MAXIMIZING YOUR 1999 RETURNS: TAX CONSIDERATIONS FOR INVESTING

By Clark M.Blackman II and Ellen J. Boling

Tax considerations should not drive investment decisions, but they certainly should not be ignored. Fundamental tax rules every investor should know.

Intelligent investing requires at least a passing knowledge of those tax rules that will have an impact on your returns. It may be a cliché, but it is true: "It's not what you make, it's what you keep." Familiarity with these tax rules is a starting point to maximizing what you keep.

This column is the first part of a two-part series on fundamental tax rules every investor should know.

CAPITAL GAINS

New tax rules in 1997 provided for the lowering of the long-term capital gains rate to 20% and the increasing of capital gain tax complexity to new heights. However, with the IRS Restructuring and Reform Act of 1998, capital gain tax complexity was reduced. Taxpayers now only need to consider the short-term and long-term classifications; medium-term gains have been eliminated. As before, short-term capital gains are taxed at the taxpayer's current "regular" tax rate, and long-term capital gains are taxed at 20%. For those taxpayers whose top bracket is 15%, the long-term capital gains rate is 10%.

Even with the new rules, 1998 tax filers may still face the same complexity as in 1997. Some mutual funds and real estate investment trusts (REITs) that operate on a fiscal year (not a calendar year-end) may have generated mid-term gains in 1998. This will not be an issue in 1999.

Another significant change is the point at which a capital gain becomes long-term. The 1998 Act defines long-term as any investment held for more than 12 months. Prior law required a holding period of more than 18 months to receive the more beneficial long-term gain treatment. Thus investors will be able to sell investments sooner at a potentially lower tax rate.

Remember that the holding period begins the day after purchase and ends the day of sale (trade dates, not settlement dates).

For your investments inside a qualified pension or profit-sharing plan, capital gains rules do not apply. On the plus side, the investment return on plan assets is not subject to taxes as long as the dollars remain inside the plan. On the negative side, dollars withdrawn from a plan are subject to ordinary income tax rates, so capital gain income inside a plan becomes ordinary income upon distribution.

One exception in which capital gain rules do apply to qualified plans occurs when qualified plan assets are invested in the stock of the employer. Upon retirement, if you are eligible for a lump-sum distribution from the plan and you elect to receive employer stock in-kind, you will only pay tax on the cost basis of the shares (if so elected), rather than on the fair market value of those shares. (The cost basis is the amount paid by you, or your employer, for the stock.) Regular tax rates will apply to the cost basis value. Thereafter, if you sell any of those shares received in the lump-sum distribution, a capital gain results and is calculated as the difference between the fair market value of the shares on the sale date and the cost basis of those shares received. Any gain at

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TABLE 1. SELL NOW AT SHORT-TERM GAINS RATES, OR HOLD ON UNTIL LONG-TERM RATES APPLY?

If you are contemplating selling shares that you have held less than a year because you anticipate a drop in price, how much of a price drop would eliminate the tax benefit of waiting to sell when capital gains rates would be at the more beneficial long-term rates? Here's the equation:

$$\frac{\text{Current taxable gain}}{\text{Current stock value}} \times 1 - \left[\frac{1 - \text{your top marginal tax rate}}{1 - \text{anticipated LT cap gain rate}}\right] = \text{ \% decrease in stock price that would eliminate the long-term gain benefit}$$

the date of distribution (defined as the difference between the fair market value of the stock on the date of distribution from the plan to the employee and the cost basis of the stock) is long-term and would be taxed at the favorable 20% or 10% capital gains rates, depending on your tax bracket. Subsequent appreciation following the date of distribution is taxed based on the holding period beginning with the distribution date.

From a tax-planning perspective, you should try to generate long-term capital gain income rather than ordinary income. However, this does not mean that you should always delay selling an investment until after the 12-month holding period has been satisfied. By delaying, you increase the risk of netting less money after tax from the sale—if the investment price should drop before the 12-month holding period has been satisfied, the tax benefit from receiving long-term capital gain tax treatment on the delayed sale may be erased by the price decline. To calculate roughly how much the stock price would have to fall to eliminate the tax benefit, see Table 1.

CAPITAL LOSSES

Capital losses first reduce capital gains. Long-term losses reduce long-term gains first, and short-term losses reduce short-term gains first. Any long-term losses left over reduce short-term gains and vice-versa.

If you still have losses remaining after offsetting capital gains, you can reduce your "ordinary" income by up to $3,000. Losses not used this year can be carried forward to future years until they are used up.

MUTUAL FUNDS

Investment returns generated by a mutual fund can be in the form of dividends, interest, and/or capital gains and losses. A mutual fund is required to distribute investment returns to you each year (not including losses). You may choose to receive a cash distribution of this return or you may reinvest the distribution in the fund. In either event, any of this return that is taxable (municipal bond interest is tax-exempt for federal purposes) must be reported by you each year. Additional tax consequences may occur when you sell, exchange, or redeem your mutual fund shares.

There is a special rule that applies if you have sold mutual fund shares held for six months or less, at a loss. If you have received a capital gain distribution, a long-term capital loss must be recognized to the extent of the distribution. Any loss in excess of the distribution is treated as a short-term loss. This has the effect of offsetting the capital gain tax benefit of the distribution against the loss realized on sale.

A similar rule applies to tax-exempt interest received on mutual fund shares that have been held for six months or less and sold at a loss. A loss is disallowed to the extent of tax-exempt interest received. Any loss in excess of the tax-exempt interest is considered short-term capital loss.

When computing the tax basis on mutual fund shares, the load (commission) on a mutual fund is usually included in the calculation. However, if the mutual fund shares are disposed of before the 91st day following the acquisition of the shares and you acquire additional mutual fund shares, the load is not includable in the basis calculation, pursuant to a reinvestment right when the original shares were purchased. If the load cannot be deducted in the initial sale transaction, it is added to the cost basis of the shares subsequently purchased.

There are two methods of computing the basis on mutual fund shares. The first is the cost method, which includes the option to use either the "specific share identification" or the first-in, first-out (FIFO) convention. The second is the average basis method, which includes computing the basis under either the single- or double-category.

Cost Method—Specific Share Identification: Under this method, you are able to choose the shares you want sold. The downside to this method is that you are required to keep very detailed records. The IRS also requires you to inform the broker at the time of the sale which shares are being sold. The broker is required to provide a written confirmation to the IRS of your request.

This method is recommended to those who want to match capital losses with capital gains. This method offers the flexibility needed to effectively implement a "matching strategy."

Cost Method—First-In, First-Out (FIFO): This method is somewhat

less time-consuming than specific share identification. Tracking the basis of all shares acquired is still required, but identifying shares sold is easier. The basis of shares sold is assumed to be the basis of the first shares acquired. Also, there are no special IRS reporting requirements.

During a rising market, this method will produce a higher income tax liability for you. Over the long term, however, the tax consequences arising from using the average basis method or the first-in, first-out method will be comparable.

Average Basis Method—Single Category: Under this method, the basis of the shares sold is determined by computing the average cost of all the shares owned. This is done by calculating the total cost of the shares owned and then dividing this figure by the total number of shares owned. The holding period is determined using the FIFO method. If additional shares are acquired after a sale transaction, the average basis must be recalculated. Reinvested dividend and capital gain distributions will require ongoing recalculation of basis.

Average Basis Method—Double Category: The basis of the shares is computed in the same way as for the single-category method, with the exception that the shares held for less than a year are separate from the shares held for more than a year. You choose the category from which the shares are to be sold to determine whether the gain or loss will be short-term or long-term. Also, it is necessary for the broker to provide a written confirmation to the IRS specifying which category was chosen by you.

If you hold mutual funds, it is also important to understand that the wash-sale rules do apply when dealing with funds as well as stocks and bonds.

WASH SALES

If you sell an investment at a loss and then acquire, or enter into a contract or option to acquire, substantially identical stock or other securities during the period which begins 30 days before the date of sale and ends 30 days after the date of sale, the loss on the sale of those stocks or securities will be disallowed. This unrecognized loss is added to the basis of the new securities acquired. In other words, if you sell a stock or bond to recognize the tax loss, you must not buy it back for at least 31 days before or after the sale date.

It is important to point out that this rule only applies to losses; gains are taxable in the year of the sale. Also, these rules do not apply to commodity futures and foreign currencies, but they do apply to stock options (puts and calls).

Many have tried to avoid the wash sale rules by having a related party purchase the substantially identical securities after the sale. Examples of related-party transactions include an exchange between family members (including parents, grandparents, siblings, children, and grandchildren and excluding in-laws, stepparents, stepchildren, aunts, uncles, nieces, nephews, and cousins) or an exchange between an individual and a corporation where the individual owns at least 50% of the corporation. Other examples of related-party transactions are an exchange between a grantor and fiduciary of a trust, as well as an exchange between the fiduciary and beneficiary of the trust. In these situations, the loss is not allowed.

Keep several important points in mind if you have losses you would like to recognize:

- You can sell stock in one company and buy stock in a *similar* but different company, without invoking wash-loss rules. However, a different class of stock in the same company will create a wash-loss event.
- A bond will be considered similar enough to another bond to invoke these rules if attributes such as maturity, investment grade, and yield to maturity are similar enough to constitute a substantially equivalent security to the one sold—i.e., the issuer does not have to be the same to cause these rules to apply. This is generally determined on a facts and circumstances basis, and expert advice may be required.
- Mutual funds are considered separate and distinct. Therefore, even if two funds hold substantially identical securities, moving assets from one fund to another will allow for recognition of any loss realized on the sale.
- The use of options may allow for a strategy to recognize losses without losing your economic position in the stock. However, this is a sophisticated strategy with narrow application and is beyond the scope of this article. ✦