realized on the sale of real estate. Some REITs invest in mortgages secured by real estate and get their income from the collection of interest. A REIT may specialize in one type of real estate--for example, office buildings--or have holdings in a variety of types.

REITs offer a convenient way for an investor to participate in commercial real estate. First, an investor's capital commitment is lower, since the investor buys shares of a REIT rather than the actual property. Second, owning a REIT generally offers greater liquidity than owning the property itself. Most REITs trade on the major stock exchanges and can be purchased or sold through stockbrokers. Finally, you get professional property management, which means you don't have to chase after the rents or respond to late-night phone calls about maintenance problems.

REITs offer long-term growth potential and income. Also, investing in REITs helps diversify a portfolio, though diversification alone can't guarantee a profit or protect against potential loss. However, risks are associated with real estate investing. The value of real estate is affected by interest rate changes, economic conditions (both national and local), property tax rates, and other factors. It is important to discuss with a financial professional the role REITs can play in your portfolio.

Is it better to invest in a tax-free or a taxable mutual fund?

Answer:

Typically, a tax-free mutual fund is made up of municipal bonds and other government securities. Such securities are attractive to many investors because returns are tax free, often at both the state and federal levels. However, they also tend to provide lower pretax returns than comparable securities issued by nongovernmental entities. It is imperative that you consider total after-tax returns when you are comparing a tax-free fund with a taxable fund. Whether or not a taxable fund is a better choice for you will depend in large part on how much of your returns are likely to go directly to federal, state, and local taxes at the end of the year.

To determine your approximate after-tax rate of return on a taxable investment, multiply your rate of return by 100 percent minus your tax rate:

Pretax return x (100% - tax rate) = After-tax rate of return

For example, say you are in the 25 percent tax bracket and earn a pretax return of 10 percent on an investment. Your after-tax rate of return would be 7.5 percent, calculated as follows:

$10\% \times (1 - .25) = .075$ or 7.5% after-tax rate of return

In addition, consider whether the fund will be held in a qualified pension or retirement plan. If your returns will automatically accumulate tax deferred in an IRA or 401(k), there may be no reason to accept lower returns in exchange for a tax-free feature.

If you are risk averse, you may decide on a tax-free fund. The securities that it holds will be backed by the full faith and credit of the issuing bodies, be they the federal government, the state government, or a municipality. This feature coupled with the tax advantage gives some investors an added comfort level.

Note: Before investing in a mutual fund, carefully consider its investment objectives, risks, fees, and expenses, which can be found in the prospectus available from the fund. Read it carefully before investing.

How did the Jobs and Growth Tax Relief Reconciliation Act of 2003 change capital gains tax rates?

Question:

How did the Jobs and Growth Tax Relief Reconciliation Act of 2003 change capital gains tax rates?

Answer:

If you sell or exchange a capital asset for more than your adjusted basis in the asset, the result is a capital gain. The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the maximum tax rate on most long-term capital gains (those held for longer than 12 months) and eliminated the "super" long-term capital gains rates on the sale of assets held longer than five years. The reduced rates apply to sales and exchanges made on or after May 6, 2003 and before January 1, 2009.

- The 20 percent individual rate on long-term capital gains was reduced to 15 percent for individuals in a marginal income tax bracket greater than 15 percent
- The 10 percent individual rate on long-term capital gains was reduced to 5 percent for individuals in the 10 or 15 percent marginal income tax bracket (the 5 percent rate will become 0 percent in 2008)

The reduced capital gains rates apply for both regular income tax and alternative minimum tax (AMT) purposes.

For information on how you might be affected by the reduction in capital gains rates, consult a tax professional.

Note: The Tax Increase Prevention and Reconciliation Act of 2005 extended the rates effective in 2008 through 2010.

I have investment property. What does basis mean, and how do I determine the basis of my property?

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Answer:

To determine your basis in an asset for purposes of calculating capital gain or loss upon the sale or other disposition of the property, you need to understand two terms--initial basis and adjusted basis.

Often, your initial tax basis equals your cost--what you paid for the asset. For example, if you purchase one share of stock for \$10,000, your initial basis in the stock will equal \$10,000. However, your initial basis can differ from the cost if you did not purchase an asset, but rather received it as a gift, as an inheritance, or in a tax-free exchange.

It's also important to understand the concept of adjusted basis. Your initial basis in an asset can increase or decrease over time. For example, if you buy a house for \$100,000, your initial basis in the house will be \$100,000. If you later improve your home by installing a \$5,000 deck, your adjusted basis in the house may be \$105,000. You should be aware of which items increase the basis of your asset, and which items decrease the basis of your asset.

To calculate a capital gain or loss, you need to know your adjusted basis in the asset. Essentially, capital gain or loss equals the amount you realize on the sale of your asset minus your adjusted basis in the asset.

Will I have to pay tax on my investment income?

Question:

Will I have to pay tax on my investment income?

Answer:

The taxation of your investment income depends on several factors, including the type of investment income you have (e.g., tax exempt, ordinary, capital gain, or tax deferred).

If you have municipal bonds, the interest they generate is typically exempt from federal taxation and state taxation in the state the bonds are issued. The interest may or may not be subject to state income tax in the state of your residence, if different from the state of issue. U.S. Treasury bills and certain types of government savings bonds generate interest that is typically subject to federal tax, but not state tax.

Of course, not all investments are tax exempt. Investment income is generated by either the income it produces during the ownership of the investment (e.g., interest, dividends, or rent) or the gain it produces when the investment is sold at an appreciated value. Investment income such as interest and rent is considered ordinary income and will generally be taxed according to your ordinary income tax rate. If you have investment income from the sale of a capital asset that is held for more than one year (e.g., stock or investment property), the income is generally considered capital gain and is taxed at long-term capital gains rates. Qualifying dividends are also taxed at long-term capital gains rates (dividends that don't qualify for long-term capital gains rates are taxed at ordinary income tax rates).

Finally, you should know that tax-deferred investments (such as 401(k) plans) produce earnings and gains that are not taxed until later, when the money is distributed to you.

For more information, consult a tax professional.

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