

# Taxes

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## **Using this study guide.**

This study guide is intended for use prior to attempting the accompanying exam. Read the complete study guide at your convenience before beginning the exam. You may cover the material in one session or break the material into several shorter sessions, whichever best fits your learning style. All answers to exam questions are covered in this document.

Before you begin, you may find it useful to click the thumbnails button to utilize thumbnails for navigating your way through this document. Thumbnails break the document into separate pages. Clicking the third thumbnail quickly advances the screen to the third page, clicking the sixth thumbnail quickly advances the screen to the sixth page, clicking the first thumbnail sends the screen back to page one, etc. Bookmarks operate similarly by advancing to different sections of the document. Simply use your mouse to click on the section of your choice.

## Taxes

### Introduction

Most investors are familiar with income taxes, sales or excise taxes, and property taxes. Of these three, the only one that has substantial implications in the securities industry is income taxes. Higher levels of taxable income are taxed at progressively higher tax rates called tax brackets. The maximum tax bracket for personal income taxes is 39.6%. Only the taxable income is actually taxed at the given rate. Taxable income is all a person's taxable wages, salaries, commissions, dividends, interest, and profits added together less all the deductible expenses, losses, and exemptions. The taxable income, not total earnings, determines an individual's tax bracket. Since the tax law changes in 1987, the personal income tax structure is not as progressive as it once was.

A \$2,000 contribution to an Individual Retirement Account reduces taxable income by \$2,000. The real cost of the IRA contribution is much less than the \$2,000 because it can save an investor the percentage his/her tax bracket dictates times the \$2,000. That is, for anyone in the 31% tax bracket, making a \$2,000 IRA contribution can actually save 2,000 times .31 or \$620 in taxes. In essence, the real cost of the \$2,000 contribution is \$2,000 less \$620 or \$1380. The amount saved by each individual depends on his/her tax bracket.

## Investment Income

The two ways of making money from securities are dividends and interest (called investment income) and profit from the sale of investments owned (called capital gains). Both of these methods of making money have tax consequences for the investor.

Mr. Brown decides to buy 200 shares of Corporation XYZ's common stock at a price of \$32 per share. The cost is \$6400. If the Board of Directors declares a \$.25 dividend payout to shareholders, Mr. Brown will receive a dividend check of \$50. The dividend came from corporate profits after federal, state, and local taxes were paid. The \$50 has already been taxed. That is, Mr. Brown's dividend payment is from after-tax corporate profits. Nevertheless, Mr. Brown must still pay taxes on the entire \$50. All dividends received are taxable at ordinary income tax rates.

If the value of Mr. Brown's stock rose to \$40 per share, the rise is called appreciation and is not taxable because he has not sold his stock. The profit he has is on paper only and is called paper profit. Mr. Brown is now faced with the difficult decision of whether or not to sell his XYZ shares. If he sells, he will make \$8 per share profit, but he will be giving up any further profit potential; if he doesn't sell and the stock declines back to \$32 per share, he will lose the paper profit of \$8 per share. Mr. Brown must decide if he thinks the stock has peaked or will continue to rise and he must also consider the tax consequences of selling now as opposed to selling later.

If he sells now and makes the \$8 profit per share, he has a taxable profit because he has established a realized capital gain. Realized is the term used once the stock has been sold. The term unrealized describes any appreciation when it is still paper profit only. Unrealized gains are not taxable. Mr. Brown now has \$1600 taxable profit because  $\$8 \times 200 = \$1600$ .

## Capital Gains

The two categories of capital gains and losses established by the IRS depend on the length of time the investor held or owned the stock before it was sold. This is referred to as the holding period. If the securities were held for 12 months or less, the profit is labeled short-term capital gain and is taxed as ordinary income based on the investor's tax bracket. If the securities were held one day and 12 months or longer the profit is labeled long-term capital gain and is still taxed as ordinary income, but the maximum rate is 28%. This difference could be significant for investors in the higher tax brackets. Clearly, it would be to their advantage to hold investments until their profits qualify as long-term capital gains. Historically, there has been a difference in how short-term and long-term capital gains are taxed, so Congress has chosen to continue this tradition even though the difference currently affects only investors in the higher income tax brackets.

If Mr. Brown had owned his XYZ shares for 12 months or less, he would pay taxes on the \$1600 short-term capital gain at his ordinary tax rate. If his ordinary rate happened to be 15%, his taxes would be  $\$1600 \times .15$  or \$240. If Mr. Brown's tax rate were 28%, he would have to pay  $\$1600 \times .28$  or \$448 in taxes. If his rate happened to be 31%, the taxes would be  $\$1600 \times .31$  or \$496. If Mr. Brown happened to be in the 36% tax bracket, he would have to pay  $\$1600 \times .36$  or \$576. If Mr. Brown happened to be in the 39.6% tax bracket, his taxes would be  $\$1600 \times .396$  or \$633.60. That is, Mr. Brown's taxes on this short-term capital gain could range from \$240 to \$633.60, depending on his current tax rate bracket.

If, however, Mr. Brown had kept his XYX shares for more than 12 months, the tax situation would be quite different. The profits would be labeled long-term capital gains and the most he would have to pay in taxes would be  $\$1600 \times .28$  or \$448. The only range of taxes for this long-term capital gain would be \$240 (for those in the 15% tax bracket) to \$448 (for everyone else). Keeping the shares for more than 12 months would mean a considerable savings for anyone in the higher tax brackets.

## Capital Losses

The other important tax consequence is deductibility of capital losses. If Mr. Brown's XYZ shares had dropped in price to \$25 per share instead of rising to \$40, he would still have to decide to sell or not to sell, but the influences on his decision would be different. He would have a paper loss of \$7 per share or \$1400 total since he owns 200 shares. This paper loss is not tax deductible; it would only become deductible in the event of a sale. Losses must be realized capital losses in order to be deducted. If Mr. Brown sells at \$25 per share within 12 months or less, his losses are considered short-term; if he waits to sell after 12 months of ownership, his losses are considered long-term.

Realized capital losses are deducted from capital gains in the year they are realized. Net short-term and long-term capital losses (capital gains minus capital losses) are totally deductible from taxable income in the year they are realized, but there is a maximum of \$3,000 allowable per year. Losses in excess of \$3,000 may be carried over year to year and used to offset capital gains until they are used up. The total amount capital losses saves a taxpayer depends on his/her tax rate bracket.

## Short Sales

A short sale takes place when an investor turns in a sell order without really owning the security being sold. The broker/dealer loans the selling customer's account the security he needs to deliver to the buyer. Sometime later the customer closes out the short position by buying the borrowed securities in the marketplace and sending them to the lender. The closing of the short position creates the taxable event. When the investor buys the stock in order to replace the borrowed security, the IRS considers that as a purchase followed by a sale. If there is a difference in price, the investor may have a short-term gain or loss. It is almost impossible to have a long-term capital gain when the transaction is a short sale.

Since the lower tax rate on long-term capital gains is like rewarding those who take market risk for more than 12 months, the IRS has ruled that an investor who owns stock for less than 12 months and then takes a short position in the same security ("called short against the box"), removes the downside risk. The entire holding period is canceled and a new holding period will not begin until the short position is closed. If the investor had a long-term holding position in the security when the short sale began, the holding period is not canceled. In this case, the investor could have a long-term gain when the transaction included a short sale.

Stock splits or stock dividends make the calculations for capital gains or losses a bit complicated when there is a partial liquidation. In the case of a split, the adjusted cost basis must be computed by using the number of shares owned after the split and comparing it to the original cost. Per share cost is used to determine gains or losses after the sale. The initial stock purchase date is used to determine short-term or long-term qualifications. Stock dividends are handled in the same manner. To compute a gain or loss, compare the sales price to the cost basis.

## Other Adjustments to Cost Basis

Four other adjustments to cost basis involve conversion, gifts of securities, inheritance of securities and partial sale of securities acquired at varying prices. Conversion of bonds or preferred stock into common stock is not taxable because no money is exchanged. The common stock takes the cost basis and holding period of the convertible. By and large, securities acquired as gifts take the donor's basis. All gains for an inheritance are considered long-term and the inheritor is allowed to use stepped up basis rules. That is, the heir takes the securities at their value as of the date of death. A new cost basis is acquired without any money being spent.

If investors purchase stock over a long period of time and pay different prices over the years, the IRS generally uses the FIFO rule to determine taxes but also allows the identified shares method. With the latter, the investor can specify which shares are being sold. Mutual funds shares may be treated on an average cost basis.

Any activity that results in an increase in the number of shares owned leads to a decrease in cost basis. Holding periods begin only when money is actually exchanged. Holding periods end when a sale actually occurs.

## Gift and Estate Taxes

When a gift of securities or cash is made to an individual, the IRS taxes the donor, not the recipient. Often, the taxes are very stringent with top rates higher than 50%. There is, however, a \$10,000 annual gift tax exclusion per individual. The \$10,000 exclusion is doubled when the gift is made by a husband and wife jointly. Any gift in excess of \$10,000 from an individual or \$20,000 from a husband/wife is taxed after those amounts are subtracted, respectively. That is, if a husband/wife make a gift of \$25,000, they are taxed only on the \$5,000 in excess of the \$20,000 exclusion. The \$20,000 is not tax deductible, but is simply not subject to a gift tax.

Estate taxes (which can exceed 50%) are not currently applicable to the first \$600,000. Also, there is a marital exclusion that allows one mate to leave the entire estate to the other with no estate tax. Taxes are levied when the second individual of a marriage dies.

## The Wash Sale Rule

The wash sale rule states that an investor may not claim a tax benefit from selling a security at a loss if he reacquires that security, or one substantially identical to it within a 30 day period prior to or after the sale. Substantially identical means any other security that is likely to have the same investment performance as the one being sold such as securities convertible to the one being sold, etc. If an investor violates the wash sale rule, the loss claimed for tax purposes is added to the new purchase price, so the cost basis increases by the amount of loss originally used. If Mr. Smith bought 100 shares of security A at \$48 and its cost is now \$33, he may sell and use the loss for tax purposes. However, he would be violating the wash sale rule if he buys 100 shares of security A within 30 days before or after his sale or if he buys a substantially identical security within the same time period. Furthermore, if he completes either of the last two transactions, the loss of \$15 (\$48 - \$33) will be added to the cost of his new shares, thereby increasing its cost basis.

Registered representatives should recommend that clients discuss the transactions he/she is considering with a tax adviser if there are any significant tax ramifications involved.

## Bond Interest

Interest on corporate bonds is taxable at ordinary income tax rates. Interest paid by a corporation on its bonds is a pre-tax expense to the corporation just as interest on a home mortgage is a pre-tax expense to an individual. Corporations treat interest payments to stockholders as tax deductible expenses. All interest received by a shareholder on corporate debt securities is subject to ordinary income tax in the year the interest is received. This is true of most interest bearing investments such as savings accounts, CDs, etc. But, interest on bonds from the U.S. Government and its agencies gets special tax treatment.

Municipal bond interest is exempt from federal income taxes, but not from state income taxes with one exception. Interest from bonds issued by a municipality of your state of residence carry no federal or state income tax. Interest from bonds issued by the U.S. Government and most of its agencies is exempt from state income taxes, but not from federal income taxes. However, interest from Fannie Maes, Ginnie Maes, and Sallie Maes is taxable at both state and federal levels. Interest from bonds of U.S., territories and protectorates is exempt from all income taxes.

## Bond Accretion

The earnings made on the difference between the purchase price and par value of T-bills and zero coupon bonds is treated as interest. If Ms. Jones bought a \$1,000,000 par 52-week T-bill at an 8% discount, the cost would be \$920,000. One year later, she would receive the \$1,000,000 par value. Since her profit would be \$80,000, this is the amount she must declare as interest income. The same is true for zero coupon bonds, but because the maturity is much longer, there is special treatment. The IRS requires investors to declare a portion of the discount appreciation each year instead of waiting to the maturity date. This is required even though no money is paid to the investor. The process is called accretion and is a potentially negative situation for investors.

All debt securities initially issued at a discount (called Original Issue Discounts, OIDs) or those bought in the secondary market at a discount (called market discount bonds) are accreted annually. This applies to interest-bearing bonds that are bought as a new issue at a price less than par. The discount is divided by the number of years to maturity to determine the accreted amount and must be added to any interest the investor received. If Ms. Blue bought a

9% bond that matures in 10 years for \$850, the annual portion of the discount that is accreted is  $\$1,000 - \$850$  ( $\$150$ ) divided by the ten years ( $\$15$ ). Since Ms. Blue receives \$90 per year in interest ( $\$1,000 \times .09$ ), she must add \$15 to \$90 and declare \$105 total taxable interest for this bond.

The accreted amount is also added to the cost basis. After one year, Ms. Blue would have an adjusted cost basis of \$865 for this bond. After two years, the adjusted cost basis would be \$880, and so on. When the bond is sold, the adjusted cost basis is the figure used to decide if Ms. Blue has a capital gain or loss. If Ms. Blue held the bond for 5 years, her adjusted cost basis of  $\$850 + \$75$  ( $\$15$  times 5) or \$925 would be compared to her selling cost. If Ms. Blue sells for \$945, she would have a \$20 long-term capital gain. If the bond is held to maturity, there is no capital gain or loss.

## **Bond Amortization**

The treatment of bonds bought for more than par is called amortization and applies to all U.S. Government bonds, corporate bonds, and municipal bonds bought as a new issue or in the secondary market. The difference between the purchase price and par is the premium. The premium is then divided by the number of years to maturity to give the annual adjustment. If Mr. Blue bought a 9% bond with 10 years to maturity for \$1,200, the annual adjustment is \$20. Since Mr. Blue is losing this premium, the IRS allows him to deduct this loss. If this were a government or corporate issue, the \$90 in coupon interest each year would usually be taxed as ordinary income. But, the \$20 amortization can be deducted, so Mr. Blue would have to declare only \$70 in interest income for this bond. If this were a municipal security, the interest income would be tax-exempt.

The amortized amount is also deducted from the cost basis of the security each year. In this case, Mr. Blue's cost basis after one year would be \$1,180; after two years, \$1,160, and so on. Just as with the example involving Ms. Blue, Mr. Blue's adjusted cost basis at the time the bond is sold will determine if he has a capital gain or loss. If Mr. Blue holds the bond for 5 years, his adjusted cost basis will be \$1,100 ( $\$1,200$  minus  $\$20 \times 5$ ). If he sells the bond for \$1,060, he would have a \$40 long-term capital loss. If he held the bond to maturity, there would be no capital gain or loss.

## Other Taxes

Regressive taxes are fixed rate taxes on money spent such as sales taxes and excise taxes. Sales tax is regressive because it impacts those who have less money to spend more deeply than it does those with much money to spend. Sales taxes paid by the poor represent a larger portion of their spendable income than the same sales taxes paid by a wealthy person. The lower the income, the deeper the hurt from regressive taxes. Taxes which require more of those at higher levels of income such as income tax are called progressive. The tax rate progresses or becomes higher as the income to be taxed increases.

Taxes on the transfer of property are referred to as transfer taxes. Generally, the seller in the transaction of securities is the person responsible for paying the taxes.

Since the IRS considers corporations legal entities, most of the same rules that apply to taxpayers also apply to corporations. Corporate income is taxed at corporate rates. Corporations pay the same sales tax as individuals for items that are subject to sales taxes. When corporations buy gasoline, they pay the same excise and fuel taxes as individuals. Corporations pay property and asset taxes on things owned by the corporations just as individuals. However, the corporate income tax maxes out at 35% of taxable profit earned. If a corporation buys stocks of other domestic corporations, they get substantially different tax treatment on dividends received. Corporations have the advantage of a 70% dividend exclusion not available to individuals. That is, 70% of all dividends paid on the stock of domestic corporations is tax-free to a corporate investor. Furthermore, if the corporation owns 20% or more of the corporation paying the dividend, the exclusion increases to 80%. This is a huge incentive to corporations to invest in the securities of other corporations.

## Retirement Plans

Congress has passed laws that offer incentives to Americans to save for their future in order to alleviate the problems of how the elderly can support themselves as they age. The Keogh plan to benefit self-employed individuals and their employees was passed in 1962. Sole proprietors and partners in a partnership are considered self-employed. Employees of the self-employed who meet certain age and employment requirements must also be covered. All full-time employees of a self-employed person, must also be covered if they

have worked at the business for one year or more. The self-employed person may make a maximum contribution of \$30,000 or 25% of self-employment earned income, whichever is less. This self-employment income is earnings from the self-employment only, not any income from dividends, interest or capital gains on investments. Whatever percentage the self-employed person makes for himself, he must also make for his employees.

If anyone under any qualified retirement plan takes a distribution from his/her account before age 59½, he/she must pay income taxes on the amount withdrawn and pay a 10% penalty for the premature distribution.

After reaching retirement age, a person covered under a Keogh plan has the option of a monthly payout or a lump sum distribution. With the monthly payout, all proceeds are taxed as ordinary income. With a lump sum distribution, the IRS allows a special five-year income averaging which can substantially reduce the taxes. The distribution is spread over a five-year period to determine taxes rather than claiming the entire amount in the year it is received.

It should be noted that an individual could conceivably be self-employed and take advantage of a Keogh plan at the same time he works full-time for a corporation and is covered under the corporation's retirement plan and he could be contributing to a personal individual retirement plan.

Legislation for individual retirement plans (IRAs) was first passed in the early 1970s and was expanded in 1982. Any person with earned income is allowed to have an IRA. \$2,000 or 100% of the person's earned income (whichever is smaller) can be deducted for tax purposes. Earned income is money earned from a job or profession and does not include dividends, interest or capital gains. The maximum deductible for a married couple on a joint return is \$4,000 if both partners are employed and meet the qualifications. If one spouse works and the other is not employed, a spousal IRA may be established. Deductions for a spousal IRA may be taken only on a joint return. The spousal account is really one account with two sub-accounts. The contribution can be anything up to \$4,000 and may be split in any manner as long as neither account receives more than \$2,000.

The Tax Reform Act of 1986 changed the deductibility of certain IRA contributions. Any person covered under any retirement plan (corporate or Keogh) with earnings of \$25,000 or more as an individual or \$40,000 as a

husband/wife team is subject to a phase-out of the deductibility of contributions to an IRA. That is, all or part of the IRA contributions may not be deductible. All money in the IRA, however, will still be tax deferred.

There are restrictions on how the IRA contributions may be invested. The U.S. Retirement Bond, certain types of savings accounts and certificates at banks, certain annuities from insurance companies, and most any debt or equity security qualifies. Investments suitable for retirement plans such as mutual funds and variable annuities should be used. Speculative stocks and bonds should not be used, and art works, antiques, gems, collectibles, stamps, etc. do not qualify. There are, however, some new gold and silver coins issued by the U.S. Government that do qualify through the Tax Reform Act of 1986. If IRA assets are used to buy collectibles, the amount used is considered a distribution from the account and is taxed and in some cases carries a penalty.

Since the purpose of an IRA is to have funds for retirement, payouts may not begin without a 10% penalty until age 59½ unless due to a death or disability. Payouts must begin at age 70½ or face up to a 50% penalty of the insufficient distribution. The IRS has life expectancy tables that help determine what is and is not “sufficient.” This is a big incentive for all IRA investors to withdraw their money rather than leave it in to accumulate after age 70½. If a gentleman had \$10,000 in his IRA and reached age 70½, the IRS requires that he withdraw at least 1/12<sup>th</sup> of the \$10,000 or \$833 per year to avoid penalties because a man who is 70½ has a life expectancy of 12 years. If he withdrew only \$500, he would be penalized up to 50% of the insufficient \$333. If he withdrew nothing, he would have penalties of up to \$417 (50% of \$833). If a client withdrew \$1,000 from his IRA at age 58, he would have to pay \$100 in penalties (10% of \$1,000) in addition to paying the normal ordinary income tax on the \$1,000 withdrawal. These penalties somewhat complicate recommendations for IRAs. That is, a registered representative must look at individual situations and needs rather than live by the motto that everyone should have an IRA.

At payout time, there are two options- monthly payouts or a lump sum payout. Both result in ordinary income taxes on all proceeds, so very few people elect to use the lump sum. In the case of a termination or when a company goes out of business, an individual is given the option of a “roll over” for any part or all of the lump sum distribution into an IRA within 60 days of the distribution. This allows the individual to avoid taxation on the rolled over part. Any part not rolled over is taxed immediately.

## Corporate Retirement Plans

Pension plans are for employees of corporations and some government and municipal agencies. The contributions employers make to pension plans are tax deductible expenses for the company and the amount of the contribution is not taxed as current income to the employees. If a company establishes a pension plan, they have an obligation to make the contributions yearly, regardless of the profitability of the company. Basically, the only way to reduce the contribution is if operating results are so bad that a reduced level or no contribution is needed to help the corporation survive.

A Defined Contribution plan is one in which the employer's contribution is a fixed predetermined percentage of salary. The benefits to an employee are directly dependent on the time frame the person is under the plan, the amount contributed on his/her behalf and the performance of the investment portfolio. In general, this is a better plan for younger employees.

Defined Benefit plans are those that require specific retirement benefits such as receipt of a given percentage of an employee's salary for each year of employment. Because there is a targeted benefit as a goal, the amount of the annual contribution required by the company will vary depending on the performance of the portfolio, employees leaving their positions and giving up their rights, and the number of employees retiring in any given year. The required annual contribution is decided through actuarial assumptions. This type plan is more beneficial to older employees.

Profit Sharing plans allow a corporation to share its profits with its employees. The contribution depends on the profits and the size is at the discretion of the employer. The maximum deductible contribution is 15% of the payroll, but the amount may vary each year depending on the company's earnings. All contributions are treated as tax deductible expenses to the corporation and are not taxed to the employees as current income.

401(k) plans are also called Cash or Deferral Arrangements (CODA). These are qualified plans where employees contribute pre-tax dollars of up to 15% of their gross income, subject to a maximum dollar amount. The money is invested in stocks, bonds, and money market instruments and is payroll-deducted. The capital and earnings are tax-deferred and grow until the

employee retires or leaves the company. The employer may match the employee's contributions if so desired.

The Employee Retirement Income Security Act (ERISA) is federal legislation aimed at protecting the rights and interests of employees covered under a private pension or profit sharing plan. ERISA does not apply to government or municipal retirement plans. The actions of fiduciaries are controlled by the Prudent Man Rule. Violations can be held criminally and civilly accountable. All transactions for any plan covered under ERISA should be an "arms length" transaction. That is, the fiduciary or other interested party can not legally benefit to the detriment of the employees covered by the plan. Of course, the sales and service involvement of brokers or registered representatives is not limited by this.

The main advantage of retirement plans is that they allow all contributions to be deducted from income in the year the contribution is made and all earnings are tax deferred until monies are withdrawn.



Now that you have completed reading this course, you may proceed to the accompanying exam to earn a verifiable certificate of completion.