Personal Investments 2017

Interest & Dividends

INTEREST

Taxable interest will be reported to you by the payer on Form 1099-INT or Form 1099-OID (for the annual taxable portion of the imputed interest on original issue discount bonds).

Tax-exempt interest will be reported to you by the state or local government payer on Form 1099-INT. In addition, typically mutual funds that hold tax-exempt bonds will report this information to you on the 1099-DIV form. You must report the amount of tax-exempt interest you receive on Schedule B of Form 1040. Although you do not have to pay ordinary income tax on it, the amount of tax-exempt interest you receive can affect your tax status in some situations, including your exposure to the alternative minimum tax.

You should not report interest earned on your IRA or Coverdell education savings accounts, since these are exempt from taxation.

DIVIDENDS

Dividends you receive from stocks you hold will be reported to you on IRS Form 1099-DIV. Box 1a on the form will report total ordinary dividends you have received.

Qualified dividends received are eligible for a lower tax rate than other ordinary income. For taxpayers whose top income tax bracket is 15%, the qualified dividends rate is 0%; for higher tax bracket taxpayers, the qualified dividends rate is 15%. The exceptions are single filers with taxable income above $418,400 in 2017 ($426,700 in 2018) and married couples filing jointly with taxable income above $470,700 in 2017 ($480,050 in 2018); people in these groups will pay a 20% tax. Dividends that qualify for this treatment will be reported in box 1b of your Form 1099-DIV. Single filers with taxable income above $200,000 and married couples filing jointly with income above $250,000 will also pay the net investment income (NII) surtax of 3.8% on top of the 15% and 20% tax.

Margin Accounts

‘DISQUALIFIED’ DIVIDENDS

Be aware of a twist to the holding period requirement if you receive dividends on stock held in a margin account—not all of your dividends may qualify for the lower tax rate.

Generally, when you enter into a margin agreement with a broker, the agreement contains a clause that allows the broker to borrow shares from your account and return them at a later date, without your pre-approval. Typically, the broker will borrow shares from a large pool of shares it holds in street name on behalf of all its customers and lend the shares to another party to use in a short sale. The broker will later allocate the borrowed shares to particular customers. The loan of the shares will affect your holding period of the dividend-paying stock, which could potentially make the dividends ineligible as qualified dividend income.

This occurs because you no longer own the shares if the broker borrows them. Instead of receiving dividends, you will receive “payments in lieu of dividends,” which are not dividends and are not eligible for qualified dividend income treatment. Payments in lieu of dividends are taxed at ordinary income tax rates.

Brokers are required to report payments in lieu of dividends on Form 1099-MISC, as opposed to Form 1099-DIV.

For tax planning purposes, you may want to consider moving your high-dividend-paying stocks from margin accounts to cash accounts, in order to increase the likelihood that the dividends qualify for the lower tax rate. Alternatively, you could inquire as to whether the broker has historically borrowed shares from your account. If so, you should require the broker to sign an agreement against borrowing stock from your account. Some brokerage firms have policies that state that they generally do not borrow shares from non-institutional investors.

Some dividends are not qualified for the reduced rates. Generally, these include:

- Dividends on stock that you held for less than 61 days during the 121-day period that began 60 days before the ex-dividend date,
- Dividends related to short sales,
- Dividends received from tax-exempt organizations under sections 501 and 521,
- Dividends from a mutual savings bank for which the bank took a deduction and
- Deductible dividends paid on employer securities.

Dividends from mutual funds will qualify for reduced rates to the extent that they are from qualified dividends from stocks held by the fund.

In general, dividends from REITs will not qualify for the reduced rates. Typically, dividends paid by REITs comprise rents and other earnings, and not dividends from other corporations. Therefore, the majority of the dividends paid by REITs will be taxed as ordinary income and only a small portion may qualify as dividend income.

[You will receive a 1099-DIV from any mutual fund you hold; for more information on taxes and mutual fund dividends and distributions, see the section starting on page 8.]

HOLDING PERIOD

One of the requirements for dividends to qualify for the reduced 15% tax rate, and the 20% maximum tax rate for high-income earners, is that you must have held the dividend-paying stock for more than 60 of the 121 days surrounding the "ex-dividend" date of the stock. (The holding period is more than 90 days of a 181-day period for preferred stocks with dividends attributable to periods totaling more than 366 days.)

The 121-day period begins 60 days prior to the ex-dividend date and ends 60 days after the ex-dividend date. When counting the number of days you have held the stock, you include the day you disposed of the stock, but not the day you acquired it. If the stock fails to meet the holding period requirement, the dividend will not be eligible for the 15% or 20% tax rate and, consequently, the dividend will be taxed at ordinary income tax rates.

Dividends on insurance policies are a partial return of premiums paid and do not need to be reported, unless they exceed the total of all net premiums you paid for the contract. Taxable dividend distributions from life insurance companies are reported on Form 1099-R.

Your Child's Investment Income: The "Kiddie" Age

The kiddie tax rules require that part or all of a child's investment income be taxed at the parents' income tax rate, which is typically higher than the child's rate. The rules were put in place to limit the tax benefit families had been receiving by shifting income to children, who would then be taxed at lower rates applicable to individuals with little income.

For 2017, the kiddie tax rule applies if the child is 17 or under by the end of the year, and the child's total investment income for the year was more than $2,100 (it will stay unchanged in 2018). Investment income includes interest, dividends, capital gains and other unearned income.

In addition, the kiddie tax can apply to older children, depending on how much earned income they have and whether or not they are full-time students:

- Starting in the year that your child turns 18, the kiddie tax applies if your child's earned income (including salaries and wages, commissions, professional fees and tips) is less than half of the child's overall support.
- Starting in the year your child turns 19, the kiddie tax applies if your child is a full-time student.
- The kiddie tax ceases to apply starting in the year your child turns 24.
- The kiddie tax also does not apply if your child is married filing jointly.

If you are subject to the kiddie tax rules, it can be reported in two ways:

- Your child's investment income can be reported on Form 8615, which should be attached to the child's federal income tax return, or
- You can choose to report your child's investment income on your own tax return if the child's income consists entirely of interest and dividends (including capital gains distributions) and the amount received is less than $10,500. If you choose this option, fill out Form 8814, Parents' Election to Report Child's Interest and Dividends, and include it with your own tax return. Be aware, however, that this option may reduce certain credits or deductions that parents may claim.

Although the kiddie tax is calculated based on the parents' tax rate, it is owed by the child. Wages and other earned income received by a child of any age is taxed at the child's tax rate. More information can be found in IRS Publication 929, Tax Rules for Children and Dependents.

Although you are allowed to deduct investment interest expense on Schedule A of Form 1040, it is limited to the amount of current year net investment income (generally interest, non-qualified dividends, annuities and royalties). Dividends subject to the lower tax rate are not treated as investment income for purposes of deducting investment interest expense. However, you may elect to tax dividends and long-term capital gains at ordinary tax rates to qualify that income for calculating the interest expense deduction.

Gains & Losses

A "capital gain" is the profit you make when you sell a capital asset. Almost everything you own, including your investments, is a capital asset. Stocks, bonds, mutual fund investments, gold, silver, antiques, personal residences, gemstones and oriental rugs all fall into the capital assets category.

A long-term capital gain is the profit you make when you sell a capital asset that you have held for more than a year. A short-term capital gain, on the other hand, is the profit you make when you sell a capital asset that you have held for a year or less.

CAPITAL GAINS RATES

Long-term capital gains are currently taxed at rates that are more favorable than those that apply to ordinary income, such as salaries and interest.

Long-term capital gains are taxed at the long-term capital gains rate of 15%, and 20% for those with taxable income above the $418,400/$470,700 threshold ($426,700/$480,050 in 2018). For taxpayers whose top bracket is 15%, the long-term capital gains rate is 0%. Short-term capital gains are taxed at the same rate as ordinary income. Taxpayers with taxable income above the $200,000/$250,000 threshold are also subject to the 3.8% NII surtax.

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 gains income inside a plan becomes ordinary income upon distribution.

Other Special Rates

SECTION 1250 PROPERTY

The lower capital gains rates do not apply in all situations. The long-term capital gains rate on business or investment real estate (called "section 1250 property" on the tax forms) will be 25% up to the amount of depreciation on the property while you owned it. However, there are no losses counted in the 25% rate group and any loss from this group must be taken into account in computing net gain or loss in the 15% rate group.

COLLECTIBLES

Also, the long-term capital gains rate on collectibles such as art, rugs, jewelry, precious metals or gemstones, stamps or coins, fine wines, or antiques remains at 28%.

HOLDING PERIOD

A capital gain becomes long term if it is held for more than 12 months. The holding period begins the day after purchase and ends the day of sale (trade dates, not settlement dates).

Your brokerage firm will send you a Form 1099-B listing the cost basis for stocks purchased after January 1, 2011, and the proceeds from all your sales of stocks purchased before January 1, 2011, and sold during 2017 based on the trade date. It is best to rely on this document for information when tax filing time rolls around, rather than on your periodic brokerage statements.

Why not use your brokerage statement? If you buy or sell stock near the end of the year, these trades may not appear on your December statement, and, as a result, you may overlook them. But you should reconcile the information in your records with what is reported on your Form 1099-B.

If your Form 1099-B is incorrect, contact your brokerage firm or other financial services institution, and ask them to issue a corrected form. It is important that amounts and specific shares of stock sold (for shares sold in 2017 and that have their cost basis reported by your broker, which includes stocks purchased after January 1, 2011) shown on Form 1099-B be included in the proceeds reported on your Form 8949, Sales and Other Dispositions of Capital Assets. The totals from Form 8949 will be entered on Schedule D, Capital Gains and Losses, of Form 1040. If the information does not match, the IRS will likely send you a notice and may assess a penalty for negligence if you have failed to report income.

CALCULATING YOUR GAIN

To determine a gain or loss on the sale or exchange of an asset, an asset's "basis" is subtracted from the sales proceeds. Basis is generally the amount you pay for an asset plus certain expenses such as sales commissions.

For each investment sold or exchanged during the year, you must know the:

- number of shares bought,
- amount paid per share,
- date of each purchase,
- total dollar amount of the purchase, including items such as commissions and fees,
- number of shares sold or exchanged,
- price received per share from the sale or exchange,
- date of each sale or exchange, and
- the total dollar amount received from each sale or exchange.

This information may be obtained from personal records, monthly statements and Form 1099-Bs from brokerage firms or financial institutions. If less than all of the investment in a particular stock, bond or other security is sold, you must also identify which shares were sold so you can determine the proper basis to use. For stocks bought after January 1, 2011, and sold in 2017, the specific share lots will be designated on Form 1099-B. For stocks purchased before 2011, and mutual funds and ETFs, there are two different methods to identify the shares sold.

Selling Specific Shares

If you know how many shares you bought, when you purchased them and how much you paid, the law requires you to use the specific-share method. This method may give you a choice about whether to realize a gain or a loss.

Example: You own 565 shares of stock in XYZ Corp. You purchased 250 shares at $10/share in February 201A, 150 shares at $15/share in January 201B, 200 shares at $14/share in July 201B and 100 shares at $12/share in August 201B. Assume your broker holds your shares for you. Now, you instruct your broker, in writing, on June 1, 201C, to sell the 200 shares you purchased in July 201B at $14/share. Because you specified the shares to sell, figuring your basis is easy. In this case, it is $14/share—the price you paid for them.

If you sell the 200 shares at $11/share, you report a short-term capital loss of $3/share—that is, your $11 selling price less your $14 basis. Your total loss comes to $600 ($3 × 200 shares). Since you owned the shares less than a year, your loss is a short-term one.

You may use your $600 loss to offset some capital gains you may have had from other transactions. If you had no capital gains, the rules say you can subtract the $600 from your ordinary income. However, there is a limit on how much capital loss you may deduct each year from your ordinary income.

First In, First Out

Where there are no records concerning the purchase of a stock, bond or other investment, you may have to use the first in, first out (FIFO) method (in other words, the first bought is the first one sold). Also, if you do not specify which shares are to be sold in advance, you will be required to use the FIFO method.

Brokers are required to report both the cost basis of and the proceeds from stocks sold by investors. This rule applies specifically to stocks purchased after January 1, 2011; it does not apply to stocks purchased on December 31, 2010, or earlier. Mutual funds, exchange-traded funds (ETFs) and stocks acquired through a dividend reinvestment program (DRP) after January 1, 2012, are covered by this rule. The cost basis rules for options and traditional bonds phased in on January 1, 2014, and phased in on January 1, 2016, for complex bonds—including those with variable coupon payments.

First-in, first-out (FIFO) is the default accounting methodology that will be used when the purchase of a stock involves more than one transaction. You can, however, specify to your broker which shares are to be sold first. In order to do this, you must provide written instructions to your broker detailing your intentions by the time the order is executed, not afterward. Be sure to keep a copy of the dated letter sent to your broker or fund. Also, you should receive written documentation back from your broker confirming that specific shares were sold.

Your mutual fund family or DRP operator has the option to use a different methodology, such as average cost basis, instead. Average cost uses the average purchase price of all your holdings. Check with them to see which method they use. Your broker will follow a default method of amortizing bond premiums, but you can specify how market interest and discounts are treated. The rules are complex, and we suggest speaking to your broker and a tax professional.

Exceptions

There are a few exceptions to the rules governing basis:

- ***Gifts:*** If you receive stock as a gift, your basis is the basis of the stock to the donor at the time of the gift. In other words, the donor's basis becomes your basis. What if you sell the stock at a loss? Then your basis is the lesser of the donor's basis or the fair market value of the stock on the date the gift was made.
- ***Wash sales:*** A wash sale is a sale of stock, including stock in a mutual fund, at a loss either 30 days before or after you make another purchase of the same (or substantially identical) stock. (For more on this, see page 8.) A wash sale that results in a loss may not be deducted. Your basis in the new stock is what you paid for it, but it is increased for any loss that is disallowed.
- ***OIDs:*** With original issue discount securities, your basis is the amount you paid for the securities plus the interest income that accrues annually.
- ***Amortized bond premiums:*** If you deducted the amortization of bond premiums, the deductions will reduce your basis in the bond.
- ***Inheritances:*** Heirs must use the fair market value as of the date of death (step-up basis). You should plan on using the value shown on the estate tax return, or the value reported to you by the executor for estate tax returns filed after July 31, 2015.
- ***Stock dividends, splits and reorganizations:*** Your stock basis can be affected if the corporation issues stock dividends, declares a stock split or undergoes a reorganization. These events are generally non-taxable at the time they occur. Typically, your original basis will be allocated equally among shares owned after the event. [For more on this, see the box on the next page.]
- ***Mutual funds:*** See the Mutual Fund section beginning on page 8 for information concerning the calculation of the capital gain or loss.

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.

Worthless Securities

A capital loss can be claimed in the year securities (e.g., stock, bonds, etc.) become worthless. Determinations of whether a stock has become worthless and, if worthless, the year in which it ceased to have value, are questions of fact, and the burden of proof is on the taxpayer. Thus, you should consult your tax adviser before claiming a deduction on worthless securities.

Caution: Mere shrinkage in value of stock of a corporation through market fluctuations or otherwise does not entitle you to a loss deduction, and, in such a case, the loss is allowable only upon the disposition of the stock.

Capital Losses on Collectibles

If you invest in jewelry, coins, stamps, antiques or the like, and you incur capital losses on the sale of these items, the tax law allows a deduction only if the following conditions are met:

Splits, Dividends and Mergers

One day when you're reviewing your brokerage account statement, you might find that you have more or less shares of a particular stock than you recall from the previous month's statement. You might even find yourself owning shares of a company you know you never purchased. If so, it is likely that your company has undergone a stock split, reverse split, stock dividend or merger. Be aware that such events will alter your basis per share and, as a result, the capital gain or loss you recognize should you subsequently sell less than 100% of your holdings in that stock.

In the case of a stock split, you end up with more shares than you previously had, but no change to your total basis occurs. However, the per-share basis value will change. For example, if you purchased 100 shares of a stock for $5 per share, your basis is $500. If the stock splits 2-for-1, you will now have two shares for each one share you previously held, thus doubling your shares to 200. Your total basis remains at $500, but your basis per share is now $2.50 ($500 divided by 200 shares). When you sell the shares, $2.50 is the per-share basis amount you should use to calculate your capital gain or loss. The acquisition date for the new 100 shares is the same as for the original 100 shares.

A reverse split is the opposite of a normal split in that it results in fewer shares being held. In our previous example, if the 100 shares you own split 1-for-2, you will have one share for every two shares you previously held, thus halving your shares to 50. Again, your total basis remains at $500, but your basis per share is now $10 ($500 divided by 50 shares).

A stock dividend is a dividend paid in stock instead of cash. Its effect on basis is similar to that of a stock split. For example, assume you purchased 100 shares of a stock for $5 each, so that your total basis is $500. If a company declares a stock dividend of 10%, you will receive additional shares equal to 10% of the number of shares you already own. In this case, you will receive 10 additional shares (100 shares multiplied by 10%). Your total basis remains at $500, but your basis per share is now $4.55 ($500 divided by 110 shares).

Finally, when two companies merge, you may wind up owning an entirely new stock. For example, assume you owned 100 shares of Company X with a basis of $500 before the merger. The merger requires you to exchange your Company X shares for Company Y shares. After the merger, you now own 75.4 shares of Company Y. Your total basis remains at $500, but your per-share basis has changed. Before the merger it was $5 per share ($500 divided by 100 shares); after the merger it has become $6.63 per share ($500 divided by 75.4 shares).

You should note that with mergers, the new company may decide to cash you out of any partial shares you own after the merger. You might receive a payment to compensate you for the sale of your partial shares. In our example, Company Y may decide to pay you for the 0.4 share. In this case, your basis of the 0.4 share sold would be $2.65 (0.4 shares multiplied by $6.63 per share). In this case, your taxable gain is the difference between the amount you were paid for the fractional share and $2.65. Your remaining shares continue to have a basis of $6.63 per share for a total basis in your holdings of $497.25.

- You must prove that your primary purpose in purchasing the item was to make a profit; and
- You must show that you did not purchase these items purely as a hobby or for your personal enjoyment.

Tip: Maintain detailed records on the purchase and sale of collectibles. Your reputation as an investor is your best defense in the event of an IRS audit.

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 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 loss recognition on the sale.

Mutual Funds & Taxes

If you are a mutual fund shareholder, you will receive tax reporting statements with information on each individual fund by late January. These statements include information that the fund reports to the IRS on Forms 1099-DIV (which reports fund distributions to shareholders) and 1099-B (which reports sales of fund shares). You report this information to the IRS on your income tax return, Form 1040—with each fund reported separately, even if it is within the same mutual fund family.

MUTUAL FUND DISTRIBUTIONS

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 dividends, interest and net realized gains each year.

Mutual fund distributions are taxable whether you take them in cash or reinvest them in fund shares. Exceptions:

- Income dividends from municipal bond funds are usually exempt from state and local taxation, depending on what portion of the fund's assets were invested in a particular state; and
- Income dividends and net capital gains distributed to IRA and other retirement accounts are tax-sheltered until withdrawn.

Distributions are taxable for the year in which they are paid. However, the tax law states that mutual fund dividend or capital gains distributions declared within the last three months of the year but paid the following January are taxable as though they were paid on December 31. Therefore, such distributions are included on Form 1099-DIV.

The status of any capital gains or dividend distributed to you by a mutual fund depends on how long the fund owned the securities that produced the gain or dividend—not on how long you owned shares in the fund. The information you will need to determine how your distributions are taxed will be on your fund's Form 1099-DIV. This year's Form 1099-DIV includes:

- Total ordinary taxable dividends, and the portion that qualifies for the lower dividend rates;
- Total long-term capital gains distributions and the amount of the distribution that is subject to special other gains rates: section 1250 gain, section 1202 gain (from small business stock that may be subject to a 50% exclusion) and collectibles gain;
- Any federal income taxes withheld;
- Your share of investment expenses of a non-publicly offered mutual fund; and
- Foreign taxes paid (and which you may be able to claim as a deduction or credit).

WHAT ABOUT LOSSES?

A mutual fund's capital losses are never distributed to shareholders, but are used to offset capital gains realized by the fund during the year. Any additional losses are carried forward by the fund to apply against gains realized in the future. The only losses you can claim are those you may have incurred when you redeemed your own shares of a fund.

Save Money: Because distributions are taxed even if they are reinvested, it is important to remember that you should add reinvested income dividends and capital gains (from both taxable and tax-free funds) to your original cost basis when it comes time to figure gains or losses on any mutual fund shares sold. If you do not, you will, in effect, be paying taxes twice on those distributions.

When a distribution is made, the net asset value (NAV) of the fund decreases by an equal amount. Suppose the NAV of your fund XYZ is $20 per share on December 20. On December 21, the fund makes a distribution of $2 per share, and as a result, the NAV decreases by a like amount to $18 per share. Since you received the $2, you still have $20 of asset value, but now $2 is subject to tax. The $2 is taxable even if you reinvest it in that fund, although the reinvested amount increases your tax basis in the fund.

Mutual funds commonly make distributions toward the end of the year. Investors must be wary of this distribution date. Generally, you should not invest in a mutual fund shortly before its distribution date, because a portion of your investment will be immediately returned to you with an accompanying tax liability.

Most mutual funds should be able to give you a good idea of when their year-end distributions will take place, so calling the fund company prior to investing can be a wise move.

SELLING MUTUAL FUND SHARES

Shareholders can generate capital gains by selling or exchanging shares in mutual funds.

The tax rate that applies to your sale of mutual fund shares depends on how long you held the shares. Short-term capital gains for securities held one year or less are taxed at ordinary income rates. Long-term gains on securities held more than one year receive the more favorable rates.

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 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 method.

As stated previously, mutual fund companies and brokerage firms will report the cost basis of all mutual fund shares bought and sold after January 1, 2012. You must provide written instructions prior to the sell transaction if you want to use a method other than their default methodology (LIFO or average cost basis.)

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 or mutual fund company at or before 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."

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. Under this method, 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 may not be significant.

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 gains distributions will require ongoing recalculation of basis.

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 or mutual fund company to provide a written confirmation to the IRS specifying which category you chose.

If you hold mutual funds, it is also important to understand that the wash-sale rules do apply when dealing with funds (see page 8 for an explanation).

Unless you are conducting transactions in a tax-sheltered retirement plan, an exchange of assets from one fund to another is the same as a sale and purchase for tax purposes. In January, each mutual fund reports proceeds of sales (redemptions or exchanges) made during the year to the IRS and to you on Form 1099-B. The 1099-B does not need to be attached to your Form 1040, but the data should be reported on Form 8949 and the totals from this form entered on Schedule D of Form 1040.

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 gains 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.
