

Taxes and the investing Q and A

Managing your portfolio in today's economy is tough enough. An investor certainly doesn't want to lose any more money to the Internal Revenue Service. But with carefully planned strategies, an investor has opportunities for reducing taxes while enhancing investment returns.

Here are some tax-related investor questions answered by Bankrate.com's tax editor, Kay Bell.

Many investors spend too little time thinking about ways to be more tax efficient. What are the most forgotten or overlooked things an investor can do to reduce taxes?

Investments offer a great way to boost income. They also provide many tax avoidance options. Don't confuse tax avoidance with tax evasion. Tax avoidance -- action taken to lessen tax liability and maximize after-tax income -- is perfectly legal. Our tax structure is full of deductions, credits and adjustments to help us all avoid paying too much in taxes.

A popular tax avoidance method for investors is the deduction of investment fees, custodial fees, trust administration fees and other expenses you pay for managing your assets that produce taxable income. Don't forget that service charges on dividend reinvestment plans can be deducted in some instances, as well as interest paid on money you borrow to buy investment property. Depreciation of your home computer also is deductible if you use it to manage investments. So is your safe deposit box if you keep stocks or other investment documents there. And you can usually deduct legal expenses that you incur in attempting to produce or collect taxable income.

These investment-related expenses, however, must meet IRS thresholds. They are classified as "other" miscellaneous deductions on Schedule A; this total must all amount to more than 2 percent of your adjusted gross income before you can take it. So keep close track of your investment-related expenses, as well as other miscellaneous expenses you can use here. These include unreimbursed employee expenses, tax preparation costs, professional journal subscriptions, etc. You can use all these costs to reach the amount necessary to claim the miscellaneous deduction.

What is the latest news on capital gains tax laws and the difference between short term and long term gains, the varying tax rates, etc.?

Money gurus are always preaching long-term investing. Not only will that give you a better shot at earning more, it'll also get you a lower tax rate when you sell. Exactly what that rate is depends on several things, including when you bought it, when you sold it and any tax code law changes enacted in the meantime.

If you hold an asset for at least 366 days, any profit you make on the sale is considered a long-term capital gain and taxed at a rate that is substantially lower than what you pay on your regular income. If you cash in a holding sooner, you'll be taxed at the short-term rate, which is the same as your ordinary income tax level.

Until recently, investors whose overall income put them in the top four tax brackets faced a long-term rate of 20 percent. Lower-income investors paid capital gains taxes of 10 percent. But tax-law changes now have lowered the long-term capital gains rates.

For assets sold after May 6, 2003, the 20 percent capital gains rate drops to 15 percent and the 10 percent tax goes to 5 percent. Lower-income investors get an even better investment sale deal in 2008; that year, there is no tax on sales of long-term holdings.

However, the 5 and 15 percent capital gain rates are temporary. On Jan. 1, 2009, the 10 and 20 percent rates are reinstated.

In addition, there are different capital gains rates for other types of investments.

The 25 percent rate applies to part of the gain from selling real estate you depreciated. Basically, this keeps you from getting a double tax break. The Internal Revenue Service first wants to recapture some of the tax breaks you've been getting via depreciation throughout the years.

Two categories of capital gains are subject to the 28 percent rate: small business stock and collectibles (art, coins, etc.). If you realized a gain from qualified small business stock that you held more than five years, you generally can exclude one-half of your gain from income. The taxable remainder is a 28 percent gain. If you've already hired a tax professional to help you sort out the 25 percent rate on depreciable property, he can help you figure this tax, too.

What should an investor who's looking to balance the fundamentals of an investment vs. the tax implications of that investment do? For example, what if an investor wants to sell a stock for fundamental reasons but is only 40 days away from being in the long-term capital gains category? Should she hold and risk principal loss, or hold for the long term vs. ordinary rate?

No one wants to pay more in taxes than required. But taxes should be just one part of any investment decision. Obviously, when you look at the situation hypothetically, the temptation is to hold the asset long enough to pay the lesser tax, especially if you're in the highest tax brackets.

Unfortunately, in the real-world situation, it's not that simple. In fact, there are more questions than answers:

- How large is your holding?
- Has it been trending down? Or does it just appear to be on the verge of dropping in value?
- How much do you stand to lose on this one asset if drops by 1 percent or 3 percent or 10 percent? What kind of hit would that be to your overall portfolio?
- How does potential value loss compare to the taxes you'll pay if you sell at the short-term rate? How much less in taxes would you pay if you held for another few weeks? Do the tax advantage offset the possible principal loss?
- Do you have reinvestment plans for whatever money you get from this sale? Or are you just bailing out because of fear of losing more?

Sit down at your computer and do some research. Get the advice of your broker, financial adviser or accountant. Basically, keep being the good investor you already are. Taxes are an important part of any investment vehicle, but in most instances, they should be passengers, not the driver.

Can you explain the rules behind "wash sales"?

If you buy back a loser stock you sold within 30 days, you'll violate the wash-sale rule. This IRS regulation prohibits a shareholder from selling a holding at a loss, using that loss for a tax break and then turning right around and buying the same or similar stock. It's designed to prevent taxpayers from using what the IRS calls "noneconomic losses." That's basically what you're trying to do if the whole purpose behind a transaction is to generate a tax loss but you believe in the investment itself.

Most investors encounter the regulation when they reacquire a stock soon after selling, but it works the other way, too. Specifically, the law says you may not take a tax loss on a security sale if you have obtained the same or a substantially identical security 30 days before or 30 days after a sale. So don't try to get around the wash-sale rule by buying more of a stock just before you dump the poorly performing shares you already own.

When a stock transaction violates wash-sale guidelines, the IRS will not let you take the tax break immediately. However, you can eventually use the loss to your tax advantage. The disallowed loss is added to the cost of the new shares you bought. This gives you the tax basis for the holdings, which you'll use when you sell the reacquired securities.

Do you have any tips for an investor who's looking to better organize his or her investment activities from a paperwork perspective? Are there any good services available that could be a valuable time saver for an investor?

Don't go overboard. Prolific tax pack rats insist on keeping every scrap of paper, just in case. These documents will save me, they argue, if an IRS auditor comes visiting. But that's not necessarily the case.

When it comes to tax-related documents, you should hang on to records that help you identify sources of income, keep track of expenses, determine the value of property, prepare tax returns or support claims made on those returns. However, common sense -- as well as storage space -- should be your guide

A good rule of thumb is to hold onto tax papers until the chance of audit passes. Usually, this is three years after filing. But if the IRS suspects you underreported your income by 25 percent or more, it gets six years to check into your tax life. And if the agency has questions about a worthless stock write-off, a tax examiner can come asking questions about that bad investment for up to seven years later.

Once you've identified critical records, the next step is to decide how to keep the data. Electronic bill paying can help keep track of your financial and tax life, but so can a plain old check register as long as expenditures are entered faithfully. It doesn't matter if it's a filing cabinet, cardboard boxes or a complex computer

program. The key is to find your recordkeeping comfort level, pick a system and stick with it.

When it comes to taxes, it's even more important to be proactive in recordkeeping. Keep contemporaneous tax records instead of waiting until the April deadline to find them. It's always easier to pull documentation of an expense from your computer program or out of a file folder than to try to recreate it a year after the expense occurred.

What are the best tax preparation software or web offerings available? Is it better to file electronically or the old-fashioned way?

This used to be easy. A few years ago, there were only a handful of tax prep software options. Now the IRS has authorized 80 companies to handle taxpayer's returns electronically. And this group is separate from the companies that are part of the new Free File Alliance (another 17, although some are on both lists).

With all the computer tax programs out there, the key is to find a program that fits your needs. Are your taxes relatively simple or do you have a lot of considerations, such as a freelance job on the side, that could add to or cut your tax bill and filing requirements? Not exactly sure? Then look for a program with lots of explanations that walk you through the process step by step. If, however, you're an old hand at tax filing but want primarily the software calculators that double-check your math, look for a package that lets you easily skip over sections.

Don't forget the technical requirements. Make sure your computer can handle the software: it has enough memory, the proper operating system, etc. Nothing's more frustrating than getting a product home and finding out you can't use it.

Once you've decided what you need from a tax-prep package, shop around. Don't waste any potential tax savings by overpaying upfront. Look not only at the software's base price, but also at any costs for options and upgrades. Do you have state forms to file? Are they included in the package or do they cost extra? Will the product let you complete more than one return, say the joint one you file with your wife and your son's 1040EZ? Does it support electronic filing? If so, is it free or is there a fee? What kind of support program does the package offer? Can you get help from a human if need be? Or will such advice cost you more?

As to paper or e-file -- if you're getting money back, e filing (along with direct deposit) will get you the cash sooner. The IRS also says electronic forms have fewer mistakes (can you say built-in calculators?), so in addition to speeding up the processing of your return, using a computer program could help you avoid problems that might catch an auditor's eye.

Most people, however, still file the old-fashioned way with pencil and paper. Why? Privacy concerns, better computer access at work not at home where their tax documents are, habit. The IRS is pushing us to file and pay electronically, but folks who will owe probably are going to be doing their taxes on paper and mailing them (and the payment) to the IRS at 11:55 p.m. April 15. Depending on how fast the postman does his job, you'll get a couple more days of float on your check.

What are some simple and overlooked ways a taxpayer can reduce his income taxes each year?

A tax break especially for investors can help cut tax bills and benefit worthy causes. If you have some assets that have appreciated nicely, consider giving them away to your favorite charity. This tax move is most beneficial if you donate stock you've owned for more than a year and its value has increased substantially.

Here's how it works: If you sell the appreciated stock, you'll have to pay taxes at the long-term capital gains rate on your profit. Even if you give the cash you make from the sale to a charity, you'll still have to pay the taxes. But if you give the stock directly to the qualified organization, you can claim a deduction for the full asset price at the time you donated it and escape the capital gains bill. Keep in mind that this strategy works best for long-term holdings. If you donate a stock you own for a year or less, you can only deduct what you originally paid for the asset.

A growing number of charitable groups have established programs to accept gifts of appreciated property. Check with your favorite charity to see if it can help you through this donation process.

All those bills you've been paying to keep your kid in the best school also could help at tax time. There are several education-related tax breaks. In addition to the Hope Scholarship and Lifetime Learning credits, there's the tuition and fees deduction, a new break this filing season. There are, however, income limits that could limit the availability of these breaks for some filers. The IRS also has rules about which tax breaks you can or cannot use simultaneously or in connection with money you've put away in a Coverdell Education Savings Account or prepaid tuition program. But it's worth checking into these tax breaks to see if your child's school costs can help you shave a bit off your tax bill.

Finally, maximize your home's tax advantages. If you haven't refinanced, consider doing so soon. Rates are at historic lows, but probably for not much longer. (Bankrate.com can help you track down the best rate.) By refinancing, you'll be able to get lower monthly payments or possibly pull out some of your home equity as extra cash to use other purposes. And the interest you pay on the refinanced loan is, in most instances, tax deductible.

What's the best retirement vehicle for an equity-centric investor these days -- 401(k), Roth?

IRAs and 401(k)s are the most popular tax-favored retirement options today. The decision you have to make is when you want your tax break? Now or later.

A 401(k) has a lot to offer. Contributions are automatic, they reduce your taxable income, the earnings are tax-deferred and in many cases your boss contributes to your account, too. (Your employer's contributions can help offset some of the management fees that generally are charged by companies that administer corporate retirement plans.) But you're limited to the investment choices offered by your company. And you'll have to pay taxes on eventual distributions. If you think you'll be in a lower tax bracket when you start taking money out than you are now, then the tax bite isn't as big and it's generally still worth it to start accumulating a nice nest egg.

Roth IRAs reverse the tax equation. Contributions here are made with already taxed money, but withdrawals later in life are tax-free. Plus, you have more control over where you want to invest your money.

If you're self-employed, even if it's merely a weekend job to earn a bit more spending money, look at setting up a Keogh, simplified employee pension (SEP) IRA or an individual 401(k). These savings plans let you save for retirement while simultaneously sheltering much of your self-employment income from taxes. They vary in requirements to establish, ease of administration and contribution and deduction limits. Check with your financial adviser about which self-employed option would best fit your particular situation.

Will the possible dividend tax reform impact the attractiveness of those retirement vehicles?

A more direct impact is likely to come from Bush Administration proposals to create two new tax-favored savings vehicles that would replace current IRA offerings. The proposed plans would allow individuals to make larger contributions, ease some income restrictions and give account holders more flexibility in taking out money tax free.

The Lifetime Savings Account would allow an individual to set aside up to \$7,500 a year and permanently shield all earnings from taxes. Each owner of a Retirement Savings Account also could contribute up to \$7,500 annually and earnings here, too, would grow tax-free. If the new accounts become law, people with existing Roth or traditional IRAs could no longer contribute to their original accounts. That means traditional IRA contributions that are now deductible for some individuals would be eliminated.

Holders of today's IRAs could leave funds in their original plans and let the account continue to earn money without any new contributions. They also could convert the old plan to the new retirement savings account, but in this case would have to pay any taxes that might be associated with the conversion.

Some people, especially younger investors, will find the proposed plans very appealing. But if you're older and already have a lot of money in current tax-favored accounts, your decision to change will not be so easy. These new retirement accounts underscore what seems to happen frequently when new tax legislation is devised: Tax-law change doesn't always produce the expected results. For example, when Roth IRAs were created, some started planning the funeral for traditional retirement accounts. Traditional IRAs are still around (for now) and work for many taxpayers.

Because of budget constraints, lawmakers have placed these new retirement accounts on the legislative back burner. But the Bush Administration has been a strong supporter of individuals taking more charge of their retirement accounts so this proposal is likely to reappear later.

If the new savings plans are eventually implemented, will all current IRA account holders switch? Not likely. But many individuals will have more options and generally, choice is beneficial when it comes to building investments.

How will potential dividend tax reform impact the attractiveness of "tax efficient" investment vehicles like REITs, MLPs, and municipal bonds? Should investors be thinking differently about these vehicles in anticipation of reform being passed?

Any addition to the tax-preferred investment category will affect existing options. All will be marketed to the same investor pool.

The tax-code changes that produced the lower capital gains rates also affect dividend income. Dividend income now will be taxed at the same 5 and 15 percent rates as long-term capital gains. But again, this change is temporary. After Jan. 1, 2009, prior law resumes, meaning dividends will once again be taxed at higher, ordinary income rates.

Many investors no doubt will find these new, albeit temporarily lower rates on dividend income, appealing and will adjust their portfolios accordingly. But don't make any moves rashly. And don't let taxes be the sole motivator of any financial decision. It is only one part of the equation.

What part do tax- favored investments currently play in your holdings? Are you getting the type of return you want from that REIT? Great. Keep it working for you. When it comes time to reassess and reallocate your investments, then consider if it's still appropriate, especially if other options are available.

The lesson: Look at your overall personal investment situation, do your homework about any investment option and don't be inordinately enticed by the popular investment "flavor of the day."