

Tax consequences of your investments

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In today's turbulent financial times, there is a dizzying array of investments to consider. You can select investments in fixed-income securities, both taxable and non-taxable, marketable securities, or other so-called structured products. Although we do not provide investment advice, we are often asked to evaluate the tax consequences of different types of investments. This article will discuss some investment options available to you and their tax effects.

In general, the simplest form of investment is in taxable fixed-income securities. The investment is expected to return your principal at a stated maturity date, thus no taxable gain or loss is expected at the end. In return for making the investment, you receive periodic interest payments. Depending on the investment type selected, interest may be received as often as daily or in terms of months or years. The tax consequences are as simple as the investment itself. Interest income is taxable like your other ordinary income. Thus, when making your investment decision in taxable fixed-income securities, you should consider your effective tax rate. Your effective tax rate is defined as the tax rate incurred on your next dollar of income. You also need to factor in your resident state income taxes since interest is taxable for state tax purposes.

As we move up the ladder, another investment option is in tax-free bonds or funds. The term tax-free can be somewhat inaccurate for some. Although certain tax-free investments are not taxed at all, others do carry a tax burden. For example, if you live in Ohio and invest in non-Ohio bonds, the interest is taxable for Ohio state income tax purposes. Further, there are some bonds where interest is tax-free but must be added back in calculating your alternative minimum tax (AMT) liability.

AMT has become a reality for many of you and needs to be considered in your investment analysis. AMT is a separate and distinct tax calculation starting at taxable income followed by adjustments and exemptions that are too numerous to be discussed in this article. If you are subject to AMT, or close, you



need to know if your tax-free investments are subject to an add-back. If they are, your otherwise tax-free income could be subject to a 28 percent federal tax rate.

After fixed-income securities, you move into the more complex workings of marketable equity investments. Investments in equities generally are accompanied with more risk and two types of tax issues. First, some equities include the payment of dividends, which have distinct tax consequences. Second, most equities will be sold sometime during your life resulting in capital gains or losses.

During the current and next year, qualified dividend income receives a favorable federal tax rate. The tax rate for these dividends is 15 percent for most, a large reduction from the otherwise highest 35 percent rate. Most dividends from U.S. corporations receive the lower rate as well as some non-U.S. corporations. As an added benefit, the AMT rate is the same as the regular tax rate. Another factor to consider is investments in non-US corporations. Depending on the locality, your dividends might be subject to foreign tax withholding. Normally, you get to offset the foreign tax withholding against your U.S. taxes dollar-for-dollar by claiming them on your tax returns.

When you sell your equities, capital gains and losses occur. If equities are held more

than one year, gains from their sale are classified as long-term and subject to a 15 percent rate. On the negative side, you can deduct losses only equal to your gains plus \$3,000. Net losses above that amount are carried over indefinitely to later tax years, but individuals cannot carry back losses to earlier years. Because of this onerous limitation, it is exceedingly important to carefully plan equity sales. For our clients who use multiple investment advisers, many use us as the central person to coordinate overall tax selling strategies.

There are other investment options that contain both fixed-income and equity attributes. These types of investments need to be carefully reviewed before investing. The tax consequences of so-called structured investments are similarly complicated. It is possible that although they include equity portions, they may be taxed as ordinary income.

Investing has become increasingly complicated and a prudent investor has many issues to consider. Included in these decisions are the tax consequences of your choice. While simple investments produce simple tax results, more complex investments create tax complexity. We suggest that you contemplate the tax consequences of your investments and discuss them with your tax adviser periodically.



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