Web Chapter 17

Tax-Advantaged Investments

On May 6, 2003, tax law changes partially leveled the playing field for investments that pay regular dividends. Previously, dividends had been taxed at ordinary (15%–39.6%) rates, and capital gains had been taxed at the lower capital gains (10% or 20%) rate. The current tax law has cut the 20% and 10% individual rates on long-term capital gains to 15% and 5%, respectively. Dividends received by an individual shareholder from domestic and qualified foreign corporations are now generally taxed at the same rates that apply to capital gains. A 15% tax rate on dividends applies to individuals in any marginal income tax bracket greater than 15%, while a 5% rate applies to individuals in the 10% and 15% brackets, with the 5% rate going to zero in 2008. In May 2006, the dividend tax rates were extended to dividends received through the end of 2010.

Still, there may be an advantage to owning a growth stock that appreciates in value but doesn't pay dividends. The reason: The taxation of capital gains is postponed until the stock is sold, whereas dividends are taxed throughout the holding period. A great example of such an investment is Google (Nasdaq: GOOG), the leading Internet search company. Despite the technology sector's volatility, investors who bought and sold at the right time could have benefited greatly. For example, since Google went public on August 19, 2004, its shares had risen to around $377 per share by mid-August 2006, an increase of 94% per year. However, such returns come with significant risk: At $377 per share, Google was trading at almost $100 less than its 52-week high of $475.11, reached on January 11, 2006. Also, like many growth companies, particularly in technology, Google does not pay dividends. The return comes totally from price appreciation, on which the investor defers taxes until the stock is sold.

As you will see in this chapter, taxation plays a decisive role in the investment process. An awareness of the vehicles and strategies for legally reducing one's tax liability can help investors shelter their investment profits.

Learning Goals

After studying this chapter, you should be able to:

LG 1 Understand what taxable income is and how to calculate it.

LG 2 Define tax avoidance and tax deferral, and cite the characteristics of tax shelters.

LG 3 Explain the basic strategies by which investors can earn tax-favored income.

LG 4 Summarize the characteristics of deferred annuities.

LG 5 Describe the tax status of limited partnerships and limited liability companies and their investment characteristics.

Tax Fundamentals

LG 1

It is often said that the necessities of life include food, clothing, and shelter. Shelter protects us from the elements—rain, wind, snow, extreme heat or cold—in the physical environment. Similarly, investors need shelter from the taxes charged on income; without adequate protection, investors' returns can be greatly reduced by the ravages of the tax code. Thus, in making investment decisions, we must assess not only risk and return but also the tax effects associated with a given investment vehicle or strategy. Because tax effects depend on one's "tax bracket," it is important to choose investment vehicles that provide the maximum after-tax return for a given risk. Making such choices is part of **tax planning**, which involves the formation of strategies that will exclude, defer, or reduce the taxes to be paid.

tax planning
the formulation of strategies that will exclude, defer, or reduce the taxes to be paid.

tax-advantaged investments
vehicles and strategies for legally reducing one's tax liability.

You should make tax planning an essential part of your investment strategy. An awareness of **tax-advantaged investments**, which are vehicles and strategies for legally reducing one's tax liability, and an understanding of the role they can play in a portfolio are fundamental to obtaining the highest after-tax returns for a given level of risk. We begin this chapter by looking at tax fundamentals.

The provisions of the tax code may change annually with regard to tax brackets amounts and types of deductions and personal exemptions, and similar items. Often these changes are not finalized until late in the year. Major tax law revisions occur less frequently, but present much greater tax planning opportunities. Table 17.1 summarizes the highlights of the Economic Growth and Tax Relief Reconciliation Act which Congress passed in 2001. In 2003, Congress passed the Jobs and Growth Tax Relief Reconciliation Act of 2003 which advanced the implementation of the 2001 tax law provisions and produced several additional changes to the tax code (see Table 17.2 on page 17-4). The Working Families Tax Relief Act of 2004 resulted in some additional favorable tax refinements for working familites. The tax rates and example calculations in this chapter reflect the tax laws applicable to calendar year 2006—the most current for which full rate schedules and regulations were available. (Please refer to our Web site for the latest tax information.) *Although tax rates and other provisions can change, the basic procedures will remain the same*. When doing your own tax planning, you should of course, review the current regulations, IRS publications, and other tax preparation guides.

As currently structured, federal income tax law imposes a higher tax burden on higher taxable income. This is done through a progressive rate structure that taxes income at one of six rates: 10, 15, 25, 28, 33, 35%. There are four tax filing categories including single, married filing jointly, married filing separately, and head of household. Of these, single and married/filing jointly are most commonly used by taxpayers. Table 17.3 on page 17-4 shows the tax rates and income brackets for these two major filing categories in 2006. Note that you pay not only more taxes as your taxable income increases but also *progressively* more if your taxable income rises into a higher bracket.

Taxable Income

taxable income
the income to which tax rates are applied; equals adjusted gross income minus itemized deductions and exemptions.

Taxable income is the income to which tax rates are applied. From an investments perspective, this includes such items as cash dividends, interest, profits from a sole proprietorship or share in a partnership, and gains from the sale of

TABLE 17.1 Key Provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001

The tax-cut plan passed by Congress in mid-2001 lowered tax rates, increased or added new deductions and tax credits, reduced the top estate tax rate, and increased the estate tax exemption. Most of the bill's provisions, however, expire in 2010. The highlights include:

- **Addition of 10% bracket**. Effective at the beginning of 2001, a 10% tax rate applied to the first $6,000 (increased to $7,000 in 2003) of taxable income for singles, $10,000 for head of household and $12,000 (increased to $14,000 in 2003) for married couples.
- **Reduction in top income tax rates.** In addition to the new 10% tax rate, the other tax rates, except for the 15% bracket (paid by about 75% of taxpayers) were scheduled to gradually decrease by approximately 3% from 2003 to 2006. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) (See Table 17.2 on page 17-4) accelerated the scheduled tax rate reductions into 2003.

Current rate	2002–3*	2004–5	2006+
28%	27%	26%	25%
31%	30%	29%	28%
36%	35%	34%	33%
39.6%	38.6%	37.6%	35%

*The first reduction is effective July 1, 2001, and applies to the second half of the year, 2001.

- **Increase in the child tax credit.** The child tax credit for each under-age-17 dependent child, stepchild, foster child, or grandchild rose from $500 to $600 in 2001 and was scheduled to rise to $1,000 by 2010. The JGTRRA of 2003 accelerated the increase to $1,000 into 2003. The child tax credit can be claimed in part by workers making a little over $10,000 a year, even if they owe no income tax.
- **Phaseout of the marriage penalty.** The 2001 law planned to reduce the marriage penalty for married couples by increasing the standard deduction and the 15% tax bracket over a six-year period starting in 2005. The JGTRRA of 2003 accelerated those changes into 2003.
- **Repeal of the estate tax.** The top estate tax rate (55% in 2001) fell to 50% in 2002 and decreases by 1% per each year thereafter until it reaches 45% in 2007. The bill increased the estate tax exemption to $1 million in 2002–2003 and it increases to $1,500,000 for 2004–2005, $2,000,000 for 2006–2008 and finally reach $3,500,000 in 2009. Estate taxes are scheduled to be repealed in 2010 (the gift tax will remain), but reappear in 2011 with the exemption reverting back to $1,000,000.
- **Expanded retirement contributions.** Contribution limits for most types of retirement plans increased. For example, annual IRA contributions increased from $2,000 in 2001 to $3,000 in 2002–3004, to $4,000 in 2005–2007, and $5,000 in 2008 and beyond. If you are age 50 or older, you can contribute even more to your IRA. Contribution limits for 401(k), 403(b) and 457 account plans also rose, to $11,000 in 2002, $12,000 in 2003, $13,000 in 2004 and will continue to increase to $15,000 in 2006. Thereafter, the limits for all employer-sponsored programs will be adjusted for inflation in $500 increments.
- **Education benefits**. A new deduction for higher education expenses was introduced in 2002. In 2004 and 2005, the maximum deduction is $4,000, but it will expire in 2006.

Source: Bill Bischoff, "A Bush Tax Cut Tutorial." *Smartmoney.com*, May 31,2001, **www.smartmoney.com/taxmatters/index.cfm?story=20010531**; and Shailagh Murray and Gregg Hitt, "Tax-Cut Bill Moves to Bush's Desk But Some Cuts Still Face Hurdles," *The Wall Street Journal*, May 29, 2001, pp. A3, A10.

securities or other assets. Federal tax law makes an important distinction between ordinary income and capital gains (and losses).

To review, *ordinary income* broadly refers to any compensation received for labor services (active income) or from invested capital (portfolio or passive income). The form in which the income is received is immaterial. For example, if you owe a debt to someone and that person forgives the debt (excuses you from repaying it), you may still have to report the amount as taxable income, depending on how the debt was initially created and treated for tax purposes in previous periods. As a general rule, *most income is taxable income, and unless it is considered a long-term capital gain or dividend, it is ordinary income.*

TABLE 17.2 Key Provisions of the Jobs and Growth Tax Relief Reconciliation Act of 2003

- **Accelerated 10% tax bracket expansion**. The 10% tax bracket for singles increased from $6,000 in 2002 to $7,000 in 2003 and beyond while the amount for married couples filing jointly increased to $14,000.
- **Accelerated reduction in income tax rates.** The scheduled reductions in marginal tax rates were accelerated into 2003 resulting in new rates of 25%, 28%, 33% and 35% (in addition to the 10% and 15% brackets).
- **Accelerated reduction of marriage penalty.** The standard deduction for married couples was increased to double the amount of the standard deduction for single taxpayers for 2003 and 2004. The width of the 15% tax bracket for married couples was increased to twice the width for the single taxpayers in 2003 and 2004. These provisions were scheduled to phase-in over the period between 2005 and 2009.
- **Accelerated increase in the child tax credit**. The amount of the child tax credit was increased to $1,000 for 2003 and 2004 (from $600), accelerating a scheduled phase-in over the period between 2005 and 2010.
- **Reductions in tax rates on dividends and capital gains.** The maximum tax rate on dividends paid by corporations to individuals and on individuals' long-term capital gains is reduced to 15% in 2003 through 2008. For taxpayers in the 10% and 15% tax brackets, the rate on dividends and long-term capital gains is reduced to 5% in 2003 through 2007, and to zero in 2008. The new tax rates applied to capital gains realized on or after May 6, 2003 and to dividends received in 2003 and after.

Source: **www.ustreas.gov/press/releases/js408.htm**, May 22, 2003. Downloaded February 11, 2004.

capital asset
anything owned and used for personal reasons, pleasure, or investment.

basis
the amount paid for a capital asset, including commissions and other costs related to the purchase.

The tax law as revised by the *Jobs and Growth Tax Relief Reconciliation Act of 2003* treats gains or losses from the sale of capital assets differently from ordinary income. A **capital asset** is defined as anything you own and use for personal reasons, pleasure, or investment. A house and a car are capital assets; so are shares of common stock, bonds, and even stamp collections. Your **basis** in a capital asset usually means what you paid for it, including commissions and other costs related to the purchase. If an asset is sold for a price greater than its basis, a *capital gain* is the result; if the reverse is true, then you have a *capital loss*. The exception to this rule is that capital losses for personal property (home and auto, for example) cannot be claimed as a loss for tax purposes. Depending on how long the capital asset was held, the capital gain may be taxed at a lower rate than that applicable to ordinary income. (*Note:* The tax rates applicable to capital gains were described in Chapter 1 and are also discussed in the following section.) As for capital losses, a maximum of $3,000 of losses in excess of capital gains can be claimed in any one year. Any losses that cannot be applied in the current year can be carried forward to future years and then deducted. (Timing the sale of securities to optimize the tax treatment of capital gains and losses, which is an important part of tax planning, is treated more thoroughly later in this chapter.)

TABLE 17.3 Tax Rates and Income Brackets for Individual and Joint Returns (2006)

	Taxable Income	
Tax Rates	Individual Returns	Joint Returns
10%	$0 to $7,550	$0 to $15,100
15%	$7,551 to $30,650	$15,101 to $61,300
25%	$30,651 to $74,200	$61,301 to $123,700
28%	$74,201 to $154,800	$123,701 to $188,450
33%	$154,801 to $336,550	$188,451 to $336,550
35%	Over $336,551	Over $336,551

Determining Taxable Income

Determining taxable income involves a series of steps. Because these are illustrated more clearly with an example, let us consider the 2006 income tax situation of the Edward and Martha Meyer family, a family of three, including their 17-year-old child. In 2006, the family had the following income items:

1. Wages and salaries	
Edward	$40,000
Martha	25,000
2. Interest on tax-free municipal bonds	400
3. Interest on savings accounts	900
4. Dividends on common stock	600
5. Capital gains on securities (all held for less than 1 year)	1,500

The family also had the following deductions in 2003:

1. Deductible contribution to IRA account	$ 3,000
2. Interest on home mortgage	9,050
3. Property taxes	1,750
4. Charitable contributions	1,000
5. State and local income taxes	2,800

The Meyers' income tax due for 2006 was $5,260.00, as determined in Table 17.4 on page 17-6 and explained below.

gross income
all includable income for federal income tax purposes.

Gross Income **Gross income** begins with all includable income but then allows certain exclusions that are provided in the tax law. Table 17.4 shows that in the Meyers' case, all income is included except interest on the tax-free municipal bonds, which is not subject to federal income tax. Note that interest on savings accounts and dividend income are both included as well as all capital gains.

adjusted gross income
gross income less the total allowable adjustments for tax purposes.

standard deduction
an amount, indexed to the cost of living, that taxpayers can elect to deduct from adjusted gross income without itemizing.

Adjustments to Gross Income Adjustments to gross income reflect the intent of Congress to favor certain activities. The only one shown for the Meyers is their allowable IRA contribution of $3,000. You should note the tax-sheltering quality of the IRA; without it, the Meyers would have paid taxes on an additional $3,000 of income for 2006.

Adjusted Gross Income Subtracting the adjustments from gross income yields **adjusted gross income**. This figure is necessary in calculating certain deductions (e.g., medical and dental expenses, charitable contributions, job and other expenses, and the amount of allowable property losses) not illustrated in our example. The Meyers' adjusted gross income is $65,000.

HOTLINKS

Making out their tax return is probably near the top of the list of things people do not like to do. Unfortunately, taxes are a must for virtually every American adult. The majority of taxpayers have similar difficulties in preparing their returns. A variety of Web sites offer help on the most commonly asked questions. The following site addresses some general-interest personal tax topics.

www.investorguide.com/igup1-taxes.htm

Itemized Deductions Taxpayers can elect to take a **standard deduction,** which is indexed to the cost of living, or itemized deductions, whichever is larger. The standard deduction for 2006 ranged from $5,150 to $14,300, depending on filing status, age, and vision. (There are specific deductions for taxpayers who are age 65 or older and/or blind.) The standard deduction for the Meyers, if they choose to take it, is $10,300.

TABLE 17.4 Determining the 2006 Federal Income Tax Due for the Edward and Martha Meyer Family

I. GROSS INCOME	
1. Wages and salaries ($40,000 + $25,000)	$65,000
2. Interest on savings accounts	900
3. Dividends	600
4. Capital gains	1,500
Gross income	$68,000
II. ADJUSTMENTS TO GROSS INCOME	
Deductible IRA contribution	$ 3,000
III. ADJUSTED GROSS INCOME (I − II) = ($68,000 − $3,000)	$65,000
IV. ITEMIZED DEDUCTIONS	
1. Mortgage interest	$ 9,050
2. Property taxes	1,750
3. Charitable contributions	1,000
4. State and local income taxes	2,800
Total itemized deductions	$14,600
V. EXEMPTIONS	
Edward, Martha, and one child (3 × $3,300)	$ 9,900
VI. TAXABLE INCOME (III − IV − V) = ($65,000 − $14,600 − $9,900)	$40,500
VII. FEDERAL INCOME TAX (rate schedule in Table 17.3)	
Tax Calculation: $15,100 × 10% = $1,510.00 (10% Bracket)	
$24,800 × 15% = $3,720.00 (15% Bracket)	
$ 600 × 5% = $ 30.00 (Dividend tax rate)	
$5,260.00	
VIII. TAX CREDITS	$ 0
IX. TAX DUE (VII − VIII) = $5,260.00 − $0	$ 5,260.00

If they don't wish to take the standard deduction, taxpayers can choose to *itemize deductions*. Taxpayers with itemized deductions in excess of the applicable standard deduction will prefer to itemize. This group typically includes those individuals or families who own a mortgaged primary and/or second home. Such was the case with the Meyers, because their itemized deductions of $14,600 exceeded the $10,300 standard deduction.

itemized deductions
personal living and family expenses that can be deducted from adjusted gross income.

A number of personal living and family expenses qualify as **itemized deductions**; the most common are residential mortgage interest, property taxes, state and local income taxes, charitable contributions, and medical and dental expenses (in excess of 7.5% of adjusted gross income). All other things being equal, there is a tax advantage to ownership of a principal (and even of a second) residence, because interest on the associated mortgage loans is tax-deductible. Consumer interest (such as interest paid on credit card accounts) is *not* tax-deductible, whereas investment interest—interest paid on funds borrowed for personal investment purposes—is deductible, subject to certain limitations. Clearly, tax deductibility reduces the cost of allowable interest charges.

exemption
a deduction from adjusted gross income for each taxpayer and each qualifying dependent of a federal taxpayer.

Exemptions The tax law allows a deduction, called an **exemption**, for each taxpayer and each qualifying dependent. Specific rules determine who qualifies as a dependent. These should be reviewed if the potential dependent is not

INVESTOR FACTS

A CHECKLIST OF DEDUCTIBLE INVESTMENT EXPENSES—The following investment expenses are deductible as miscellaneous itemized deductions subject to the 2% adjusted gross income (AGI) floor.

- Accounting and tax fees for keeping records of investment income
- Bank and brokerage fees
- Fees for a safe-deposit box to hold securities
- Investment management or financial planning fees
- Employee salaries to keep track of your investment income
- Travel costs to look after investments or to confer with your attorney, accountant, or investment counsel

your child or an immediate member of your family residing in your home. Table 17.4 shows that the Meyers claimed three exemptions. The personal exemption in 2006 was $3,300. When taxpayers have adjusted gross income above specified values ($150,500 for single taxpayers and $225,750 for married taxpayers filing jointly in 2006), their allowable exemptions are reduced by formula. The restrictions on personal exemptions constitute an area addressed by the Economic Growth and Tax Relief Reconciliation Act of 2001. The phase-out limits will themselves be phased out by year 2009.

Taxable Income Subtracting itemized deductions and exemptions from adjusted gross income leaves *taxable income;* in the Meyers' case, this amount is $40,500. Although the Meyers have none, certain *miscellaneous expenses,* which include union dues, safe-deposit box rent, investment advice, membership dues for professional organizations, and the cost of business publications, generally can be deducted only to the extent that they exceed 2% of adjusted gross income. In addition, certain *unreimbursed employee expenses,* such as 50% of entertainment bills, 100% of travel expenses, and 50% of meal expenses, are deductible if substantiated by receipts.

You can use Table 17.3 to calculate the tax due for the Meyers. Their taxable income of $40,500 puts them in the 15% income bracket. Thus, their tax, as calculated in the table, is $5,260.00. The Meyers pay a 15% **marginal tax rate**, which means the tax rate on additional income up to $61,300 is 15%. *It is the marginal tax rate that should be considered when evaluating the tax implications of an investment strategy.*

marginal tax rate
the tax rate on additional income.

average tax rate
taxes due divided by taxable income; different from the *marginal tax rate.*

Do not confuse the marginal tax rate with the average rate. The **average tax rate** is simply taxes due divided by taxable income. The Meyers' average tax rate is 12.99% ($5,260 ÷ $40,500). For taxpayers in the 15, 25, 28, 33 and 35% tax brackets, the marginal will exceed the average tax rate. The average tax rate has absolutely no relevance to the Meyers' investment decision making.

tax credits
tax reductions allowed by the IRS on a dollar-for-dollar basis under certain specified conditions.

Tax Credits A number of **tax credits** are available. These are particularly attractive because they reduce taxes on a dollar-for-dollar basis, in contrast to a *deduction*, which reduces taxes only by an amount determined by the marginal tax rate. Two frequently used tax credits are the credit for child and dependent care expenses and the adoption tax credit. Other common tax credits include the credit for the elderly or the disabled, foreign tax credit, credit for prior year minimum tax, mortgage interest credit, and credit for a qualified electric vehicle. The Meyers were not eligible for any tax credits.

Taxes Due or Refundable The final amount of tax due is determined by subtracting any tax credits from the income tax. The Meyers' tax due is $5,260. They now compare this amount to the total of tax withheld (indicated on their year-end withholding statements) and any estimated taxes they paid during 2006. If these two add up to more than $5,260.00, then they are entitled to a refund of the difference; if the total is less than $5,260.00, they must pay the difference when they file their 2006 federal income tax return.

alternative minimum tax (AMT)
a tax passed by Congress to ensure that all individuals pay at least some federal income tax.

The Alternative Minimum Tax As a result of many taxpayers effectively using tax shelters (tax-favored investments) to reduce their taxable incomes to near zero, Congress in 1978 introduced the **alternative minimum tax (AMT)**.

The purpose of this law is to raise additional revenue by making sure that all individuals pay at least some tax. The AMT rate is 26% of the first $175,000 of the alternative minimum tax base and 28% of the excess. The AMT base is determined by making adjustments to the individual's regular taxable income. The procedures for determining the alternative minimum tax base and the alternative minimum tax are quite complicated. You should consult a tax expert if you think the alternative minimum tax might apply in your situation.

CONCEPTS IN REVIEW

Answers available at: www.myfinancelab.com

17.1 What is *tax planning?* Describe the current tax rate structure and explain why it is considered progressive.

17.2 What is a *capital asset?* Explain how capital asset transactions are taxed, and compare their treatment to that of ordinary income.

17.3 Describe the steps involved in calculating a person's taxable income. How do tax credits differ from tax deductions?

Tax Strategies

LG 2

A comprehensive tax strategy attempts to maximize the total after-tax income of an investor over his or her lifetime. The goal is either to avoid taxable income altogether or to defer it to another period when it may receive more favorable tax treatment. Even when deferral does not reduce one's taxes, it still gives the investor the use of saved tax dollars during the deferral period.

Tax Avoidance and Tax Deferral

tax evasion illegal activities designed to avoid paying taxes by omitting income or overstating deductions.

tax avoidance reducing or eliminating taxes in *legal ways.*

Tax avoidance is quite different from **tax evasion**, which consists of illegal activities such as omitting income or overstating deductions. **Tax avoidance** is concerned with *legal ways* of reducing or eliminating taxes. As we have already noted in the Meyers example, the most popular form of tax avoidance is investing in securities that offer tax-favored income (to be explained in greater detail in the next section). Another broad approach to avoiding taxes is to distribute income-producing assets to family members (usually children) who either pay no taxes at all or pay them at much lower rates. Because this is also a highly specialized area of the tax law, we do not pursue it further in this text. Again, you should seek professional counsel whenever you contemplate a tax strategy of this type.

tax deferral the strategy of delaying taxes by shifting income subject to tax into a later period.

Tax deferral deals with means of delaying taxes and can be accomplished in a number of ways. Frequently, taxes are deferred for only one year as part of a year-end tax strategy to shift income from one year to the next when it is known that taxable income or tax rates will be lower. More often, the tax deferral is part of a longer-term tax deferral strategy involving retirement planning. A simple way to defer taxes is to use vehicles specifically designed to accomplish this objective—401(k)s, Keoghs, and IRAs—and annuities. The role of each of these vehicles is described later in this chapter.

Tax Shelters

tax shelter
an investment vehicle that offers potential reductions of taxable income.

A **tax shelter** is any investment vehicle that offers potential reductions of taxable income. Usually, you must own the vehicle directly, rather than indirectly. For example, if the Meyers had incurred a tax-deductible loss of $1,000 on investment property directly owned by them, it could have provided a tax shelter. Had they instead set up a corporation to own this property, the net loss of $1,000 would have been the corporation's, not theirs. Thus, they could not have claimed that tax deduction and the related tax savings on their individual tax return. Similarly, when publicly owned corporations show huge losses, those losses are of no immediate tax benefit to the shareholders. Although the market price of the stock probably falls, which means you could sell it at a tax loss, such a capital loss is limited to $3,000 a year (in excess of capital gains). If you owned a large amount of stock, your loss might be many times that amount and yet be of no immediate use in reducing your taxes.

Thus, there is a tax advantage in organizing certain activities as sole proprietorships or partnerships, and even more specifically, as limited partnerships. The majority of these business forms can pass on losses resulting from certain deductions—depreciation, depletion, and amortization—directly to individual owners. The amount, if any, of such losses that can be deducted when calculating taxable income is currently limited by law. The few remaining tax shelters and the structure of the limited partnerships that are commonly used to organize them are explained later in this chapter. Now, however, let us turn our attention to those vehicles that offer tax-favored income.

CONCEPTS IN REVIEW

Answers available at: www.myfinancelab.com

17.4 How does *tax avoidance* differ from *tax deferral?* Explain whether either of these is a form of *tax evasion.*

17.5 What is a *tax shelter?* What is the tax advantage of organizing certain business activities as a sole proprietorship or a partnership rather than as a corporation?

Tax-Favored Income

LG 3

tax-favored income
an investment return that is not taxable; is taxed at a rate less than that on other, similar investments; defers the payment of tax to a later period; or trades current income for capital gains.

An investment is said to offer **tax-favored income** if it has any of the following results:

1. Offers a return that is not taxable.
2. Offers a return that is taxed at a rate less than that on other, similar investments.
3. Defers the payment of tax to a later period—typically to the next year or to retirement.
4. Trades current income for capital gain income.

These tax "favors" have been written into the tax law to foster or promote certain activities as well as to provide convenient tax-reporting procedures. In Web Chapter 18, we examine in detail how real estate can provide shelter from taxes

for certain investors. Here, we briefly examine a number of other noteworthy tax-sheltered vehicles and strategies; later in the chapter, we'll look at two other vehicles: deferred annuities and single-premium life insurance.

Income Excluded from Taxation

Some items are simply *excluded from taxation,* either totally or partially. These include interest earned on tax-free municipals and on Treasury and government agency issues, as well as certain proceeds from the sale of a personal residence. Tax exclusion was written into the tax code for these vehicles in order to encourage investment in them. (If Congress so decided, the tax exclusions on these investment vehicles could be removed.)

Tax-Free Municipal Bond Interest Municipal bonds were described in Chapter 10. All interest received from the most common form—tax-free municipals—is free of federal income tax. However, any gains or losses resulting from the sale of municipal bonds must be included as capital gains or losses. In addition, interest paid on money borrowed to purchase municipal bonds is *not* tax-deductible.

Treasury and Government Agency Issues Treasury and government agency issues were also discussed in Chapter 10. Although interest on these securities is included as income on the federal tax return, for most issues it is excluded for state and local income tax purposes. States and localities are prohibited from taxing interest income derived from federal government debt in order to make it easier and less expensive for the federal government to borrow to finance its operations. Because combined state and local income tax rates can be as high as 20%, individuals in high tax brackets may find such exclusions worthwhile.

Sale of Personal Residence A capital gain results if you sell your personal residence for a price greater than its basis (the price originally paid for it). However, a tax provision aimed at stimulating home ownership softens the tax impact and actually makes investment in a home an excellent tax shelter. On individual returns, a taxpayer who has owned and used a property as a principal residence for at least two years can exclude up to $250,000 of the gain from its sale. On a joint return, the exclusion applies to as much as $500,000. Under the right conditions, this exclusion can be used as frequently as every two years, and a partial exclusion may be available under special circumstances described in the tax code. If a personal residence is sold for a price lower than its basis, a capital loss results. Note, however, that capital losses for personal use assets (personal residence and personal auto) are not deductible for individual income tax purposes.

Strategies That Defer Tax Liabilities to the Next Year

Very often, an investor may enjoy sizable gains in a security's value with a relatively short period of time. Suppose you bought 100 shares of XYZ common stock in early 2006 at $30 a share and by year-end 2007 your investment has increased in value by 50%, to around $45 per share. Assume that at year-end 2007, after 21 months of ownership, you believe the stock price has just

about peaked and you wish to sell it and invest the $4,500 elsewhere. In such a case, you would be taxed on a long-term capital gain of $1,500 ($4,500 − $3,000 cost). Now, even though you're in the 25% tax bracket, *you would qualify for a 15% tax rate on the capital gain because the stock was held for more than 12 months*. You therefore owe income taxes for 2007 of $225 on the sale. However, you wish to defer tax on this transaction to the following year (2008). Two available strategies for preserving a gain while deferring tax to the following year are (1) a put hedge and (2) a deep-in-the-money call option.

put hedge
the purchase of a put option on shares currently owned, to lock in a profit and defer taxes on the profit to the next tax year.

Put Hedge The put hedge can be used to lock in a profit and defer the taxes on the profit to the next tax year, without losing the potential for additional price appreciation. Essentially, a **put hedge** involves buying a *put,* which, as noted in Chapter 14, is an *option* that enables its holder to sell the underlying security at a specified price over a set period of time, on shares currently owned. (Options were discussed in Chapter 14.) If the price of the stock falls, your losses on the shares are offset by the profit on the put option. For example, suppose that when XYZ was trading at $45, you purchased for $150 a six-month put option with a contractual sale price of $45. By doing this, you locked in a price of $45: If the price fell to, say, $40 a share, your $500 loss on the stock would be offset exactly by a $500 profit on the option. However, you would still be out the $150 cost of the option. At a closing price of $40 and a 25% tax rate, your ending after-tax position would be as follows:

1. Initial cost of 100 shares		$3,000
2. Profit on 100 shares [100 × ($40 − $30)]		1,000
3. Profit on the put option	$ 500	
4. Cost of the put option	− 150	
5. Taxable gain on put option [(3) − (4)]		350
6. Total tax on transaction		
Profit on stock ** (2)	$1,000	
Plus taxable gain on put	+ 350	
Total gain	$1,350	
Times tax rate	× .25	
Total tax		337.50
7. After-tax position [(1) + (2) + (5) − (6)]		$4,012.50

**Assumes short term capital gain as a result of a holding period of less than one year.

The final after-tax position in this example is about the same as if you had simply held the stock while its price declined to around $43.50 a share. However, keep in mind two important points: (1) The put hedge locks in this position regardless of how low the price might fall, whereas simply holding the stock does not, and (2) any price appreciation will be enjoyed with either approach.

deep-in-the-money call option
a tax-deferral strategy that involves selling a call option on shares currently owned, thus locking in a price equal to the amount received from the sale of the call option but giving up future price appreciation.

Deep-in-the-Money Call Option Selling a **deep-in-the-money call option** is a strategy similar to the put hedge, but with important differences: In this case, you give up any potential future price increases, and you lock in a price only to the extent of the amount you receive from the sale of the call, which, as noted in Chapter 14, is an option that gives its holder the right to buy the underlying security at a specified price over a set period of time.

To illustrate, suppose that call options on XYZ with a $40 contractual buy price and six-month maturity were traded at $600 ($6 per share) when XYZ was selling for $45. If six months later XYZ closed at $40, it would result in this ending after-tax position:

1. Initial cost of 100 shares		$3,000
2. Profit on 100 shares [100 × ($40 − $30)]		1,000
3. Profit on the sale of the option; because the stock closed at the contractual buy price of $40, profit is the total amount received		600
4. Total tax on transaction		
Profit on stock ** (2)	$1,000	
Plus profit on option (3)	+ 600	
Total gain	$1,600	
Times tax rate	× .25	
Total tax		400
5. After-tax position [(1) + (2) + (3) − (4)]		$4,200

**Assumes short term capital gain as a result of a holding period of less than one year.

This final after-tax position is better than with the put hedge, but it closes off any price appreciation. In effect, when you sell the call option, you are agreeing to deliver your shares at the option's contractual buy price. If the price of XYZ increases to, say, $50 or beyond, you do not benefit, because you have agreed to sell your shares at $40. Furthermore, your downside protection extends only to the amount received for the option—$6 per share. Therefore, if XYZ's price went to $35, you would lose $4 a share before taxes [$45 − ($35 + $6)].

Summary of the Strategies As you can see, deferring tax liabilities to the next year is a potentially rewarding activity requiring the analysis of a number of available techniques. The choice can be simplified by considering which method works best given one's expectation of the future price behavior of the stock. Table 17.5 summarizes how each strategy performs under different expectations of future price behavior.

To complete the analysis, you would have to consider commission costs—something we have omitted. Although these costs can be somewhat high in absolute dollars, they are usually a minor part of the total dollars involved if the

TABLE 17.5 Ranking of Strategies to Defer Tax Liabilities to the Next Year Given Different Expectations About the Future Price of the Stock

Strategy	Price Will Vary by a Small Amount Above or Below Current Price	Price Will Vary by a Large Amount Above or Below Current Price	Future Price Will Be Higher than Current Price	Future Price Will Be Lower Than Current Price
Do nothing—hold into next tax year	2	4	1	4
Put hedge	3+	1	2	2
Sell deep-in-the-money call option	1	2+	3	3

Note: Ranking: 1, best; 4, worst.

potential savings are as large as the ones we have been considering in our examples. However, if the savings are relatively small—say, under $500—then commissions may be disproportionately large in relation to the tax savings and/or deferral. Clearly, you need to work out the specific figures for each situation.

Programs That Defer Tax Liabilities to Retirement

As noted in Chapter 1, accumulating funds for retirement is the *single most important reason for investing*. A large part of the retirement income of many people comes from Social Security and basic employer-sponsored programs. Such programs may be totally funded by the employer, may require employee contributions, or may involve a combination of employer and employee contributions. Here we focus on arrangements that give the employee (or self-employed person) an option to contribute to a retirement program that provides tax shelter by deferring taxes to retirement. Four such programs are 401(k) plans, Keogh plans, SIMPLE IRAs and individual retirement arrangements (Traditional and Roth IRAs).

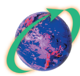
401(k) plans
retirement programs that allow employees to divert a portion of salary or wages to a company-sponsored tax-sheltered savings account, thus deferring taxes until the funds are withdrawn.

guaranteed investment contracts (GICs)
portfolios of fixed-income securities with guaranteed competitive rates of return that are backed and sold by insurance companies.

401(k) Plans

Many employers offer their employees *salary reduction plans* known as **401(k) plans**. (*Note:* Although our discussion here will center on 401(k) plans, similar programs are also available for employees of public, nonprofit organizations; known as *403(b)* plans, they offer many of the same features and tax shelter provisions as 401(k) plans.) Basically, a 401(k) plan gives you, as an employee, the option to divert a portion of your salary or wages to a company-sponsored tax-sheltered savings account. Taxes on both the salary (wages) placed in the savings plan and the investment earnings accumulated are deferred until the funds are withdrawn.

Generally, participants in 401(k) plans are offered several options for investing their contributions—typically, a money market fund, company stock, one or more equity funds, or a guaranteed investment contract (GIC). About 45% of all 401(k) plan investments are made in **guaranteed investment contracts (GICs)**, which are portfolios of fixed-income securities with guaranteed competitive rates of return that are backed and sold by insurance companies. A firm's pension plan manager buys large GIC contracts and invests employees' 401(k) contributions in them.



Of course, *taxes will have to be paid on 401(k) funds eventually, but not until you start drawing down the account at retirement*. At that point, presumably, you will be in a lower tax bracket. A special attraction of most 401(k) plans is that the firms offering them often "sweeten the pot" by matching all or part of your contribution (up to a set limit). Currently, about 85% of the companies that offer 401(k) plans have some type of matching contribution program, often putting up $0.50 (or more) for each $1 contributed by the employee. Such matching programs provide both tax and savings incentives to individuals and clearly enhance the appeal of 401(k) plans.

In 2006 an individual could put as much as $15,000 (depending on salary level) into a tax-deferred 401(k) and 403(b) plan. Each year the limits for all employer-sponsored retirement plans are adjusted for inflation in $500 increments. To encourage savings for retirement, such contributions are "locked up" until the employee turns 59½ or leaves the company. A major exception to this rule lets employees tap their accounts, without penalty, in the event of any of a number of clearly defined "financial hardships."

INVESTING *in Action*

Don't Ignore Your 401(k) Plan

Traditional pension plans—funded by employers and managed by professionals—are on the decline. The chances are that you'll have to manage your own defined-contribution plan—401(k)s at private firms and the similar 403(b)s for public, nonprofit employees. How much retirement money you'll have depends on how much you invest and how well you manage the funds.

Federal regulations relating to 401(k) plans require that companies offer at least three different investment options in addition to company stock, provide information about investment options so that participants can assess risk–return features, report performance frequently, and allow more frequent changes to employees' plans. Having more fund choices is good news, in a way, except that as investment choices increase, so does confusion about selecting the right investments.

A trap many fall into is being too conservative with their 401(k) investments. The average 401(k) investor chooses GICs and low-yielding money market funds, focusing more on the safety of capital than on the way inflation erodes returns. Another common mistake of those who manage their own pension plans is buying too much company stock. It's too risky to invest in one stock, especially when you also work for the company. Advisers typically suggest limiting company stock to 10% to 25% of your 401(k).

What do financial planning experts suggest as an ideal 401(k) plan? They recommend investing heavily in common stock; the percentage and type of equities should change as you move through life cycle stages. You should also coordinate your 401(k) plan with your other investments so that you have an appropriate balance overall. Most importantly, start your plan now and save whatever you can—especially if your employer matches contributions—even if you can't contribute the maximum.

Also, consider a Roth IRA, which allows you to accumulate savings on a tax-free basis. In contrast, the 401(k) is a tax-deferred investment that is ultimately taxed when you withdraw the money at retirement. However, the 401(k) plan has one big advantage: You can save more per year in the 401(k) than with the Roth. However, the Economic Growth and Tax Relief Reconciliation Act of 2003 introduced a new option for the 401(k) plan, called the Roth 401(k), which will offer some features of both 401(k) plans and Roth IRAs. The tax laws for pension plans are definitely in flux, as Congress attempts to balance the country's spending with its revenues. You will need to keep checking the changing tax laws as you fund your 401(k) and other retirement plans.

To see how such tax-deferred plans work, assume you earned $60,000 in 2007 and want to contribute the maximum allowable (assumed $15,000) to the 401(k) plan where you work. Doing so would reduce your taxable income to $45,000 and enable you to lower your federal tax bill (assuming you're in the 25% bracket) by $3,750 (0.25 × $15,000). Such tax savings will offset a good portion of your contribution. In effect, you will add $15,000 to your retirement program with only $11,250 of your own money; the rest will come from the IRS via a reduced tax bill. What's more, *all the earnings* on both the earnings placed in the 401(k) plan and the investment earnings accumulated on them are deferred until retirement. The *Investing in Action* box above provides some tips from professionals on managing your 401(k) plan.

Keogh plans
programs that allow *self-employed individuals* to establish self-directed, tax-deferred retirement plans for themselves and their employees.

Keogh Plans **Keogh plans** allow *self-employed individuals* to establish self-directed, tax-deferred retirement plans for themselves and their employees. Like contributions to 401(k) plans, payments to Keogh accounts may be taken

as deductions from taxable income, to reduce the tax bill of self-employed individuals. The maximum contribution to this tax-deferred retirement plan in 2006 was $44,000 per year (indexed to the rate of inflation) or 25% of net earned income, whichever is less. Net earned income is the amount of earned income after the Keogh contribution. This reduces the actual contribution to 20% of gross earned income. For example, an individual who earns $220,000 can only contribute $44,000 (25% of $176,000 which is $220,000 less the $44,000 contribution). Any individual who is self-employed, either full- or part-time, is eligible to set up a Keogh account. Keoghs can be used not only by the self-employed businessperson or professional but also by individuals who hold full-time jobs *and* "moonlight" on a part-time basis—for example, the engineer who has a small consulting business on the side and the accountant who does tax returns in the evenings and on weekends. Take the engineer, for example. If he earns $10,000 a year from his part-time consulting business, he can contribute 20% of that income ($2,000) to his Keogh account and in so doing reduce his taxable income and the amount he pays in taxes. Also, he is eligible to receive full retirement benefits from his full-time job.

Keogh accounts can be opened at banks, insurance companies, brokerage firms, mutual funds, and other financial institutions. Annual contributions must be made by the time the respective tax return is filed, or by April 15 of the following calendar year (you have until April 15, 2008 to make the contribution to your Keogh for 2007). A designated financial institution acts as custodian of all the funds held in a Keogh account, but *the actual investments held in the account are under the complete direction of the individual contributor*. Unlike the 401(k) plan, these are self-directed retirement programs. The individual decides which investments to buy and sell (subject to a few restrictions). All growth and income inside a Keogh plan accrues tax-deferred. One potential downside for the small business owner is that the employer must make specified contributions on behalf of eligible employees. This raises the cost of the plan for the employer.

All Keogh contributions and investment earnings must remain in the account until the individual turns 59½, unless the individual becomes seriously ill or disabled. However, you are *not required* to start withdrawing the funds at age 59½. Rather, they can stay in the account and continue to earn tax-free income until you turn 70½, at which time you have the remainder of your life to liquidate the account. In fact, as long as the self-employment income continues, an individual can continue to make tax-deferred contributions to a Keogh account, up to the maximum age of 70½. Of course, once an individual starts withdrawing funds from a Keogh account (at age 59½ or after), all such withdrawals are treated as active income and are subject to the payment of ordinary income taxes. *Thus, the taxes on all contributions to and earnings from a Keogh account are deferred to retirement, when they will have to be paid.*

A program that's similar in many respects to the Keogh account is something called a *Simplified Employee Pension Plan (SEP)*. It's aimed at small-business owners, particularly those with *no employees*, who want a plan that is simple to set up and administer. SEPs *can be used in place of Keoghs*. However, like the Keogh, employers are responsible for making all SEP contributions on behalf of their employees.

In 1996, Congress authorized the creation of a new retirement plan for small business owners and individuals to encourage more retirement savings.

For a small business owner the cost of adopting a regular 401(k) plan and meeting annual "testing" requirements is often too burdensome. The Savings Incentive Match Plan for Employees (SIMPLE) IRA plan was designed to ease that burden while allowing significant contributions on the part of employees.

Contributions to a SIMPLE IRA grow tax-deferred until withdrawn during retirement. Except for the higher contribution limits, the SIMPLE IRA is subject to the same rules as a Traditional IRA (see below). Participation in a SIMPLE plan is considered active participation for IRA deduction eligibility purposes. One additional requirement of the SIMPLE retirement plan is that the employer is required to make a mandatory employer contribution. Employer contributions must be either:

- 100% match for all *participating* employees (up to 3% of total compensation, the employer is allowed to reduce the match to as low as 1% of compensation in any two of five years), or
- 2% of compensation for all *eligible* employees regardless of whether the employees contribute on their own ($4,400 limit)

Businesses with 100 or fewer employees that currently offer no other retirement savings plan to their employees can adopt the SIMPLE. All employees who expect to earn $5,000 in the current calendar year and have earned $5,000 in any two preceding years are eligible to participate. The SIMPLE plan is ideal for an individual who has a part-time second business since the contribution limit is 100% of income up to $10,000 in 2006 and thereafter.

The SIMPLE 401(k) plan has eligibility and contribution limits similar to the SIMPLE IRA with the exception that the SIMPLE 401(k) plan can allow participant loans, while the SIMPLE IRA, under IRA rules, cannot.

individual retirement arrangements (IRAs) self-directed, tax-deferred retirement programs *available to any gainfully employed individual,* who can make up to a specified maximum annual contribution.

Individual Retirement Arrangements (IRAs) **Individual retirement arrangements (IRAs)** are virtually the same as any other investment account you open with a bank, savings and loan, credit union, stockbroker, mutual fund, or insurance company, with one exception: IRAs are self-directed, tax-deferred retirement programs that are *available to any gainfully employed individual*. The form you complete to open the account designates the account as an IRA and makes the institution its trustee. In 2006 and 2007, the annual IRA contribution maximum for a *traditional deductible IRA* was $4,000. It steps up to $5,000 in 2008 and beyond. Those age 50 or older can contribute even more: up to $5,000 in 2006 and 2007, and $6,000 in 2008 and beyond.

IRA contributions may be fully, partially or non-deductible as outlined below.

1. *Employee is not covered by an employer-sponsored retirement plan*
   - An IRA contribution is *fully deductible* up to the lesser of the annual contribution limit ($4,000 in 2006) or earned income.
   - A *fully deductible* IRA contribution can be made on behalf of a non-employed spouse as long as joint income is less than $150,000. A *partially deductible* spousal IRA contribution is allowed if joint income is between $150,000 and $160,000 with no contribution allowed if joint income exceeds $160,000.

2. *Employee is covered by an employer-sponsored retirement plan*

- *Fully deductible*. An IRA contribution is fully deductible if the owner's modified (pre-contribution) AGI is less than the following amounts:

Year	Single	Married, Filing Jointly
2006	$50,000	$75,000
2007 and beyond	$50,000	$80,000

- *Partially deductible*. If an IRA owner is covered by an employer-sponsored retirement plan, a contribution is partially deductible if the employee's income does not exceed certain levels. Those income phaseout levels are:

Year	Single	Married, Filing Jointly
2006	$50,000–$60,000	$75,000–$85,000
2007 and beyond	$50,000–$60,000	$80,000–$100,000

- *Nondeductible*. An IRA contribution is nondeductible if modified AGI exceeds the phase out limits shown above.

The Taxpayer Relief Act of 1997 added some new twists to IRAs. In addition to the traditional deductible IRA described above, there are two other types of IRAs: the *Roth IRA* (introduced in 1998) and the *nondeductible IRA*. In addition, a special type of IRA—the *Education IRA*, now called the *Coverdell Education Savings Account*—is available to certain taxpayers. Before describing the benefits of deductible IRAs, we describe the characteristics of these other forms of IRAs.

Roth IRA
an IRA that allows a worker and spouse with earnings from employment to, subject to certain limits, each contribute up to $4,000 annually (rising to $5,000 by 2008). Contributions are nondeductible, but the earnings are not taxable when withdrawn in accordance with certain requirements.

Roth IRA A **Roth IRA** allows a worker and spouse with earnings from employment each to contribute up to $4,000 annually (rising to $5,000 by 2008), whether or not they participate in company-sponsored pension plans. The $4,000 annual limit is reduced by any contributions made to other IRAs. In addition, a phase out of the $3,000 limit begins for couples filing jointly with adjusted gross income in excess of $150,000 (for singles, in excess of $95,000), and the opportunity to contribute is completely eliminated at $160,000 (for singles, at $110,000).

The contributions to a Roth IRA are *nondeductible*—you will have already paid taxes on the money you put into it. But as long as you are age 59½ or older and the account is at least five years old, withdrawals are tax-free. Otherwise, the earnings are taxed and you may be subject to a 10% penalty. Clearly, the tax-free accumulation in a Roth IRA makes it an attractive vehicle for tax deferral.

nondeductible IRA
an IRA with contribution limits and penalties similar to those of a traditional deductible IRA, available to taxpayers who fail to meet income cutoffs for a traditional deductible IRA or a Roth IRA. Contributions are nondeductible, earnings are deferred, and taxes are due on withdrawals.

Nondeductible IRA A **nondeductible IRA** allows taxpayers who fail to meet the income cutoffs for the traditional deductible IRA or Roth IRA to obtain the benefit of tax-deferred earnings. Like a traditional IRA, the earnings in this IRA accumulate tax-free until you withdraw funds. This IRA offers less tax

advantage than the other types of IRAs: As in a Roth IRA, contributions *are not tax-deductible,* but it is unlike the Roth IRA in that withdrawals *are taxable*. Contribution limits and penalties on nondeductible IRAs are similar to those on the traditional deductible IRA except that there is no income cutoff.

IRA Features All three of the IRAs described so far allow the withdrawal of cash without the 10% early withdrawal tax penalty if the proceeds are used to (1) buy a first home (subject to a $10,000 limit), (2) fund a college education for you, your spouse, or your children or grandchildren (no income limit), or (3) pay medical expenses in excess of 7.5% of your adjusted gross income. All three of these IRAs allow penalty-free withdrawals for any reason starting at age 59½. But the Roth IRA, unlike the traditional and nondeductible IRAs, which *require* withdrawal to start by age 70½, allows you to leave your money in the account for as long as you wish. The Roth IRA allows contributions (not accumulated earnings) to be withdrawn at any time without penalty or taxes; the other IRAs do not permit penalty-free withdrawal until age 59½.

IRAs are *self-directed accounts*—that is, you are free, within limits, to make whatever investment decisions you wish with the capital in your IRA. Of course, your investment options are limited by the products offered by financial institutions. Banks and thrift institutions push savings vehicles, insurance companies have annuities, and brokerage houses offer everything from mutual funds to stocks, bonds, and annuities. Except for the limited exceptions noted earlier, any withdrawals from an IRA prior to age 59½ are subject to a 10% penalty on top of the regular tax on the withdrawal itself.

Bear in mind that deductible IRAs, along with all other retirement plans that permit contributions on a pretax basis, *defer* but do not *eliminate* taxes. When you receive the income (contributions and investment earnings) in retirement, it is taxed at the then-prevailing tax rates. Even so, the impact of tax deferral is substantial. Table 17.6 compares the results of investments in a traditional deductible IRA and a non-IRA account, both of which earn an annual rate of return of 8%. This example assumes that you invest $1,000 of earned income each year. If you choose the traditional deductible IRA, you shelter from taxes both the $1,000 initial investment and its subsequent earnings, so that at the end of the first year, for example, you have accumulated $1,080. If you select the same investment vehicle but do not make it an IRA, you must first pay $250 in taxes (assuming a 25% tax rate), leaving only $750 to invest. The subsequent earnings of $60 (0.08 × $750) are also taxed at 25%, leaving after-tax income of only $45 [$60 – (0.25 × $60) = $60 − $15 = $45]. Thus,

TABLE 17.6 Terminal Value from a $1,000-a-Year Investment in a Traditional Deductible IRA vs. a Fully Taxable (Non-IRA) Account*

Years Held	IRA	Non-IRA	Years Held	IRA	Non-IRA
1	$ 1,080	$ 795	25	$ 78,954	$ 43,617
5	6,335	4,481	30	122,345	62,851
10	15,645	10,478	35	186,102	88,590
15	29,324	18,504	40	279,781	123,035
20	49,421	29,244	45	417,426	169,131

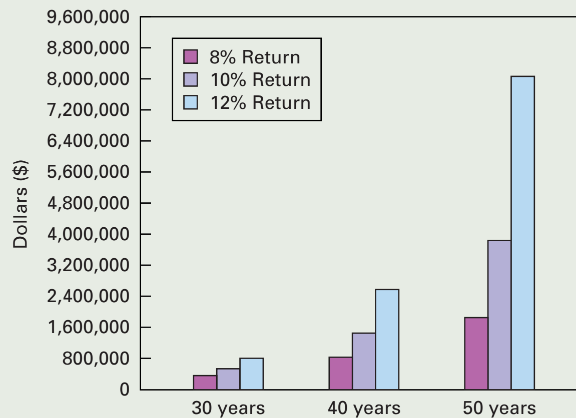
*Contributions and earnings are taxed at 25% in the non-IRA account but are tax-deferred in the traditional deductible IRA; an annual rate of return of 8% is assumed in both cases.

INVESTING *in Action*

You're Never Too Young to Start That IRA

As a 20-year-old working your way through college at the campus bookstore, you earned $5,000, which you used to pay for entertainment and transportation expenses. Because you have earned income, you are eligible to contribute to an IRA, although you haven't really thought about it because retirement is so far away. However, your grandparents are impressed with your hard work and want to make a gift to you, so they open a Roth IRA in your name and plunk $3,000 into a mutual fund. They figure that if that mutual fund earns an average annual return of 10%, the $3,000 account will be worth over $350,000 in the year 2056 when you retire at age 70. If the account earns an average annual return of 12%, then the account will be worth about $867,000. All from a single $3,000 deposit!

They're also planning on making additional $3,000 contributions to your IRA as long as you're in school. Using future value tables, they show you that an annual $3,000 contribution to a Roth IRA for the next 50 years would be worth nearly $3.8 million if the account earned 10% and over $8.0 million if it earned 12%. Duly impressed, you pledge to them that you will make the annual $3,000 contribution as long as you are gainfully employed.



Because there is no minimum age requirement for IRAs, many youngsters who have earnings can get into the game. A four-year-old who earns money modeling clothes for a local retailer's sales catalog, a 12-year-old with income from baby-sitting or a paper route, a teen who bags groceries or flips burgers, and a college student who works at the bookstore are all eligible. Even if children don't have an outside job, they can work for their parents, getting paid for doing chores around the house.

If an IRA is set up for a minor, then the parent or other adult must serve as custodian, making investment decisions and controlling the funds until the child comes of age. The Roth IRA, started in 1998, has encouraged more parents to set up IRAs for their children's future benefit.

the first-year accumulation is just $795. As the table indicates, after about 30 years, accumulated funds in the IRA are about twice as great as for the non-IRA; after 45 years, the funds are nearly 2.5 times as great ($417,426 vs. $169,131). The power of compounding is even greater when earnings are not taxable, as the *Investing in Action* box above on Roth IRAs demonstrates. One important item to note, however, is that the $417,426 has not been taxed yet. Still, the after-tax results of tax-deferred investing clearly has an advantage over taxable investing.

Funding Keoghs and IRAs As with any investment, an individual can be conservative or aggressive when choosing securities for a Keogh or IRA, though the nature of these retirement programs generally favors a more conservative approach. In fact, conventional wisdom favors funding your Keogh

and IRA with *income-producing assets*. This strategy would also suggest that if you are looking for capital gains, it is best to do so *outside* of your retirement account. The reasons for this are twofold: (1) Growth-oriented securities are by nature *more risky*, and (2) you cannot write off losses from the sale of securities held in a Keogh or IRA account. This does *not* mean it would be altogether inappropriate to place a good-quality growth stock or mutual fund in a Keogh or IRA. In the end, *it is how much you have in your retirement account that matters, rather than how your earnings were made along the way.*

Although very few types of investments are prohibited outright, some should be avoided simply because they are inappropriate for such accounts. For example, with tax-free municipal securities, the tax shelter from a Keogh or IRA would be redundant because their income is tax-exempt anyway. In addition to most long-term securities, money market accounts—both bank deposits (MMDAs) and mutual funds (MMMFs)—also appeal to Keogh and IRA investors, especially those who view short-term securities as one way to capture volatile market interest rates. Not surprisingly, as the size of an account begins to build up, an investor often uses more than one kind of security to diversify the portfolio.

Remember that although Keoghs and IRAs offer tax advantages, they in no way affect the underlying risks of the securities held in these accounts. Also, though the specific investment vehicles may (and probably should) be changed occasionally, once money is put into a Keogh or IRA, it's meant to stay there for the long haul.

Tax Deferred Investing in Education Savings Plans

In addition to a number of tax-deferred retirement accounts available to individuals, there are two educational savings plans which offer tax-deferred investing. The *Coverdell Education Savings Account (ESA)* and the *Section 529 College Savings Plan* are two such accounts which will help Americans invest after-tax dollars on a tax-deferred basis to help meet the rising cost of a college education.

Coverdell Education Savings Account (ESA)
an education savings plan that allows the taxpayer, subject to income limits, to contribute a *nondeductible* $2,000 per year for each child under age 18 into an account in which earnings accumulate tax-free and distributions are tax-exempt if they are used to pay higher-education (college) expenses for the child for whom the account exists.

Section 529 Plan
a state-sponsored, tax-deferred college savings plan with both annual and lifetime contribution limits; growth inside the plan is tax-deferred and withdrawals are tax-free if used for qualified college expenses.

Coverdell Education Savings Account (ESA)

The **Coverdell Education Savings Account (ESA)**, formerly called the *Education IRA*, can be used to save for the future educational expenses of a child under age 18. In 2006 the maximum annual contribution per beneficiary was $2,000. The contribution is phased out for couples filing jointly with modified adjusted gross income in excess of $190,000 (for singles, in excess of $95,000) and is completely eliminated at $220,000 (for singles, at $110,000). The contributions to these accounts are *nondeductible*, but earnings accumulate tax-free, and withdrawals to pay college expenses of the child for whom the account exists are tax-exempt. The tax-free withdrawals are also available for elementary and secondary education expenses. An individual's contributions to an Education Savings Account are separate from, and in addition to, contributions to an individual's IRA.

Section 529 College Savings Plans

The **Section 529 Plan** is a state-sponsored, tax-deferred college savings plan which has an annual contribution limit of $11,000 ($22,000 if contributing with a spouse). Special rules allow a one-time contribution of as much as $55,000 per account (with the contribution treated as if it was made over the next five years) and total lifetime contri-

butions on behalf of any one student are limited to between $100,000 and $270,000, depending upon the state limit. Growth inside the section 529 plan is tax-deferred and withdrawals are tax-free if used for qualified college expenses. Most plan sponsors offer several pre-determined investment allocations from which the account owner can choose. Individuals can still make contributions to a Coverdell ESA even after making a contribution to the Section 529 plan.

Strategies That Trade Current Income for Capital Gains

Whereas ordinary income is taxed in the year it's received, capital gains are not taxed until they are actually realized. This means that *unrealized* capital gains are not taxed. For example, the receipt of $100 in interest from a bond in the current year would be taxed at your assumed 25% rate, leaving $75 of after-tax income. On the other hand, if the price of a stock that pays no dividend rises by $100 during the current year, *no tax is due until the stock is actually sold*. Sooner or later, you'll pay taxes on your income, but at least with capital gains, you defer the taxes until the profit is actually realized, which could be years away. Therefore, if the market price of the stock is stable or increasing, earning capital gains may achieve a tax-deferred buildup of funds. From a strict tax viewpoint, investment vehicles that provide such a tax-deferred buildup of value may be more attractive than those that provide annual taxable income. Some of the more common methods for trading current income for capital gains are described below.

Growth Versus Income Stocks Choosing growth rather than income stocks or mutual funds is a simple yet basic way to earn capital gains income. Companies and funds that pay out a low percentage of earnings as dividends usually reinvest the retained earnings to take advantage of growth opportunities. During the bull market of the 1990s, index funds were very effective in this regard. They earned market returns and paid out very low dividends, thereby providing capital gains nearly equivalent to the rate of appreciation of the market portfolio of stocks.

If you select a company that pays dividends amounting to a 10% current return on your investment, your after-tax return will be 8.5% assuming you are in the 15% capital gains tax bracket. In comparison, a company or fund that pays no dividends but is expected to experience a 10% annual growth in its share price from reinvestment of earnings also offers an after-tax rate of return of 8.5%, but in this case the taxes will not have to be paid until the stock or fund is actually sold and the gain realized. At that point, the hope is that you will be in a lower tax bracket or that the tax rate will be lower. If neither is the case, at least in the interim you've been able to keep invested the funds that you otherwise would have paid out in taxes. The deferral of tax payments is, of course, appealing as long as the stock price continues to increase.

deep-discount bond
a bond selling at a price far below its par value.

Deep-Discount Bonds Purchasing a **deep-discount bond**—one that is selling at a price far below its $1,000 par value—also offers a capital gains opportunity. To illustrate, suppose you have the choice of buying two different $1,000 par value bonds: ABC's bond, which has a coupon rate of 5% and is selling for $700 in the market, or DEF's bond, with a coupon of 10% and selling at par. Which would you prefer if both mature at the end of 10 years? With the ABC bond, you will earn interest of $50 a year taxed as ordinary

income. At the end of 10 years, you will have a $300 capital gain, which will be taxed at the lower capital gains tax rate. With the DEF bond, all of your return—that is, the $100 you receive each year—is ordinary income. From a strict tax perspective, the ABC bond is clearly the better of the two, *because the portion of the return represented by the capital gain is not taxed until it is realized at maturity, and the rate at which it is taxed is below that applicable to ordinary income*. Remember, though, that the higher-coupon bond is giving you a higher return earlier, and that adds to its attractiveness.

To choose between the two bonds, you could perform a rate-of-return analysis. Assuming you have $7,000 to invest, you could purchase 10 ABC bonds or 7 DEF bonds. Total annual interest on the ABC bonds would be $500; on the DEF bonds, it would be $700. Assuming you are in the 25% tax bracket, the after-tax advantage of the DEF bonds is $150 (0.75 × $200) a year. However, the ABC bonds will be worth $10,000 at maturity, whereas the DEF bonds will be worth only their current value of $7,000. Assuming a 15% capital gains tax rate, on an after-tax basis, the additional $3,000 is worth $2,550 [$3,000 − (0.15 × $3,000)].

The choice boils down to whether you prefer $150 of additional income each year for the next 10 years or an additional $2,550 at the *end* of 10 years. Using the future value techniques developed in Chapter 4, Appendix 4A, you would arrive at the conclusion that it would take about an 11.3% rate of return to make you indifferent between the two bonds. That is, if you invest $150 a year for 10 years at 11.3%, it accumulates to around $2,550 at the end of 10 years. Interpreting this answer, if you can invest at an after-tax rate greater than 11.3%, you should select the DEF bonds; if you feel your after-tax reinvestment rate will be lower, then you should select the ABC bonds.

Income Property Depreciation Federal tax law, as discussed in Web Chapter 18, permits the *depreciation* of income property such as apartment houses and similar structures. Essentially, a specified amount of annual depreciation can be deducted from ordinary pretax income. The depreciable life of residential rental property (apartments) is 27.5 years. Nonresidential property (office buildings and shopping centers) placed in service after May 13, 1993, has a depreciable life of 39 years. In both cases, straight-line depreciation is used. When a property is sold, any amount received in excess of its original cost basis is treated as a capital gain and is taxed at the applicable capital gains rate. Recaptured depreciation, the difference between the original cost basis and the property's book value, is taxed at the 25% recaptured depreciation tax rate. This is why a taxpayer in the 15% marginal income tax bracket should not attempt a strategy of utilizing depreciation as a tax reduction strategy (gaining a 15% tax write-off) if it will result in recaptured depreciation later (thus incurring a 25% tax). However, taxpayers in the 25% or higher tax brackets can benefit from the use of depreciation.

To see the tax effects of depreciation, assume you buy a four-unit apartment building for $100,000 and hold it for three years, taking $2,900 in depreciation each year. Now suppose that at the end of the third year you sell it for its original $100,000 purchase price. The depreciation you took reduced ordinary income each year by $2,900 and was worth, assuming a 25% tax bracket, $725 (0.25 × $2,900). Your gain on the sale is $8,700 (3 years × $2,900 per year), which results in a tax of $2,175 (0.25 × $8,700). There is no tax savings in this situation; however, you received a tax deferral because the

tax savings of $725 in each of the first three years did not have to be paid back until the property was sold at the end of the third year. (Of course, if the property were sold for less than its original purchase price, full repayment would not occur.) Individuals in a tax bracket higher than the 25% bracket would actually garner a tax advantage from this situation.

The use of the depreciation deduction (which does not involve any cash payment) results in a type of interest-free loan. The deduction reduces taxes during the property's holding period and delays the repayment of those taxes until the property is sold. *This tax deferral is the primary tax benefit provided by depreciation.* In our example, the tax deferral of $725 in each of the first 3 years (3 × $725 = $2,175), which is repaid as $2,175 of taxes at the end of the third year, represents a loan at a 0% rate of interest. However, very restrictive limits on the use of tax losses resulting from real estate investments, established by the Tax Reform Act of 1986, may severely limit an investor's ability to take advantage of these depreciation tax benefits. As a result, the appeal of real estate investment no longer lies in its potential value as a tax shelter but in its ability to earn a profit from annual rents and/or appreciation.

Tax Swaps: A Strategy That Reduces or Eliminates a Tax Liability

Thus far we have considered several short-term strategies aimed at affecting an investor's tax liability: (1) ways to exclude income from taxation, (2) ways to defer taxes from one tax year to the next, (3) programs that defer tax liabilities to retirement, and (4) techniques that trade current income for capital gains. We will now look at a strategy that essentially reduces or eliminates a tax liability altogether. This procedure, called a tax swap, is extremely popular at year-end among knowledgeable stock and bond investors.

tax swap
selling one security that has a capital loss and replacing it with another, similar security to offset, partially or fully, a capital gain that has been *realized* in another part of the portfolio.

A **tax swap** is simply the replacement of one security that has a capital loss with another, similar security to offset, partially or fully, a capital gain that has been *realized* in another part of the portfolio. Of course, because the aim is to offset a gain, the security that is sold in the tax swap should be one that has *lost* money for the investor. Because you are selling one security that has experienced a capital loss and replacing it with another, similar security, your stock or bond position remains essentially unchanged, although your tax liability has been reduced—and perhaps substantially so.

A tax swap works like this: Suppose that during the current year you realized a capital gain of $1,100 on the sale of bonds. Assume that in your portfolio you held 100 shares of International Oil Corporation common stock, purchased 20 months earlier for $38 per share and currently selling for $28 per share. Although you wish to maintain an oil stock in your portfolio, it does not matter to you whether you hold International Oil or one of the other multinational oils. To realize the capital loss of $10 per share on International Oil while not altering your portfolio, you sell the 100 shares of International Oil and buy 100 shares of World Petroleum, which is also selling for $28 per share. The result is a *realized* capital loss of $1,000 [100 × ($28 − $38)], which can be used to offset all but $100 of the $1,100 capital gain realized on the earlier bond sale. However, since the 2003 tax law change lowered long-term capital gains tax rates to 15% or 5%, the tax swap strategy may lose part of its appeal. It may now be more preferable to pay the capital gains tax (15% of $1,100 = $165) on the $1,100 of capital gains and wait to apply the $1,000

loss against ordinary income the next year (thus saving $250 if the taxpayer is in the 25% tax bracket).

Swaps of common stock are an important part of year-end tax planning. Even more popular are bond swaps, because it is usually far easier to find a substitute bond for the one held. Most full-service brokerage houses publish a list of recommended year-end swaps for both stocks and bonds. You might wonder why it wouldn't make sense just to sell the security for tax purposes and then immediately buy it back. This procedure, which is called a **wash sale**, is disallowed under the tax law. A sold security cannot be repurchased within 30 days before or after its sale *without losing the tax deduction*.

wash sale
the procedure of selling securities on which capital losses can be realized and then immediately buying them back; disallowed under the tax law.

CONCEPTS IN REVIEW

Answers available at: www.myfinancelab.com

17.6 What is *tax-favored income?* Briefly describe the following forms of income excluded from taxation.

a. Tax-free municipal bond interest
b. Treasury and government agency issues
c. Sale of a personal residence

17.7 Explain conditions that favor the following strategies for deferring tax liabilities to the next year.

a. A put hedge
b. Selling a deep-in-the-money call option

When is it best simply to hold the stock and do nothing?

17.8 Briefly describe each of the following programs for deferring taxes to retirement.

a. 401(k) plans
b. Keogh plans
c. Individual retirement arrangements (IRAs)

17.9 Describe and compare the key features of each of the following types of individual retirement arrangements (IRAs).

a. Traditional deductible IRA
b. Roth IRA
c. Nondeductible IRA
d. SIMPLE IRA

17.10 According to the example in the *Investing in Action* box, what advantage does a Roth IRA offer that traditional and nondeductible IRAs do not?

17.11 Describe and compare the key features of the following types of educational savings plans.

a. Coverdell Education Savings Account (ESA)
b. Section 529 College Plan

17.12 What are *guaranteed investment contracts (GICs),* and what role do they play in 401(k) plans? What investment vehicles might be suitable for funding a Keogh or IRA?

17.13 Briefly describe each of the following strategies that trade current income for capital gains income.

a. Growth stocks
b. Deep-discount bonds
c. Income property depreciation

17.14 Describe how a *tax swap* can be used to reduce or eliminate a tax liability without significantly altering the composition of one's portfolio.

Deferred Annuities

LG 4

annuity
a contract issued by an insurance company that guarantees a series of payments for a number of years or over a lifetime.

single-premium annuity
an annuity purchased with a single lump-sum payment.

installment annuity
an annuity acquired by making payments over time; at a specified future date, the installment payments, plus interest earned on them, are used to purchase an annuity.

annuitant
the person to whom the future payments on an annuity are directed.

accumulation period
under an annuity, the period of time between when payments are made to the insurance company and when payments to the annuitant begin.

distribution period
under an annuity, the period of time over which payments are made to the annuitant.

immediate annuity
an annuity under which payments to the annuitant begin as soon as it is purchased.

deferred annuity
an annuity in which the payments to the annuitant begin at some future date.

current interest rate
for an annuity contract, the yearly return the insurance company pays on accumulated deposits.

minimum guaranteed interest rate
for a deferred annuity purchase contract, the minimum interest rate on contributions, which the insurance company guarantees over the full accumulation period.

Effective tax strategy seeks to defer taxable income for extended periods of time. The earnings on investment are therefore available for reinvestment during the period of deferment. The additional earnings resulting from investment of pretax rather than after-tax dollars over long periods of time can be large. That is why it is important to understand deferred annuities thoroughly.

Annuities: An Overview

An **annuity** is a contract issued by an insurance company that guarantees a series of payments for a number of years or over a lifetime. The two types of annuities are classified by their purchase provisions: The **single-premium annuity** is purchased with a single lump-sum payment. The purchaser pays a certain amount and receives a series of payments that begins either immediately or at some future date. The second type of annuity, the **installment annuity**, is acquired by making payments over time; at a specified future date, the installment payments, plus interest earned on them, are used to purchase an annuity. The person to whom the future payments are directed is called the **annuitant**. Annuities of many types are issued by hundreds of insurance companies.

The period of time between when payments are made to the insurance company and when payments to the annuitant begin is the **accumulation period**. All interest earned on the accumulated payments during this period is tax-deferred: Because no payment is made to the purchaser, no tax liability is created. The period of time over which payments are made to the annuitant is the **distribution period**. Earnings on the annuity during the accumulation and distribution periods become taxable to the annuitant when received.

An **immediate annuity** is one under which payments to the annuitant begin as soon as it is purchased. The amount of the payment is based on statistical analyses performed by the insurance company and depends on the annuitant's gender and age; the payment is a function of how long the insurance company expects the annuitant to live. A **deferred annuity**, in contrast, is one in which the payments to the annuitant begin at some future date. The date is specified in the contract or at the annuitant's option. The amount the annuitant will periodically receive depends on his or her contributions, the interest earned on them, the annuitant's gender, and the annuitant's age when payments begin.

Characteristics of Deferred Annuities

Deferred annuities generally pay market-competitive interest rates. An annuity contract's **current interest rate** is the yearly return the insurance company pays on accumulated deposits. The current interest rate fluctuates with market rates over time and is not guaranteed by the insurance company. However, some contracts have a "bailout" provision that allows an annuity holder to withdraw the contract value—principal and all earned interest—if the insurance company fails to pay a specified minimum return. The minimum is typically a return that is 1% or more below the initial rate.

The deferred annuity purchase contract specifies a **minimum guaranteed interest rate** on contributions, which the insurance company guarantees over the full accumulation period. The minimum rate is usually substantially less

than the current interest rate. You should study a prospectus or contract and remember that *the minimum rate is all you are guaranteed*. (Very often, the promotional literature provided by the company emphasizes the high *current* interest rate.)

Special Tax Features Deferred annuities, both single-premium and installment, have several advantageous tax shelter features. First, interest earned on the purchaser's contributions is not subject to income tax until it is actually paid by the insurance company. Suppose you invest $10,000 in a 7% single-premium deferred annuity. During the first year the contract is in effect, the account earns $700 in interest. If none of this interest is withdrawn, no income tax is due. Thus, if you are in the 25% tax bracket, your first year's tax savings is $175. The tax-deferral privilege permits you to accumulate substantial sums of compound interest that can be used to help provide a comfortable retirement income. However, note that the Tax Reform Act of 1986 provides that this tax-favored treatment is available only on annuity contracts held by individuals, trusts, or other entities (such as a decedent's estate, a qualified employer plan, a qualified annuity plan, or an IRA). In all other cases, the income on the annuity is taxed when earned.

Certain employees of institutions such as schools, universities, governments, and not-for-profit organizations may qualify for a **tax-sheltered annuity**. A special provision in the income tax laws allows these employees to make a *pre-tax contribution* from current income to purchase a deferred annuity. The interest earned on these contributions is tax-deferred as well. The maximum amount that can be contributed is limited. Purchasers of these annuities do not have to pay any income tax on contributions or on interest earnings until they actually receive annuity payments in future years. The expectation is that, if timed to coincide with retirement, the deferred income will be taxed at a lower rate than current income would be.

tax-sheltered annuity
an annuity that allows employees of certain institutions to make a *pre-tax contribution* from current income to purchase a deferred annuity.

Investment Payout The investment return, or **payout**, provided by an annuity is realized when the distribution period begins. The annuitant can choose a **straight annuity**, which is a series of payments for the rest of his or her life. Most companies also offer other payout options, such as a contract specifying payments for both annuitant and spouse for the rest of both their lives, as well as a contract specifying rapid payout of accumulated payments with interest over a short period of time.

payout
the investment return provided by an annuity; it is realized when the distribution period begins.

straight annuity
an annuity that provides for a series of payments for the rest of the annuitant's life.

The amount an annuitant receives depends on the amount accumulated in the account and on the payout plan chosen. It is important to choose the program that provides the highest return for the desired payout plan. Such a plan will probably have a relatively high interest rate and relatively low (or no) sales charges and administration fees.

Deferred Annuities and Retirement Plans

Many investors tie the purchase of deferred annuities to their overall retirement plans. Because Keogh plans and IRAs are somewhat similar to deferred annuities, they should be evaluated with them. If you are not fully using any allowable deductible IRA exclusion each year, you may prefer adding to it as a part of your retirement plan, rather than purchasing a tax-deferred annuity. Far greater benefit results from deducting from taxable income the full amount

of the allowable IRA payment. With an annuity, unless you're in one of the qualified professional fields noted above, you cannot deduct its purchase price but can only defer earned income. In particular, you should note that the Roth IRA, with its tax-free withdrawals after age 59½ has a far superior tax treatment than the annuity on which all growth is eventually taxed. However, if an individual has taken advantage of all available qualified retirement plan and IRA opportunities, the deferred annuity offers an additional opportunity for tax deferred investment.

Although both IRA (except for contributions to a Roth IRA) and deferred annuity withdrawals prior to age 59½ are subject to a 10% additional tax, it is important to recognize that income withdrawn from a deferred annuity will be taxed in the year it is withdrawn. Moreover, any annuity withdrawal is first viewed for tax purposes as income; once all income is withdrawn, subsequent withdrawals are treated as a return of principal, so any partial withdrawal is likely to be fully taxable.

INVESTOR FACTS

ARE ANNUITIES FOR YOU?—You may want to consider annuities if you meet most of the following criteria:

1. Have maxed out your 401(k) plans and IRAs but want more tax deferred investment gains.
2. Prefer mutual funds to investing in individual securities.
3. Will keep the annuity for at least 15 to 20 years.
4. Are in a 25% or higher income tax bracket today, but expect to be in a lower tax bracket in retirement.
5. Don't need the annuity proceeds prior to age 59½.
6. Are unconcerned that heirs must pay ordinary income taxes on any appreciation.
7. Desire a "guaranteed" income for life in retirement.

Source: The Motley Fool, www.fool.com/retirement/annuities.

Fixed Versus Variable Annuity

The annuity payout during the distribution period can be either fixed or variable. Most contracts are written as **fixed annuities**: Once a payment schedule is selected, the amount of monthly income does not change. In contrast, a growing number of annuity plans adjust the monthly income according to the actual investment experience (and sometimes the mortality experience) of the insurer. These latter contracts are called **variable annuities.** The advantage of a fixed annuity is that the dollar amount of monthly income is guaranteed regardless of how poorly or well the insurer's investments perform. A major disadvantage, however, is that in periods of inflation, the purchasing power of the dollar erodes. For example, with a 5% annual inflation rate, $1 of purchasing power is reduced to $0.78 in just five years.

fixed annuity
an annuity that pays an unchanging amount of monthly income during the distribution period.

variable annuity
an annuity that adjusts the monthly income it pays during the distribution period according to the investment experience (and sometimes the mortality experience) of the insurer.

The variable annuity was developed to overcome the lack of inflation protection provided by fixed-dollar annuities. With this plan, annuitants face a different risk, however. They cannot be certain how well the insurer's investments—which may consist of common stocks, bonds, or money market funds—will do. Annuitants therefore take a chance that they will receive an even lower monthly income, in absolute dollars, than a fixed-dollar contract would provide. Most people who participate in variable annuity plans, of course, anticipate that they will be able at least to keep up with the cost of living. Unfortunately, variable annuity values and inflation, often measured by the consumer price index (CPI), do not always perform the same.

Some people invest in a variable annuity during the accumulation period and then switch to a fixed annuity at retirement. In this manner, they participate in the growth of the economy over their working careers but guard against short-term recessions that may occur during their retirement years.

Annuities as Investment Vehicles

Annuities have several potential uses in an investment program. An immediate annuity can provide a safe and predictable source of income for the balance of one's life. A deferred annuity offers tax shelter and safety features and in addition can provide a convenient method for accumulating funds. When considering the purchase of a deferred annuity, you need to assess its investment suitability and understand the purchase procedures.

Investment Suitability The principal positive feature of deferred annuities is that they allow you to accumulate tax-deferred earnings. The tax-deferral feature allows interest to accumulate more quickly than would be the case if earnings were taxed. For those who qualify for a tax-sheltered annuity, current income tax on premium payments can be deferred as well. Furthermore, annuities are a low-risk type of investment.

On the negative side, deferred annuities have at least one major disadvantage: high sales charges and administration fees. The relatively high charges and fees are due largely to the fact that sales commissions are generous. In addition, insurance companies have high overheads that must be met from annuity proceeds, all of which take a real toll on returns.

In general, then, although annuities can play an important role in an investment portfolio, they should not be the only vehicle held. Other vehicles providing higher returns may be available.

Buying Annuities Annuities are sold by licensed salespersons and many stockbrokers. There are probably 50 or more annuity plans available through these outlets in a given community. Before you invest in a particular annuity, you should obtain a prospectus and any other available literature on a number of them. Then carefully compare these materials. The annuity you choose should be one that contains features consistent with your investment objectives and also offers the highest actual return on investment after all charges and fees are deducted.

Many annuities are sold by salespersons who must be compensated for their services. Some annuities, called "no-load," have no sales charges paid by the purchaser; in this case, the insurance company pays the salesperson directly. Other annuities require the purchaser to pay commissions of up to 10%. Administration fees for management, yearly maintenance, and one-time "setup charges" may also be levied.

Also, because *the annuity is only as good as the insurance company that stands behind it,* check to see how the company is rated in *Best's Insurance Reports*. These ratings are much like those found in the bond market and reflect the *financial strength* of the insurance company. Letter grades (ranging from A+ down to C) are assigned on the principle that the stronger the company, the lower the risk of loss. Accordingly, if security is important to you, stick with insurers that carry A+ or A ratings. If you're considering a *variable annuity,* go over it in much the same way as you would a traditional mutual fund: Look for superior past performance, proven management talents, moderate expenses, and the availability of attractive investment alternatives.

CONCEPTS IN REVIEW

Answers available at: www.myfinancelab.com

17.15 Define an *annuity,* explain the role it might play in an investment portfolio, and differentiate between:
   a. Single-premium and installment annuities.
   b. Immediate and deferred annuities.
   c. Fixed and variable annuities.

17.16 Define the following terms as they are related to deferred annuities.
   a. Current interest rate
   b. Minimum guaranteed interest rate
   c. Payout

17.17 Explain how a deferred annuity works as a tax shelter. How does a *tax-sheltered annuity* work, and who is eligible to purchase one? Discuss whether a deferred annuity is a better tax shelter than an IRA.

17.18 Discuss the investment suitability of a deferred annuity, particularly its positive and negative features. Briefly describe the procedures for buying annuities.

Syndicated Investments: Limited Partnerships and Limited Liability Corporations

LG 5

syndicate
a joint venture—general partnership, corporation, or limited partnership—in which investors pool their resources.

corporation
a form of organization that provides a limited-liability benefit to shareholder investors and that has an indefinite life.

general partnership
a joint venture in which all partners have management rights, and all assume unlimited liability for any debts or obligations the partnership incurs.

limited partnership (LP)
vehicle in which the investor can passively invest with limited liability, receive the benefit of active professional management, and apply the resulting profit or loss (subject to limits) to his or her tax liability.

limited liability company (LLC)
a business entity that provides the same liability protection as corporations but offers the option of being taxed as either a partnership or corporation.

To obtain economies of scale and diversify risk, investors often pool their resources and form joint ventures. These joint ventures, frequently called **syndicates**, can take several forms: corporations, general partnerships, or limited partnerships.

The corporate form of syndication—that is, a **corporation**—provides a limited-liability benefit to shareholder investors. Additionally, corporations have an indefinite life and do not cease to exist if a stockholder dies (whereas a partnership could end if a general partner dies). However, the corporate form has a significant disadvantage: Its profits and losses cannot be passed directly to its stockholders.

The partnership form of syndication, on the other hand, allows for a flow through of profits and losses. In a **general partnership**, all partners have management rights, and all assume unlimited liability for any debts or obligations the partnership incurs. Obviously, the unlimited-liability feature can be disadvantageous to *passive investors* (those who do not wish to participate actively in the partnership's operation). The **limited partnership (LP)** combines the favorable investment features of both the corporation and the general partnership: It provides an investor with a limited-liability vehicle that allows profits and losses to flow through to each partner's tax return.

A newer type of business entity, the **limited liability company (LLC)**, is replacing the limited partnership. Now approved in every state and the District of Columbia, the LLC combines the corporate advantages of limited liability with the partnership advantage of pass-through taxation. First authorized by Wyoming in 1977, LLCs became popular after a 1988 tax ruling that treats them like partnerships for tax purposes.

An LLC is owned by its *members*, whose function is the same as partners in a partnership or shareholders in a corporation. The members can choose to manage the LLC or choose a manager or managers to handle the company's affairs. With selected managers, the LLC's members do not participate in management and are similar to shareholders in a corporation. If the members manage the LLC themselves, they are like partners because they have a voice in decision making. Ownership of an LLC is represented by a member's "interests," analogous to partnership interests and the corporation's stock.

Investing in Limited Partnerships and Limited Liability Companies

Both the LP and LLC provide for the flow-through of profits and losses. They allow you to passively invest with limited liability, receive the benefit of active professional management, and apply the resulting profit or loss (subject to

limits) to your tax liability. The Tax Reform Act of 1986 in effect eliminated the tax-sheltering appeal of LPs. It limited the tax deductions for net losses generated by passive activities to the amount of net income earned by the taxpayer on all passive activities. Generally, a **passive activity** is one in which the investor does not "materially participate" in its management or activity. Unused passive losses are carried forward to future tax years and can eventually be used when the investment in the limited partnership is liquidated.

passive activity
an investment in which the investor does not "materially participate" in its management or activity.

In the past, LPs were a popular vehicle for investments in the real estate, energy resources, and equipment leasing industries. The value of LPs for tax shelters is no longer significant for individual investors, and in fact very few LPs are being formed today for public investment. Private investment opportunities in LLCs may exist for sophisticated investors. This form of ownership is sometimes used to structure profit-making, cash-flow-generating investments—for example, corporate investments in venture capital transactions.

LLCs should be purchased on their investment merits only, after considering both risk and return. They are illiquid and can be risky; thus, they are not suitable for conservative investors primarily interested in preservation of capital. Investors can realize a return from their investment in two ways—through periodic cash payments as the investment generates income and through price appreciation from an increase in the value of the investment. Like the appreciation experienced on any investment vehicle, this form of return may be realized or unrealized (as an actual return of dollars or as a "paper" return). Of course, realized capital gains are taxable to the partners or members.

CONCEPTS IN REVIEW

Answers available at: www.myfinancelab.com

17.19 How does a *limited partnership (LP)* differ from a *corporation* and a *general partnership?* How did the Tax Reform Act of 1986 affect the popularity of LPs as tax shelters?

17.20 What is a *limited liability company (LLC)* and why has it become a popular business entity?

Summary

LG 1 **Understand what taxable income is and how to calculate it.** As taxable income increases, so do tax burdens imposed by federal tax law. Taxable income can be either ordinary income—active, portfolio, or passive—or capital gains. The tax rates applicable to capital gains realized on assets held for at least certain periods of time are lower than the rates applicable to a taxpayer's ordinary income. Taxable income is calculated first by finding gross income, which includes most forms of income; then subtracting certain adjustments to gross income, to get adjusted gross income; and finally subtracting standard (or itemized) deductions and exemptions. Federal income taxes are calculated on the taxable income. Taxes due are found by subtracting any eligible tax credits from the federal income tax.

LG 2 **Define tax avoidance and tax deferral, and cite the characteristics of tax shelters.** Tax-avoidance strategies attempt to earn tax-favored income—income not subject to taxes.

Tax-deferral strategies attempt to defer taxes from current periods to later periods. A tax shelter is an investment vehicle that earns a portion of its return by offering potential offsets to the investor's other taxable income.

LG 3

Explain the basic strategies by which investors can earn tax-favored income. Strategies for earning tax-favored income include excluding income from taxation, deferring tax liabilities to the next year, deferring tax liabilities to retirement through retirement programs, trading current income for capital gains, and tax swaps. Tax-favored income excluded from taxation includes tax-free municipal bond interest, Treasury and government agency issues (free of state and local income taxes), and the sale of a personal residence. Strategies that defer tax liabilities to the next year include a put hedge and selling a deep-in-the-money call option. Each strategy has relative advantages and disadvantages, depending on the assumed future movement of the stock's price.

Programs that defer tax liabilities to retirement include 401(k) plans, Keogh plans, and individual retirement arrangements (IRAs). We looked at four types of IRAs in this chapter, including the traditional deductible IRA, the Roth IRA, the nondeductible IRA, and the SIMPLE IRA. Two education savings plans which help individuals save for college include the Coverdell Education Savings Account (ESA) and the Section 529 College Savings Plan. Popular strategies that trade current income for capital gains include buying growth rather than income stocks, buying deep-discount bonds, and investing in income property. Tax swaps are a strategy that can be used to reduce or eliminate a tax liability without altering the basic portfolio.

LG 4

Summarize the characteristics of deferred annuities. Because they pay relatively high market rates of interest and allow for tax-free reinvestment, deferred annuities have some appeal as a tax-deferral vehicle. Employees of certain institutions can purchase tax-sheltered annuities by making limited tax-free contributions from current income. Annuity payouts can be either fixed or variable; the payouts on variable annuities depend on the insurer's actual investment performance. Deferred annuities are relatively low-risk vehicles that may not produce earnings on a par with inflation rates.

LG 5

Describe the tax status of limited partnerships and limited liability companies and their investment characteristics. Both the limited partnership (LP) and limited liability company (LLC) provide for the flow-through of profits and losses. They allow you to passively invest with limited liability, receive the benefit of active professional management, and apply the resulting profit or loss (subject to limits) to your tax liability. The Tax Reform Act of 1986 in effect eliminated the tax-sheltering appeal of LPs. Today the LLC, which combines the corporate advantages of limited liability with the partnership advantage of pass-through taxation, is more popular than the LP. LLCs should be purchased on their investment merits only, after considering both risk and return. They are illiquid and can be risky; thus, they are not suitable for conservative investors primarily interested in preservation of capital. Return on an LLC investment may come from cash flow or price appreciation.

Key Terms

accumulation period, *p. 17-25*
adjusted gross income, *p. 17-5*
alternative minimum tax (AMT), *p. 17-7*
annuitant, *p. 17-25*
annuity, *p. 17-25*
average tax rate, *p. 17-7*
basis, *p. 17-4*

capital asset, *p. 17-4*
corporation, *p. 17-29*
Coverdell Education Savings Account (ESA), *p. 17-20*
current interest rate, *p. 17-25*
deep-discount bond, *p. 17-21*
deep-in-the-money call option, *p. 17-11*
deferred annuity, *p. 17-25*
distribution period, *p. 17-25*
exemption, *p. 17-6*
fixed annuity, *p. 17-27*
401(k) plans, *p. 17-13*
general partnership, *p. 17-29*
gross income, *p. 17-5*
guaranteed investment contracts (GICs), *p. 17-13*
immediate annuity, *p. 17-25*
individual retirement arrangements (IRAs), *p. 17-16*
installment annuity, *p. 17-25*
itemized deductions, *p. 17-6*
limited liability company (LLC), *p. 17-29*
limited partnership (LP), *p. 17-29*
Keogh plans, *p. 17-14*
marginal tax rate, *p. 17-7*
minimum guaranteed interest rate, *p. 17-25*
nondeductible IRA, *p. 17-17*
passive activity, *p. 17-30*
payout, *p. 17-26*
put hedge, *p. 17-11*
Roth IRA, *p. 17-17*
Section 529 Plan, *p. 17-20*
single-premium annuity, *p. 17-25*
standard deduction, *p. 17-5*
straight annuity, *p. 17-26*
syndicate, *p. 17-29*
taxable income, *p. 17-2*
tax-advantaged investments, *p. 17-2*
tax avoidance, *p. 17-8*
tax credits, *p. 17-7*
tax deferral, *p. 17-8*
tax evasion, *p. 17-8*
tax-favored income, *p. 17-9*
tax planning, *p. 17-2*
tax shelter, *p. 17-9*
tax-sheltered annuity, *p. 17-26*
tax swap, *p. 17-23*
variable annuity, *p. 17-27*
wash sale, *p. 17-24*

Discussion Questions

LG 1

Q17.1 Obtain a copy of the most recent year's Form 1040 (*U.S. Individual Income Tax Return*), along with Schedules A (*Itemized Deductions*), B (*Interest and Dividend Income*), and D (Capital Gains and Losses) and instructions for preparing the return. Use your actual (or forecast) data to prepare your return for the most recent year. If you earn no or very low income, use data provided by a family member.

- **a.** Discuss the exemptions claimed and their effect on taxable income.
- **b.** Study Schedule A and discuss how each of the following are treated:
  - (1) Medical and dental expenses
  - (2) Mortgage interest
  - (3) Job expenses
- **c.** Discuss the key factor affecting whether to itemize deductions or take the standard deduction.
- **d.** Describe how the total tax was calculated. What top tax bracket applied?
- **e.** What, if any, recommendation would you give with regard to actions that might be advantageous from a tax standpoint?

LG 3

Q17.2 Assume you have a sizable gain on 200 shares of stock that you bought 2 years ago for $22 per share and that is now (December 15) selling for $50 per share. Given a just-announced tax rate cut, effective next calendar year, you want to delay realizing the gain until next year, but you are concerned that the stock's price might decline in the interim. To defer the tax liability to next year, you are considering either using a put hedge, or selling deep-in-the-money call options.

a. Contact a stockbroker and obtain the approximate cost of implementing each of these strategies.
b. Compare and contrast the brokerage costs associated with these strategies. Which strategy is cheaper in terms of these costs?
c. What, if any, impact should the brokerage costs have on the selection of the better strategy? (Be sure to measure these costs on a *per-share* basis.)
d. For the cheaper strategy, by approximately how much will the brokerage costs reduce the unrealized gain on the stock?

LG 3

Q17.3 Imagine that, given your current age and marital status, you have decided to make the maximum contribution to an individual retirement arrangement (IRA) each year from now until age 65. (Assume that the current maximum contribution rate will remain unchanged over this period.) You expect to earn a 10% annual rate of return on IRA investments and are subject to a 30% tax rate.

a. Determine how much you will have in the IRA account at age 65 if you can earn 10% on IRA investments and IRA contributions are:
   (1) Deductible.
   (2) Nondeductible.
b. How much better off would you be as a result of having a traditional deductible IRA rather than a nondeductible IRA? What, if any, tax benefit does a nondeductible IRA offer?
c. Describe and justify the overall investment strategy you would employ on your IRA investments.
d. What specific types of vehicles would you include in your IRA investment portfolio? Justify your choices.
e. Compare and contrast the traditional deductible IRA to (1) a 401(k) plan and (2) a Keogh plan. If you could contribute to only one of these plans, which would be preferable? Why?

LG 4

Q17.4 Obtain from a licensed salesperson or stockbroker a prospectus and any other literature available on a popular deferred annuity. Analyze the terms, and answer the following questions.

a. What is the *current interest rate?* How does it compare to T-bill rates? To AAA bond yields?
b. What is the *minimum guaranteed interest rate* on contributions? How does it compare to T-bill rates? To AAA bond yields?
c. What, if any, *tax benefit* does it offer the investor?
d. What *payout options* does it offer? Is it a *fixed* or *variable annuity?* Which payout option do you find most appealing?
e. What sales charges and administrative fees are levied on this annuity? How does it compare to other annuities?
f. What is the rating of the financial strength of the insurer given in Best's Insurance Reports?
g. What are the pros and cons of purchasing this annuity?

Problems

LG 1

P17.1 Using Table 17.3, calculate Ed Robinson's income tax due on his $35,000 taxable income, assuming that he files as a single taxpayer. After you make the calculation, explain to Ed what his marginal tax rate is and why it is important in making investment decisions.

LG 1

P17.2 During the year just ended, Jean Sanchez's taxable income of $48,000 was twice as large as her younger sister Rachel's taxable income of $24,000. Use the tax rate schedule in Table 17.3 to answer the following questions with regard to the Sanchez sisters, who are both single.

a. Calculate each sister's tax liability.

b. Determine (1) the marginal tax rate and (2) the average tax rate for each sister.

c. Do your findings in part (b) demonstrate the progressive nature of income taxes? Explain.

LG 1

P17.3 Sheila and Jim Mendez reported the following income tax items in 2006:

Salaries and wages	$48,000
Interest on bonds	1,100*
Dividends (jointly owned stocks)	1,000
Capital gains on securities (all held for more than 18 months)	1,500
Deductible IRA contribution	2,000
Itemized deductions	12,000

*$400 of this total was received from tax-free municipal bonds.

If Sheila and Jim claim 3 dependents and file a joint return for 2006, calculate their income tax due. Use Table 17.4 and assume an exemption of $3,300 for each qualifying dependent. Assume that all 3 children qualify for the child tax credit.

LG 1

P17.4 The Akais just finished calculating their taxable income for their 2006 joint federal income tax return. It totaled $68,750 and showed no tax credits. Just prior to filing their return, the Akais realized that they had treated a $2,000 outlay as an itemized deduction, rather than correctly treating it as a $2,000 tax credit.

a. Use the tax rate schedule in Table 17.3 to calculate the Akais' tax liability and tax due on the basis of their original $68,750 estimate of taxable income.

b. How much taxable income will the Akais have if they correctly treat the $2,000 as a tax credit rather than a tax deduction?

c. Use your finding in part **a** to calculate the Akais' tax liability and tax due after converting the $2,000 tax deduction to a tax credit.

d. Compare and contrast your findings in parts **a** and **c**. Which would you prefer, a tax deduction or an equal-dollar-amount tax credit? Why?

LG 3

P17.5 Shawn Healy bought 300 shares of Apple Computer common stock at $32 a share. Fifteen months later, in December, Apple was up to $47 a share and Shawn was considering selling her shares, because she believed Apple's price could drop as low as $42 within the next several months. What advice would you offer Shawn for locking in the gain and deferring the tax to the following year? Explain.

LG 3

P17.6 Karen Jones purchased 200 shares of Mex Inc. common stock for $10 per share exactly 2 years ago, in December 2005. Today, December 15, 2007, the stock is selling for $18 per share. Because Karen strongly believes that the stock is fully valued in the market, she wishes to sell it and invest the proceeds in the stock of an attractive emerging company. Karen, who is in the 25% tax bracket, realizes that if she sells the stock prior to year-end, the capital gain of $1,600 [200 shares × ($18 sale price − $10 purchase price)] will result in taxes for 2007 of $240 (.15 × $1,600). Because Karen would like to lock in her $1,600 profit but defer the tax on it until 2008, she plans to investigate the strategies available for accomplishing this objective.

a. If Karen can purchase two put options on Mex Inc.'s stock at a contractual sale price of $18 for a total cost of $180 ($90 per 100-share option), what will her after-tax position be if the stock price declines to $16 per share? Will Karen be able to benefit from any future increases in Mex Inc.'s stock price using this put hedge strategy?
b. If Karen can sell 2 call options on Mex Inc.'s stock with a $16 contractual buy price and 6-month maturity for $480 ($240 per 100-share option) when the stock is selling for $18 per share, what will her after-tax position be if the stock price declines to $16 per share? Will Karen be able to benefit from any future increases in Mex Inc.'s stock price using this deep-in-the-money call option strategy? Is the price of $18 fully locked in using this strategy?
c. Use your findings in parts **a** and **b** to compare and contrast the 2 strategies. Then recommend a strategy to Karen, assuming the stock price does drop below the current price.

LG 3

P17.7 Juan Gonzalez, a single person working for Harla, Inc., will earn $48,000 in 2006 and contribute $7,000 to the firm's 401(k) plan. If Juan is in the 25% tax bracket, what will his reportable income be? How much tax savings will result, and how much will it cost Juan, on an after-tax basis, to make the $7,000 contribution?

Case Problem 17.1 *Tax Planning for the Wilsons*

LG 1 LG 3

Hal and Terri Wilson had most of their funds invested in common stock in the spring of 2007. The Wilsons didn't really do very much investment planning, and they had practically no background or understanding of how income taxes might affect their investment decisions. Their holdings consisted exclusively of common stocks, selected primarily on the advice of their stockbroker, Sid Nichols. Despite a relatively lackluster market, they did experience some nice capital gains, even though several of their holdings showed losses from their original purchase prices. A summary of their holdings on December 20, 2007, follows.

Stock	Date Purchased	Original Cost	Current Market Value
Consolidated Power and Light	2/10/05	$10,000	$16,000
Cargon Industries	7/7/07	3,000	8,000
PYT Corporation	6/29/07	7,000	6,000
Amalgamated Iron & Steel	8/9/06	8,000	5,000
Jones Building Supplies	3/6/03	4,500	4,700

Hal feels this might be a good time to revise their portfolio. He favors selling all their holdings and reinvesting the funds in several growth-oriented mutual funds and perhaps several real estate investment trusts (REITs). Terri agrees that their portfolio could use some revision, but she is reluctant to sell everything. For one thing, she is concerned that federal income taxes might take a sizable share of their profits. In addition, she strongly believes Amalgamated Iron & Steel will make a significant recovery, as will all steel stocks, in 2008.

After some discussion, the Wilsons decided to consult their friend, Elaine Byer, who was a CPA for a major public accounting firm. Byer indicated that she was not an expert in the investment field and therefore couldn't tell the Wilsons which securities to

buy or sell from that perspective. From a tax point of view, however, she did not recommend selling everything in the 2007 tax year. Instead, she said that Consolidated Power and Light, PYT Corporation, Amalgamated Iron & Steel, and Jones Building Supplies should be sold in December 2007 but that Cargon Industries should be carried into 2008 and sold then—if that was what the Wilsons wanted to do.

Hal and Terri were grateful for Byer's advice, but they had 2 major concerns. First, they were concerned about waiting to sell Cargon Industries, because it had showed such a sizable gain and they were afraid its price might decline sharply in a stock market sell-off. Second, they were reluctant to sell Amalgamated Iron & Steel despite the benefit of its tax loss, because they wanted to remain invested in the steel industry over the long run. As a final step, they contacted Nichols, their stockbroker, who agreed with Byer's advice; he said not to worry about the Cargon situation. The stock was selling at $80 a share, and he would sell a deep-in-the-money call option on Cargon, which would enable them to deliver the shares sometime early in 2008. He also explained that they could use a tax swap to get the tax benefit of the loss on Amalgamated Iron & Steel while staying invested in the steel industry. He suggested United States Iron as a swap candidate, because it was selling for about the same price as Amalgamated.

Questions

a. Assuming the Wilsons are in the 25% ordinary income tax bracket, calculate the resulting federal income tax (1) if they sold all their securities in 2007 at their current market values, and (2) if they sold Consolidated Power and Light, PYT Corporation, Amalgamated Iron & Steel, and Jones Building Supplies at their respective market values in 2007 and then sold Cargon Industries at its current market value on January 2, 2008. What do you conclude from your calculations?

b. As noted, Nichols suggested selling a deep-in-the-money call option on Cargon. Explain his reasoning about the future price of this stock.

c. Suppose you thought Cargon had a good possibility for further price increases in 2008, but you were equally concerned that its price could fall sharply. Would you then agree with the strategy Nichols recommended, or would you prefer a different strategy? Explain your answer.

d. Discuss the tax swap suggested by Nichols. Does this strategy allow the Wilsons to minimize taxes while retaining their position in the steel industry? Explain.

e. What overall strategies would you recommend to the Wilsons, given their investment objectives and tax status? Explain.