

TAXOLUTIONS



►► *ideas on taxes*

MUTUAL FUNDS AND TAXABLE TRANSACTIONS

For many mutual fund shareholders, some confusion exists regarding what exactly constitutes a taxable transaction. This bewilderment can become a headache at tax filing time when some shareholders discover they have unwittingly incurred a tax liability because they misunderstood the tax rules pertaining to mutual funds.

Mutual fund distributions, whether or not they are reinvested, generally must be reported as income. This includes any ordinary dividends and capital gains distributions. Qualified dividends are taxed at 15% for taxpayers in the top four brackets and 5% for those in lower brackets. The long-term capital gains rates are the same.

In addition to distributions, selling mutual fund shares will also affect your tax liabilities. As we look at taxable transactions, a distinction must be made between closed-end and open-end funds. A closed-end fund has a fixed number of shares that are traded on either the New York Stock Exchange (NYSE) or American Stock Exchange (AMEX). An open-end fund continues to issue shares as long as there are investors willing to buy. There is no limit on the number of shares that can be issued.

What Is a Sale?

The rules discussed below apply only to regular investment accounts, not to tax-deferred accounts such as Individual Retirement Accounts (IRAs) and 401(k) plans.

Shares of closed-end funds are bought and sold in the same manner as stock shares. Gain or loss is the difference between adjusted basis (usually cost) and selling price. All of the rules that apply to stock sales also apply to sales of shares of closed-end funds. Sales of closed-end shares are usually straightforward and cause little confusion.

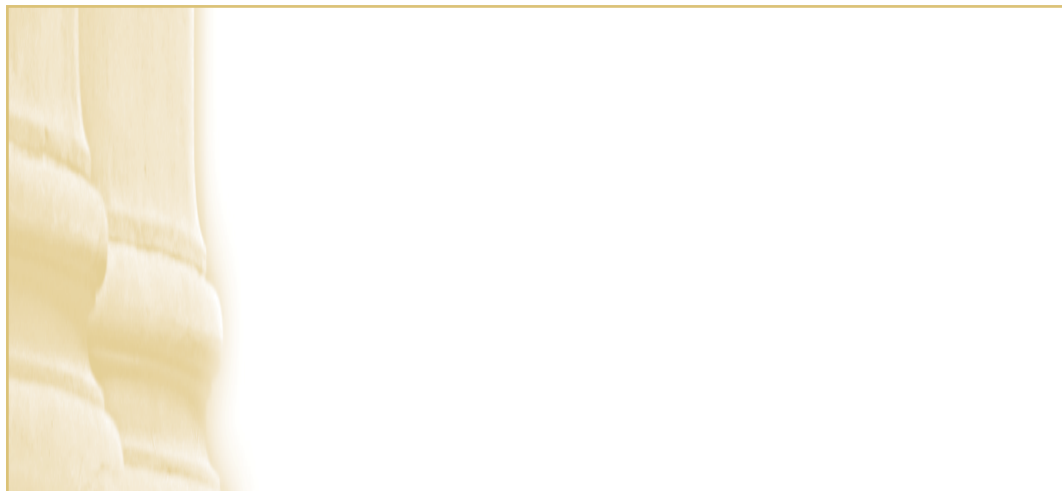
In contrast, sales of open-end shares are a little more complicated, and this is where most of the confusion exists.

Although the rules that apply to stock sales also apply to sales of open-end shares, there are a few wrinkles and some special rules that apply only to open-end shares.

A sale of open-end shares is called a redemption, because the shares are sold back to the fund rather than to another party (as would be the case with the sale of stock or closed-end shares). In addition to a normal sale, there are other events that are also redemptions and, consequently, taxable transactions:

- An exchange of shares from one fund into another is treated as a sale and purchase; it is not a tax-free exchange, even when the same company manages the two funds.

►► *cont'd on page two*



►► *cont'd from page one*

MUTUAL FUNDS AND TAXABLE TRANSACTIONS

- Writing a check on a mutual fund account results in a sale. The fund redeems a sufficient number of shares to cover the check.
- An automatic withdrawal plan triggers periodic redemptions.

These events are all taxable transactions and gain or loss must be reported. Moreover, the sale, exchange, or redemption of shares in a tax-exempt fund results in taxable gain or loss—only the dividends representing interest from such funds are tax exempt. (Some “tax-exempt” funds also make capital gain distributions from sales of securities held in the fund. These distributions, unlike the dividends representing interest, are taxable, even though they originate in a tax-exempt fund.)

Basis of Mutual Fund Shares

Generally, the basis of most mutual fund shares, including shares purchased with reinvested dividends, is their cost. (The basis of shares acquired by gift or inheritance is determined in the same way as other similarly acquired property.)

When shares are sold, an individual has several options that affect the amount of gain or loss recognized. You can identify *specific* shares by notifying the fund and receiving written confirmation. When shares have been purchased at different prices over a long period of time, this option allows the investor more control of the tax consequences. If specific shares are not identified, the general rule is that the *first* shares purchased are the ones sold. Since share prices tend to rise over time, this option usually results in shares with the lowest basis (cost) being sold, producing the largest gain.

Alternatively, if shares were purchased at various times and prices, an individual may elect to use an *average* basis. The average can be computed using either the single category method (combining all shares in the account into one group), or the double category method (calculating separate averages for shares held short term or less than one year; and long term, those held more than one year).

Year-Round Planning

As with many tax strategies, timing is key. Long-term gains are taxed at rates

lower than short-term gains, which are taxed as ordinary income. You may also lower your tax bill by planning your mutual fund transactions for certain times of the year. Many funds make capital gains distributions in November or December. Buying into the fund before the distribution date means that you will owe tax on the gains even though they have already been reflected in the share price. It may be to your advantage to wait until January to purchase shares.

As you consider mutual funds, bear in mind that some are more tax efficient than others. Because you have no control over the timing of sales within a mutual fund, carefully weigh the tax implications of funds that favor active trading versus those that implement a buy-and-hold strategy.

Accurate records and thorough research will help you make the best decisions. To simplify the calculation of your gains or losses, be sure to save all of your mutual fund statements. For more information and specific advice, give us a call. We can help you align your investment goals with your tax strategies. ■

STRETCHING AN IRA INTO FUTURE GENERATIONS

Imagine you could wave a magic wand and turn your baby granddaughter, Emily, into a millionaire. Believe it or not, you don't need to be rich yourself—or become a fairy godparent—to give Emily a head start in life. Even a relatively modest amount tucked away in a so-called “stretch” IRA could, under the right conditions, evolve into a rather substantial nest egg that Emily, or another heir, can enjoy in years to come.

A Long-Term Strategy

The stretch IRA is simply an Individual Retirement Account (IRA) in which earnings are allowed to grow tax deferred

over multiple generations. If you have an IRA that you don't need to tap into to support yourself during retirement, you can opt to restrict your withdrawals to the minimum annual distribution required by the Internal Revenue Service (IRS) starting at age 70½. Required minimum distributions are based on your life expectancy, the age of your beneficiary, and the amount of money in your account.

If you decide you want to stretch your IRA, you can add language to the documentation that allows for tax-deferred growth and the distribution of IRA assets to primary, and possibly

secondary, beneficiaries. After you die, your beneficiary will be permitted to take distributions over time, based on his or her own age and life expectancy. This not only gives the investments in the account a chance to grow and compound, it also means that income taxes owed on the IRA can be paid over an extended period of time.

If you choose a very young beneficiary, like Emily, the funds in the IRA may experience substantial compounding over the course of her lifetime. Provided Emily



►► *cont'd on page three*

►► *cont'd from page two*

STRETCHING AN IRA INTO FUTURE GENERATIONS

takes no more than the required minimum distributions during her younger years, she may amass a considerable sum by the time she reaches retirement. If the laws governing IRAs remain the same, Emily will be able to name her own beneficiary to inherit the account.

Be Cautious

Before you integrate the stretch IRA into your estate planning strategy, you should be aware that this approach does come with some risks. If the stock market goes through a prolonged bad patch, or if high inflation erodes the value of your savings, the hefty returns your heirs may have been counting on will not materialize.

It is also possible that the funds in your IRA will not survive over several generations if you, or your initial beneficiary, grow very old. If, for example, you live to

age 95, the amount you will be able to leave Emily will be considerably less than if you had passed on a decade earlier. If Emily, in turn, lives to age 100, there may be nothing left in the account to pass on to her own children.

Bear in mind, too, that stretch IRAs work best when only the required minimum distributions are taken. If Emily withdraws additional funds to buy a car or pay the rent, the account may be quickly depleted.

Finally, it is important to consider the tax implications of including a stretch IRA in your inheritable estate. While there is some talk in Washington of abolishing the federal estate tax and generation skipping transfer (GST) taxes, permanent repeal is by no means certain beyond the one-year reprieve scheduled for 2010. It is, therefore,

advisable to take into account what impact the IRA could have on the tax liability of your heirs.

Despite these potential drawbacks, a stretch IRA can be a tax-efficient means for passing on savings to future generations. While there is no guarantee that inheriting a stretch IRA from her grandparents will turn little Emily into a millionaire, it could help to make her own retirement a lot more comfortable. ■



QTIPs AND YOUR ESTATE

Is a qualified terminable interest property (QTIP) trust for you? It could be if your answer is “yes” to the following three questions: 1) Are you interested in providing income to your surviving spouse for his or her lifetime? 2) Do you want your assets to qualify for the unlimited marital deduction? 3) Do you wish to designate *who* will receive the remainder of the trust’s principal after your spouse’s death?

A QTIP trust is often teamed with a bypass trust. As a result, some estate planners refer to this as an A-B trust arrangement.

For the purposes of taxation, the value of assets within a QTIP trust are placed into your spouse’s estate, not your estate. However, you are able to designate who receives the trust’s assets after your spouse dies. Wondering if there’s some kind of catch? There is. Your spouse must receive all the income generated by the trust as long as he or she lives. Additionally, the surviving spouse

cannot assign his or her interest in the trust assets to other persons.

A Case Study

Here’s an example of how a QTIP trust works. Let’s say your estate is worth \$2 million and your spouse’s is valued at \$500,000. The first step would be to establish a bypass trust for \$1.5 million (basing this on the estate tax exemption for 2005). This move protects 75% of your assets from the estate tax. How about the remaining 25% or \$500,000? If you left it to your spouse, there would not be a tax penalty, thanks to the unlimited marital deduction, but your spouse would then designate who would ultimately receive the assets. You could also give the assets to your heirs, but they would have an immediate tax bill.

If you place the \$500,000 into a QTIP trust, the assets are counted as part of your spouse’s estate for tax purposes. When your spouse dies, the assets are

transferred to the person or persons *you* designate. Meanwhile, if your spouse’s assets are still under the estate tax exemption, there’s no estate tax bill. As the estate tax exemption increases to \$3.5 million in 2009, a QTIP trust can become increasingly attractive as an estate planning tool. Bear in mind that the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) repeals the estate tax in 2010, but without further legislation the estate tax will return in 2011 at levels in effect prior to EGTRRA.

Because a QTIP trust allows individuals to direct who will receive their assets when the second spouse dies, it can be useful to those who have children from a prior marriage, and who wish their property be left to those particular heirs.

However, if you establish a QTIP trust, keep in mind that your heirs will not receive the assets until your spouse dies. As a result, a QTIP trust may be less

►► *cont'd on page four*

▶▶ *cont'd from page three*

QTIPs AND YOUR ESTATE

suitable for couples where one spouse is much younger than the other.

In addition, establishing a QTIP trust requires careful planning. If your QTIP is funded with unproductive assets that do not generate cash flow, it may not be able to satisfy the surviving spouse's

annual income requirements and the marital deduction could be lost.

One final note: A QTIP trust can be useful if a surviving spouse does not have the experience or desire to manage assets. In such instances, a QTIP trust could be created as part of your will and, in



accordance with your wishes, be managed for the security of the surviving spouse, while ensuring that those assets are preserved for the ultimate beneficiaries. ■

RETIREMENT PLANS GET A BOOST FOR 2005

Increases in the cost of living during 2004 triggered adjustments to certain retirement plan limits for 2005. Some limits will remain the same, while others will increase as stipulated by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Participants in a 401(k) plan can defer as much as \$14,000 of their salary in

2005, up from \$13,000 in 2004. Additional catch-up contributions of up to \$4,000 may be made to a 401(k) by those who are age 50 and older. Pre-tax contributions to a Simplified Employee Pension (SEP) plan are limited to the lesser of 25% of the first \$210,000 of compensation or \$42,000. Owners of sole proprietorships or partnerships are

limited to 20%. The minimum compensation amount for SEP eligibility remains \$450. Participants in a Savings Incentive Match Plan (SIMPLE) may contribute up to \$10,000 in 2005, up from \$9,000 in 2004, and those who are 50 or older may contribute an additional \$2,000. ■

Minimize the Risk of Identity Theft

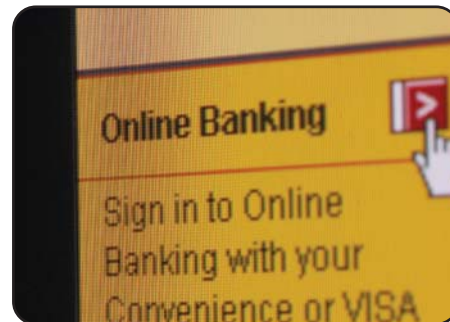
Prevention is still the best form of protection against identity theft. The *2005 Identity Fraud Survey Report* by the Better Business Bureau and Javelin Strategy & Research reports that online fraud is less common than identity theft crimes stemming from a lost or stolen wallet or checkbook. The survey sheds light on a common misconception that online security breaches are responsible for most incidents of fraud. In fact, monitoring your financial information electronically may be one of the best ways to detect suspicious activity.

Only 11.6% of ID crimes were computer based, and of these, half were the result of spyware. Proper, up-to-date software, including virus and firewall protection, can minimize your risk exposure. It is also important to be careful download-

ing data and responding to unsolicited e-mail requests for your personal information.

The following tips from the Better Business Bureau, Wells Fargo, Visa and CheckFree can help you prevent fraud:

- Go electronic. Protect your personal information by replacing paper bills, statements, and checks with Internet



versions. Pay the bills you can electronically and have your paychecks automatically deposited. Remember, proper computer protection becomes paramount as you manage more and more of your finances online. Only shop online at websites that will encrypt your credit card information and with vendors who have a privacy policy that protects your personal information.

- Scan your accounts for unauthorized activity. Early detection is key to minimizing loss. Also review your credit report annually.
- Act promptly if fraud occurs. Alert the appropriate parties as soon as possible and know your rights in terms of zero liability.