44 Investment Actions To Take Today

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In total, your objectives are to reduce taxes on investment gains, equalize gains and losses, and protect your investment portfolio.

Investment Facts and Tax Strategies
To Help You Save Taxes and Maximize Income

There are many valuable options available in the tax law that can help you minimize capital gain and personal income taxes, maximize tax savings from investment losses, and increase investment income. Many of the ideas and strategies in this **Resource Report** are applicable *both* before yearend and throughout the year. Note those that apply to you and your family and discuss them with your advisers.

Your objectives: You want to **lower** taxes on capital gains, **reduce** taxable investment income, **increase** your overall return, and **protect** your investment portfolio. You accomplish those objectives by doing the following, all of which are explained further in this Report.

- Eliminate or defer taxes on short- and long-term capital gains.
- Hold short-term gains until they become long-term.
- Take as many capital losses as possible.
- Move potential taxable gains and income to next year or to family members in lower tax brackets.
- Effect tax-deferring investment options.
- Lower taxes by "matching" sales against the shares with the highest cost basis.
- Use dollar-cost averaging when buying and selling securities.
- Consider buying and selling "option contracts" to defer taxation, protect investment gains, and generate additional income.
- Increase your *after-tax* investment income by changing portfolio components and percentage allocations among stocks, bonds, and other securities.
- Move the ownership of investments to family members, e.g., for your children's education.

- Keep track of all realized and unrealized gains and losses so you can make tax-saving investment decisions at a moment's notice and at any time, particularly at yearend.

Now to some investment and tax facts to help you understand better the tax-saving strategies listed later.

Fact #1. The maximum tax rate on long-term capital gains (held for more than one year) is 15% for assets sold in 2007 through Dec. 31, 2010. For taxpayers in the lower 10% and 15% income tax brackets, the maximum tax rate on long-term capital gains is 5% for 2007, and 0% in 2008 through 2010. On Jan. 1, 2011, the prior tax rates of 8%, 10%, and 20% are reinstated. In addition, qualified dividends will continue to receive the same tax treatment as capital gains through the end of 2010.

Fact #2. The spread between the maximum personal income tax rate and the long-term capital gain rate is **20** percentage points (35% less 15%). For every $10,000 you can qualify as capital gain, **you save $2,000 in taxes**. That doesn't include the savings from any reduced state and local taxes.

Fact #3. The spread between your personal income tax rate and your children's can be **25** percentage points (35% less 10%). For every $10,000 of income and short-term capital gain you move to your children (say, for educational expenses), **you save $2,500 in taxes**.

Fact #4. For movement of a long-term capital gain to your children, the spread can be **10** percentage points (15% capital gain rate less 5%). For every $10,000 you move to your children, **you save $1,000 in taxes**.

Fact #5. The maximum capital loss that can be used to *offset* income in any one year is $3,000. Any *unused* capital losses can be carried forward indefinitely.

Fact #6. For 2007, the 10% tax bracket applies to taxable income up to $15,650 and the 15% tax bracket on income from $15,651 to $63,700 for married taxpayers, filing jointly. For single taxpayers, the rates are 10% for taxable income up to $7,825 and 15% for income from $7,826 up to $31,850. (For other tax rates for 2007, both married and single, please see page 32.)

Fact #7. Through 2010, common and preferred stock dividends received from qualified sources are taxed at the lower 15% capital gain rate and at 5% for individuals in the 10% and 15% tax brackets. The 5% rate drops to 0% for all of 2008 through 2010. In 2011 and thereafter, dividends will again be taxed at personal income tax rates up to 35%. There are exclusions to the lower 15% dividend rate, principally on dividends received from real estate investment trusts, certain preferred stocks which are really debt instruments, ESOPs, and foreign entities.

Fact #8. On the sale of real property, the maximum tax rate on long-term capital gains is 15%. However, the tax rate is 25% for depreciation deductions taken on that property on prior tax returns; it's referred to as *depreciation recapture*.

Fact #9. The gain on the sale of collectibles, e.g., art and antiques, is taxed at 28% (not 15%). If the gain is short-term, it's taxed at rates up to 35%.

Fact #10. For children under age 18, taxable income above $1,700 is taxed at the parent's highest tax rate. For children age 18 and over, the regular tax rates apply, i.e., 10%, 15%, 25%, 28%, 33%, and 35%.

Fact #11. For 2007, you can give $12,000 to each child without any gift tax consequences. If your spouse joins in the gift, the amount is $24,000. The gift limit is adjusted annually for cost-of-living adjustments (COLA).

In addition, you and your spouse each have an estate tax exemption of $2.0 million in 2007, $1 million of which can be used to make gifts to children and other family members in excess of the $12,000 annual limit.

Now to investment strategies to use today.

Investment Ideas and Strategies to Use Today

The following ideas will help you better plan for and reduce the taxes payable on both your investment income and capital gains.

☐ *Overall strategies:* With the lower capital gain rate of 15%, you might want to rethink some investment strategies. For example, the tax rate spread is **20 percentage points** between capital gains (15%) and personal income (35%) taxation, so capital gains are more valuable. Thus, annuities and other investments, where the distributions are taxed at personal income tax rates, are relatively less attractive. While you should still be putting as much as you can into retirement plans, what you put into those plans is more important. You might want to hold dividend-paying stocks and investments most likely to generate capital gains in your own name while using the retirement plan for investments that pay current interest, which is tax deferred.

☐ *Capitalize on tax bracket spread:* If you anticipate large capital gains, carefully analyze your tax bracket for this year and next to help you determine in which year the gain should be realized and reported. If the spread between the tax rates is nominal, you may *not* want to take the risk of the security dropping in price by holding onto the stock.

☐ *Take capital losses:* If you want to claim a tax loss for this year, securities must be sold by Dec. 31. This trade date, not the settlement date, is the last date for recording losses and gains.

☐ *Defer short-term gains:* Postpone taking short-term gains (held under one year) until next year; remember, all net short-term gains are *fully taxed* at income tax rates up to 35%.

☐ *Match unrealized gains with losses:* It might pay to take any unrealized long-term gains this year to take advantage of the 15% maximum tax rate,

particularly if you're in the top tax brackets of 25% to 35%. In addition, if you have *unrealized* losses, particularly short-term losses, consider taking sufficient losses to offset any *realized* gains.

☐ *Use capital losses by taking gains:* You can deduct net losses up to a maximum of $3,000 a year. Thus, if you currently have $3,000 or more of net losses, including carry-forward losses from last year, plan to take more gains this year to use against those losses to save taxes. You still can carry forward any unused losses for use in future tax years.

☐ *Sale of no-price or worthless stock:* If you have worthless securities and there's no public market for them, get a letter from your broker stating that the securities are worthless. However, if the value is uncertain or quoted at a very low price, say $0.10 per share, consider selling the securities to the brokerage firm or a friend. *Caution:* Be sure to transfer the securities and get paid; you don't want the IRS to disallow the capital loss by labeling the transaction a "sham."

☐ *Save taxes by matching the sale of securities:* If you have more than one lot of the same security, identify and sell the lot which results in the *lowest* capital gain. *Example:* You buy 100 shares of XYZ stock at $20 per share and another 100 shares at $30. You then sell 100 shares at $40. If you sell against the higher $30 purchase price, the capital gain will be $1,000. However, if you don't specify which lot (shares) you want to sell against, the IRS will assume first-in, first-out, i.e., you sold against the $20 trade, which results in a $2,000 taxable gain, rather than $1,000.

What about losses? Use the same approach for capital losses; specify that the shares being sold are against those shares purchased at the highest price. Again, by doing this, you maximize your current losses and reduce your tax bill.

☐ *Move capital gains to children:* Take advantage of your children's lower tax rates of 10% and 15%, particularly on short-term capital gains which can be taxed to you at your personal tax rate up to 35%. *How:* Gift the stock to them.

They then sell it and realize the capital gain, say, $5,000. Based on your child's 10% tax rate, **your family saves** a potential of 25 percentage points in taxes, or $2,500, and you have provided money to your child for education expenses. *Note:* For children under age 18, this strategy doesn't work as well since their income above $1,700 is taxed at the parent's highest tax rate. For information on how to use custodial accounts, please see page 17.

☐ *Take loss before gifting:* Never gift securities which have dropped in price. You lose the tax benefit of *personally* writing off the loss. The better approach is to first take the loss and then give the proceeds to your children for education expenses or to a charity.

☐ *Buy annuities for income deferral:* To shelter current income on bonds and other interest-bearing investments (taxed at rates up to 35%), consider transferring the money to annuities to defer taxation. However, keep in mind that if you need to withdraw the money, a 10% penalty could be assessed for annuities cashed in before age 59½ .

☐ *Deductions on second or vacation home:* If you rent your second or vacation home to other individuals, don't automatically assume it's best to treat the property as a rental property; your tax writeoffs and depreciation deductions are limited. It may be better to treat the property as a *second* personal residence; you can still deduct mortgage interest and real estate taxes.

Furthermore, if you live in your second home more than 14 days a year (or more than 10% of the total days it is rented to others), other expenses like depreciation and insurance are usually tax deductible, but only up to the rental income you receive. Your tax deductions also can be affected by the IRS' complex *hobby loss* and *passive activity* rules.

What to do: Before you take any tax deductions for a second or vacation home, work through the numbers with your accountant to see whether you're better off treating that property as a second personal residence *or* as a rental property. The tax impact can be considerable. Remember, as a second residence, you can at least deduct mortgage interest and property taxes.

☐ *Defer tax on short-term investments:* If you have invested in a money-market mutual fund or other money-market accounts, you will be taxed on all the interest income earned in 2007. However, if you invest in or switch that money to a Treasury bill or certain bank certificates of deposit maturing in 2008, the interest income earned will *not* be taxed until you file your 2008 tax return in 2009.

Maturity: To obtain this tax deferral, the maturity of the investment must be one year or less; otherwise, no tax deferral occurs. In the case of bank certificates of deposit, you must specify that interest is to be credited to your account *only* at maturity, not as it is earned.

☐ *Make charitable donations of appreciated securities:* You will increase your tax deductions and avoid paying taxes on the capital gain. However, you have to be very careful; the rules are precise. For more information on donating appreciated securities and other assets, see page 19.

☐ *Try to use passive losses:* If you have unusable passive losses to write off, e.g., real property investments, consider the following: (a) purchase investments that generate passive income which can be used to offset those losses, (b) become active in managing the investment if possible, so the investment is no longer passive, and (c) sell the entire interest in the passive investment because the losses aren't doing you any good.

☐ *Borrow from your investments:* Use a margin account if you plan to borrow investment capital. Interest on the loan is tax deductible up to your investment income; any interest not currently deductible can be carried forward to future years. *Tax alert:* If the margin money is used for personal purposes (other than for investments), you *cannot* deduct the interest.

☐ *Uncollectible loans:* Tax deductible as a short-term capital loss for up to $3,000 net losses a year. Check with your accountant *before* writing off any loans to a close friend or relative; those loans may be considered a gift by the IRS and not

tax deductible as a capital loss.

☐ *Dollar-cost average your investment sales and purchases:* An example best illustrates this concept. If you own 600 shares of XYZ company, sell 100 shares per month over a six-month period. If the stock continues to increase in price, on average, you will come out ahead versus selling all of the shares today. If the stock falls in price, you at least sold shares at higher prices while it was falling in price.

In contrast, if you're buying 600 shares of stock, buy 100 shares per month. If the stock drops, you are buying *more shares* at lower prices and *fewer shares* at higher prices. This will result in a lower *average* purchase price, unless the stock continues to drop. In that case, you've just made a bad investment.

☐ *Consider zero coupon bonds:* Zero coupon bonds are popular with investors because of their discounted purchase price and sometimes higher yields than for regular bonds.

Basically, zero coupon bonds pay no current interest; that is, the interest has been stripped, i.e., it is not included as part of the purchase price. Instead, zero coupon bonds sell at a deep discount from the bond's face value. For example, a bond with a face value of $10,000, maturing in 15 years, may sell for only $5,550 today. In this case, the discount is $4,450, which will give an investor an effective annual rate of return of about 4% if the bond is held to maturity in 15 years when the $10,000 face value is paid to the buyer.

There are two other considerations to keep in mind. *First,* a portion of the discount from the face value will be taxable income each year even though you didn't receive the interest for that year. That's called a *phantom tax.* Furthermore, the amount of income you have to report each year is not simply 1/15th (15 years) of the total discount of $4,450, using the example above. It starts low and increases every year. Your broker will give you the amounts. Because of this tax treatment, zero coupon bonds are more suitable for an IRA, Keogh, or other retirement funds where the income is not taxed until withdrawn.

Second, long-term zero coupon bonds tend to be more volatile in price than other bonds. That is, when interest rates fall, they increase rapidly in value; when interest rates increase, their price can fall just as rapidly. So get good advice before buying zero coupon bonds.

☐ *Consider real estate:* Net cash flow is the name of the game. But even if the net cash flow (total cash inflow less cash outflow) is positive, you still have to be very careful. For the minimum guidelines to use *before* investing in real properties, see the list on page 21.

☐ *Consider tax-exempts:* To lessen the impact of a high tax bracket, consider moving some investment money to tax-exempt bonds or other tax-deferred investments, e.g., annuities. See page 23 for the equivalent after-tax yields based on personal income tax rates of 10% to 35%.

Technical Investment Strategies

The following are more sophisticated investment strategies which should be undertaken *only* after careful analysis with your advisers, particularly your accountant and broker. Some of these technical strategies can be risky. So get good advice before effecting any of them and factor into your transaction costs the added brokerage commissions and "lost return" on the money you invested in owning the securities.

☐ *Buy a similar company, but avoid a wash sale:* If you want to hold on to a security even though you have losses, consider taking the losses and buying the securities of a *similar* company. For example, if you have losses in NYS Utility Power, take the losses and buy Virginia Utility Corp. This approach will not trigger the 61-day, wash-sale rule and you can recognize your loss for tax purposes.

Another approach is to sell the security, take the loss, and wait 30 days before buying it back.

☐ *Strategies for deferring gains:* One method is called "like-kind" exchanges. You trade select appreciated real estate or other investment properties for similar properties. *Swapping* is a strategy for exchanging bonds and other income-producing properties. To save taxes, ask your accountant and broker about *like-kind exchanges* and *swapping.* Again, there are technical rules to follow, so be careful.

☐ *Sell a call option:* Increase your annual return by selling a call option on the shares you currently own. This approach can move out your *unrealized* capital gain to another time period, say, three to six months from today. However, there is market risk with this approach since the buyer of the call option will not exercise the option if the price falls below the option price. For more information on selling call options, see page 25.

☐ *Buy a put option:* If you want to sell a security which has increased in price but don't want to pay current taxes on the capital gain, talk to your broker about buying a *put option.* This approach is also useful when you believe the stock's price will continue to increase and you don't want to sell it. For more information on put options, see page 27.

☐ *Installment sale:* If you're getting ready to sell an investment for a big profit and want to defer the taxes on the sale, consider an installment sale with payments spread over future years. By taking only a portion of the gain into income each year, you spread out the profits and taxes, and avoid reaching a higher tax bracket in the year of the sale. Even if you are already in a high tax bracket, use of the installment sale method may still be beneficial since your tax liability from the installment sale is spread over future years when you may be in a lower tax bracket. For more information on an installment sale of property, please see page 29.

How to Analyze and Report Capital Gains and Losses

Follow these steps in reviewing all realized and unrealized capital gains and losses. Then you can determine what action to take *before* yearend.

1. Before computing your gains and losses, you first must *net* all short-term and long-term gains and losses against each other.

2. Net short-term gains or losses (held for *less* than one year) are then added to or subtracted from your taxable income and taxed at rates up to 35%.

3. Net long-term gains (held for *more* than one year) are taxed at a maximum rate of 15%.

4. Net capital losses can be deducted up to a maximum of $3,000 in any one year; any unused losses can be carried forward indefinitely.

5. The gain on the sale of collectibles is taxed at 28%. If it's short-term, the gain is taxed at rates up to 35%.

6. For real property sales, the tax rate is 15% if held for *more* than one year. However, the tax rate is 25% for depreciation deductions taken on prior tax returns, referred to as *recapture*.

Recordkeeping Advisories

Proper recordkeeping is always prudent, but it's especially critical in financial and investment areas affected by taxes. Your inability to document transactions for tax, estate, and investment purposes can be very costly. Here are ideas to help with your recordkeeping.

☐ *Investment expenses:* You can deduct all expenses incurred for security transactions (telephone, mail, travel, etc.), as well as tax preparation fees and professional dues and publications related to investments. You also can deduct the annual fees you pay for a Keogh or IRA. *Advisory:* Keep in mind that these expenses are tax deductible only to the extent they exceed 2% of your adjusted gross income (AGI).

☐ *Interest and investment income:* You can deduct interest you paid to finance investment purchases, but only up to an amount equal to your investment income. Any investment interest that is not *currently* deductible can be carried forward into future years.

Special election: Don't forget that taxpayers can file a special election to use capital gains and qualifying dividends as investment income, but only if they pay tax on the gains at their personal income tax rate, not the 15% capital gain rate. When preparing your tax return, consider this option with your accountant.

☐ *Security and investment transactions:* Save all stock and bond confirmations indefinitely, as well as all 1099s and other cost records on important investments, e.g., antiques, art, and coin collections. Remember, when you sell the investments, you will have to document your cost basis in order to determine your capital gain or loss.

☐ *Checkbooks:* Business, investment, and personal (mortgage) interest have different tax treatments. To help with your recordkeeping for tax purposes, set up separate checking accounts for recording income and expenses in each category.

☐ *Retirement plans:* IRA, Keoghs, employer plans. Again, all data should be kept indefinitely, including annual reports, contributions by you and your employer, buy and sell confirmations on investments, and correspondence from your employer and other institutions with whom you have retirement accounts. In addition, keep all information on rollovers.

After-tax contributions: The records of your *personal* contributions to all retirement plans are also very important. If you made contributions with *after-tax* income, the amounts distributed to you (excluding capital gains and income) are *not* subject to taxation. An example of this would be *voluntary* 401(k) contributions made with your after-tax income.

☐ *Keep track of term investments:* Whenever you make a term investment (e.g., a 90-day certificate of deposit), mark your calendar with the date of maturity.

In many cases (e.g., CDs), *renewal is not automatic* and interest may cease on the date of maturity, which means you have to reinvest the money if you want to continue the investment's earnings.

Advisory: Even though some financial institutions provide a maturity notice and a renewal option on your investment holdings with them, note the maturity date on your calendar. That's the time to *re-evaluate* the advisability of that investment and the new interest rate to be paid.

☐ *Do you expect interest rates to move higher?* If you do, invest in short-term securities (money market funds, one-year certificates of deposit, Treasury bills, etc.). *Reason:* If you invest long-term (say, a ten-year bond), the market value of that bond can drop significantly in price if long-term interest rates move higher. In contrast, if you expect interest rates to move lower, invest in intermediate and long-term securities. If you're uncertain of the direction of interest rates, consider buying securities with a maturity of more than two or three years since their price sensitivity to changing interest rates is *less* than longer-term bonds. For more information on interest rates and the use of *laddering* your investments to lower the risks, see *Investing When Interest Rates Are Low,* page 31.

Summary Strategies

To maximize your tax savings and deferral of income and capital gains, review your investment portfolio throughout the year and, in particular, in early December so you can take advantage of yearend strategies. Before deciding on the specific actions to take, determine the following for both short- and long-term gains and losses, i.e., know what has happened up to that point in the year.

1. What are my realized capital gains and losses?

2. Unrealized capital gains and losses?

3. Unused capital losses from prior years?

With that knowledge, you can review your options to save and defer taxes throughout the year and before yearend.

To help in your investment analysis and strategy considerations on specific subject areas, please see the following exhibits:

Exhibit 1 — How to Use Custodial Accounts, page 17

Exhibit 2 — Charitable Donation Rules and Cautions, page 19

Exhibit 3 — Before You Invest in Real Estate, page 21

Exhibit 4 — Calculating the Real Return of Tax-Exempts, page 23

Exhibit 5 — How and When to Use a Call Option, page 25

Exhibit 6 — How and When to Use a Put Option, page 27

Exhibit 7 — Installment Sale Rules and Cautions, page 29

Exhibit 8 — Investing When Interest Rates Are Low, page 31

Exhibit 9 — Personal Tax Rates and Taxable Income for 2007, page 32

Exhibit 1

How to Use Custodial Accounts

When to use custodial accounts: The assets you want to distribute are relatively small; you want a simple and convenient method of placing them in the minor's name without the legal expense and complications of establishing a trust; and you want the assets to be usable for the benefit of the child (e.g., college tuition).

Before transferring or giving assets to minor children under the Uniform Gifts to Minors Act or other methods available under state and federal laws, review the following cautions and alerts with your advisers.

- Only assets in the form of money, securities, and life insurance are generally permitted to be placed in custodial accounts.
- In most states, any gifts are *irrevocable*, i.e., you can't take them back. So before making substantial gifts, be sure you won't need the money yourself down the road.
- Name as custodian of the account someone other than yourself. Otherwise, your control of the assets in the account may make any income from the transferred assets taxable income to you and the value of the account's assets will be included and taxed in your estate.
- Your child or grandchild is entitled to receive the full amount at majority age, usually age 18, so the child's level of maturity and financial responsibility could be a consideration in how much you transfer.
- If the amount is substantial, talk to your lawyer and consider having him or her prepare a trust agreement in place of a custodial arrangement. With a trust, you can specify how and when the money will be distributed to the child, e.g., immediately at age 18 or a later age or over a period of years.
- If you exceed the annual gift limit of $12,000 ($24,000 with your spouse's consent), a gift tax return must be filed, even if the gift exceeds the $12,000 by only one penny.
- State laws differ greatly on custodial accounts. Be sure to check out the laws in the state where the custodial account is being set up.

- Be prudent when investing the money. Remember, the money is for a specific purpose, e.g., education, and investment growth is more important than tax benefits. That's because any investment losses the child incurs have limited tax benefit because of the child's low tax rate, usually only 10% to 15%. *Note:* For children under age 18, income in excess of $1,700 is taxed at the parent's tax rate.

Alternatives: Look into a Section 529 Qualified Tuition Plan with your advisers as an alternative to setting up a custodial account. A 529 plan is sponsored and administered by each state and none of the distributions from the plan is taxable income to you or the child if the money is used for qualified higher education expenses, e.g., college tuition.

Also consider the Coverdell Education Savings Account (CESA). The annual limit on contributions is $2,000. Although the amount is not tax deductible, the income grows tax-free and all distributions are not taxable income if the money is used for qualified education expenses.

Last, use of a custodial account and the alternatives above are excellent methods to save for your children's education, but be careful of going too far. Be sure to keep sufficient funds and savings to support yourself in retirement and provide a cushion for such emergencies as disability. □

Exhibit 2

Charitable Donation Rules and Cautions

Consider contributing highly appreciated securities rather than cash to a charity. *Reason:* The *full* amount of the gift, i.e., its fair market value, is generally tax deductible and you avoid paying tax on the capital gain if the asset was held by you for more than 12 months.

On all cash and non-cash (property) donations, such as securities, antiques, an auto, etc., the following rules apply:

- Donations above $250 require a receipt and statement from the charity that a value was received in return for the donation.
- If the value of non-cash gifts exceeds $500, you must provide a detailed description of the gift and file Form 8283 with the IRS when you file Form 1040. In some cases, an appraisal is required; check with your accountant.
- If you donate cash, you must provide documentation via a bank record of the check, a receipt, letter, or other written communication from the charitable organization which indicates its name, the date, and amount of the contribution.
- If you donate an auto, boat, or other vehicle, your contribution is usually limited to the amount of cash the charity receives on the sale of the property, not the fair market value at the time you donated the property.
- If total *similar* properties (other than securities) donated exceed $5,000 in any one tax year, appraisals are required by the IRS. *Note:* The word "similar" means donations from the same general category, e.g., art works, coin collections, etc.
- If you donate stock in a closely held business, you must obtain an appraisal if the value of the stock donated is $10,000 or more.

On all substantial gifts, particularly property donations, be sure to check with your accountant *before* making the gift. Also be aware of the following *don'ts*.

First, don't donate securities and other properties which have dropped in price below your cost basis. You lose the tax benefit of *personally* writing off the loss. The better approach is to first sell the securities, take the loss, and then give the proceeds to a charity.

Second, don't give securities or other properties with a short-term capital gain to a charity since you can deduct *only* your cost basis in the securities, not the fair market value. Try to wait until the gain is long-term. For example, if you own 100 shares of stock selling now at $50 per share (your cost basis is $30), you have a $20 per-share or $2,000 total capital gain. If the stock was purchased more than 12 months ago, you can take a tax deduction of $5,000 ($50 times 100 shares). With a short-term gain, your deduction is limited to your cost basis, which is $3,000 in this example. Thus, by waiting until the gain is long-term, you increase your tax deduction by $2,000 or 40%.

There are other technical rules on donating properties. It's prudent to check with your accountant before making any sizeable donations. □

Before You Invest in Real Estate

You can lose considerable money in real estate if you aren't knowledgeable about the market, financially able to wait out the slumps, and prepared to be patient until the property's potential is reached. Here is a checklist to use before you close any contract to purchase property.

- Recognize that timing, location, and the preparation of realistic cash flow projections are the keys to making good real estate investments.
- Invest only the amount of money you can afford to tie up in an illiquid investment and not so much that your net worth and access to capital for other purposes are seriously affected.
- Diversify the geographic location of your real estate investments and research each area where you're thinking of buying in terms of its tax base, industries, transportation systems, and zoning regulations.
- Investigate beforehand the IRS rules on deductions and losses and profits of real estate investments, but do not rely solely on the current tax results as financial justification for the investment. Tax laws do change. The property should be a good investment *without* the tax advantages.
- Evaluate properties in terms of their annual cash flow and potential for long-term increase in value.
- Thoroughly check out all potential tenants, insist on sizeable security deposits, and stick to standard lease agreements.
- Be equipped to properly manage the property, either with sufficient personal time if you're doing it yourself or with extra cash to hire a reputable management company.
- Solicit — and listen to — the advice of experts in choosing properties, arranging financing, and selling them off.

Last, your projected **net cash flow** (cash inflow less cash outflow) is the name of the game. If the investment won't show a *positive* cash flow initially, be sure your

projection of the potential capital appreciation in the property more than makes up for those early cash flow deficits. ☐

Exhibit 4

Calculating the Real Return Of Tax-Exempts

Lessen the impact of high tax rates by moving some funds to tax-exempt bonds or tax-deferred annuities. With a 40% overall federal and state tax rate, a 5% tax-exempt security is equivalent to an 8.3% taxable security, **an increase of 66% in your annual return**. Even at an overall 30% tax rate, the 5% return on a tax-exempt security is 7.1%, *an increase of 38% in your annual return.*

But be careful; tax-exempts have risk, particularly those from governmental agencies that have run up huge deficits; and we all know there are many of them. Stay with high quality tax-exempts and be sure the security is indeed tax-exempt from federal, state, and local taxes. If it's not tax-exempt by all government bodies, adjust your financial calculations so you know your true after-tax yield vis-a-vis non-tax-exempt investments. For your use, here are the equivalent after-tax yields based on personal income tax rates of 10% through 35%.

Tax-Free Comparison

Your	— Tax-Exempt Yield —			
Tax Rate	4%	5%	6%	7%
10%	4.4	5.6	6.7	7.8
15%	4.7	5.9	7.1	8.2
25%	5.3	6.7	8.0	9.3
28%	5.5	6.9	8.3	9.7
33%	6.0	7.5	8.9	10.4
35%	6.2	7.7	9.2	10.8

Plus. The yields above are only the federal tax rate equivalents. The exemption from any state or local taxes will increase your total yield. Again, be careful of risk and illiquidity. Buy big name, popular bonds that trade actively and thus are easier to sell. Lesser known bonds usually are sold odd-lot and bring a

lower price when selling.

Yield formula. To compute the equivalent taxable yield for any tax-exempt bond, simply subtract your overall tax bracket from 1.00 and divide the difference into the stated yield. *Example:* 1.00 minus .33 tax bracket equals .67; a 5% tax-exempt yield (.50) divided by .67 equals a 7.5% equivalent after-tax yield. □

Exhibit 5

How and When to Use a Call Option

Call options can deliver additional returns on an investment gain but you have to be very careful. Options are a sophisticated technique and there are price and timing risks that must be considered. Let's provide an example of how a call option works and then we'll discuss the risks and rewards.

You own 100 shares of ABC Corp. purchased at $20 per share. The current market value is $35, a capital gain of $15 per share. *Your goal:* To make even more money on the stock and to move out your *unrealized* capital gain to another time period, say, two months from today. (Usually you do this to move a taxable gain into the following year or to qualify what would otherwise be a short-term gain as long-term.)

How it works: You sell a call option, say, for three months at the current market price of $35. What you're doing is giving someone else the right to buy your shares at $35 per share for the next three months. You charge a fee for this right, say $400 per 100 shares (4 points). *The result:* If the price of the stock stays the same (or goes up), you still have your gain of $15 per share *and* you have realized an additional profit of $4 per share (your fee for selling the call option). That $4 represents an added return of 11% on the stock's current value of $35. Over the space of a year, that 11% added return can represent an annual return of 44% (four quarters times 11%).

The big negative: If the stock drops in price (say, to $30 per share), you will incur a loss of $5 per share since the buyer of the call option will *not* exercise his right to buy the shares at $35 when the current market value is $30. However, your loss (vis-a-vis the $35 original value) is only $1 per share (a drop in price of $5 less the $4 fee you collected for selling the call option).

Two more cautions:

- Since the buyer of the call option controls the right to exercise the option (not you), there is no guarantee that you can't lose money if the stock's price drops substantially below your breakeven point (current market value less the fee received for selling the call option). For example, if the price drops to $20, your loss is $11 per share ($35 prior value less $4 fee less $20 current value).

- If the stock price rises quickly above the $35 call price, the option might be exercised right away, thus preventing your deferral of the unrealized capital gain to the following year.

Strike price: To lessen the chances of the buyer of the call option exercising the option early or before yearend, set the strike price *above* the current market value, e.g., at $38, rather than $35. This also affords you an additional profit of $3 per share but you may have to reduce your $4 per-share fee in exchange for the higher strike price.

* * *

Using option agreements to make more money, lock in a capital gain, or defer taxation should be undertaken only with expert investment and tax advice. To use a put option, please see the next page. □

Exhibit 6

How and When to Use a Put Option

Reason #1: To defer or lower taxes on a capital gain. *What a put option does*: It gives an investor the right to sell the stock at a certain fixed price for a specific period of time into the future, usually three to six months. The put option defers any tax on the capital gain until the option is exercised by the investor and the shares sold. A put option also can effectively move an *unrealized* short-term gain to long-term (held for at least 12 months). That would make the gain taxable at the maximum long-term rate of 15% rather than at short-term personal tax rates, which can go as high as 35%.

Reason #2: To lock in a gain. *Example:* You own 100 shares of ABC Corp., now selling at $60 a share. You buy a put option that allows you to sell the stock for $60. If the stock falls below $60, say, to $40, you can "put" (tender) the 100 shares to the seller of the put for $60 per share. Your cost for locking in your gain is the cost of buying the put option, usually 10% to 20% of the stock's value, depending on how long the put option is exercisable, the volatility of the stock, and its projected market value in the near term.

If the stock increases in value, say, to $80, you still collect the added per-share profit of $20, but it's reduced by the cost of the put option. In this case, you never exercise the put option, which you bought to protect against a loss, because there was no loss in the stock's market value.

Out-of-the-money options: Be aware that some put options are "out-of-the-money." That means that the investor's actual put price is lower than the stock's current fair market value. For example, using the illustration above, if the put price was $58, rather than the stock's market price of $60, you absorb the first $2 of loss. That absorbed loss must be added to the 10% to 20% cost of effecting the put option in analyzing the overall cost of using a put option to defer or reduce taxation of a capital gain.

When the option contract is *in the money,* the put price is at the same price as the stock's current fair market value. That will effectively reduce the 10% to 20% cost of the option. ☐

Exhibit 7

Installment Sale Rules and Cautions

An installment sale of appreciated assets, e.g., business ownership, real property, and non-public securities, can reduce current tax payments since the income and capital gain is recognized in the years in which installment payments are received. But before using an installment sale to defer or save taxes, consider the following advisories:

- Be aware that you are extending credit when you arrange an installment sale so be sure the buyer's credit is good. Also try to secure the installment note with the property sold, make the downpayment as high as possible, and execute a formal agreement and promissary note.

- Since tax rates may increase or you may be in a higher tax bracket in future years, you may want to realize the gain now. In contrast, if you are expecting to move into a lower tax bracket in the near future (e.g., you are retiring), an installment sale can save you taxes.

- Another way to save taxes is to use *un*realized losses on other securities you own to offset any capital gains from the installment sale.

- If you're selling certain depreciable property, e.g., equipment, the depreciation previously deducted for that equipment on your tax return could be recaptured and taxable as income in the year of sale.

- The tax deferral of an installment sale is not available for publicly traded securities. In addition, special rules apply to installment sales in excess of $150,000; check with your accountant.

- Regarding the sale of real estate, the tax rate on any depreciation recapture from prior deductions is 25%.

- In some situations, an installment sale might result in *more* taxes since you could lose valuable tax deductions based on your higher Adjusted Gross Income (AGI) in future years, e.g., education benefits and certain itemized deductions (e.g., real estate and property taxes) whose availability is based on a taxpayer's AGI. The installment payments would increase your AGI in the years they are received.

As usual, get expert advice *before* negotiating an installment sale. A thorough analysis must be made of both your current and projected taxable income, as well as the credit of the buyer. ☐

Investing When Interest Rates Are Low

The problem: The current interest rate paid on short-term certificates of deposit (CDs) is still relatively low, in the 2% to 4% range. How can you increase your income without taking on more risk?

The strategy: Ladder your CDs. This technique involves taking the total money you want to commit to fixed-income securities and dividing it into smaller, equal portions and investing each portion for varying time periods. For example, you invest one portion each in 180-day and one-year CDs. Then invest the third and fourth portions in a 2-year and a 5-year CD. Finally, take the fifth portion and put it into a high-quality, short-term bond fund.

Note: We use bank CDs in this explanation, but the concept of laddering your investment purchases applies to many investment instruments, including bonds, tax-exempts, zero coupon bonds, and Treasury obligations, all of which can have varying yields and maturity dates. (Laddering doesn't apply to money-market funds since they have no maturity dates.)

The result: You increase your overall interest income and you have the opportunity to increase it even more if interest rates move higher. *How:* By re-investing the earlier maturities as they come due and are paid to you.

Why this approach works: Each CD earns a different interest rate, with the longer maturities earning the highest rates. By laddering your investments, you will earn more on average than if you bought a single, short-term maturity. In addition, you will *always* have a CD maturing every year or two, giving you cash to reinvest at higher rates if interest rates increase. As the longer maturities come due, you might want to adjust some of them to shorter maturities so you always have one or two CDs coming due within one year. That means you always will have cash available to invest if interest rates move upward. ☐

Exhibit 9

Personal Tax Rates and Taxable Income for 2007

Table 1 — Personal Tax Rates for 2007 — Married, Filing Jointly and Single Taxpayers (see box below)

Note — Personal Tax Rates also apply to the owners of S Corporations, Partnerships, Limited Liability Companies, and Sole Proprietorships.

2007 Tax Data Taxable Income	Marginal Tax Rate	Taxes Payable	Cumulative Income	Cumulative Taxes	Overall Tax Rate
First $15,650	10%	$ 1,565	$ 15,650	$ 1,565	10.0%
Next $48,050	15%	$ 7,208	$ 63,700	$ 8,773	13.8%
Next $64,800	25%	$16,200	$128,500	$24,973	19.4%
Next $67,350	28%	$18,858	$195,850	$43,831	22.4%
Next $153,850	33%	$50,770	$349,700	$94,601	27.1%
Over $349,700	35%				

Table 2 — Range of Taxable Income for 2007

Married, Filing Jointly	Single Taxpayers	Tax Rate
$0 to 15,650	$0 to 7,825	10%
$15,651 to 63,700	$7,826 to 31,850	15%
$63,701 to 128,500	$31,851 to 77,100	25%
$128,501 to 195,850	$77,101 to 160,850	28%
$195,851 to 349,700	$160,851 to 349,700	33%
Income over $349,700	Income over $349,700	35%

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