Minimize Investment Taxes

The following are some specific federal tax considerations. It's important to note that tax rates change periodically. For the most current information, visit the Internal Revenue Service Web site at www.irs.gov. In addition, state taxes may apply. Visit your state government Web site to learn more.

Taxes are complicated. The more you know about taxes related to investment activity, the better able you will be to manage your tax costs. Money you can save in taxes is money you can keep invested for your future.

As with any other type of investment, tax liability may differ from individual to individual, depending on your own personal circumstances. The following are some specific tax considerations associated with investing in stocks, mutual funds, and bonds:

Stocks

When investing in stocks, you may be able to control your tax liability by:

- delaying or accelerating an anticipated sale.
- selecting stocks with certain characteristics (such as stocks that do or do not pay dividends).
- choosing to trade stocks through a tax-advantaged account, such as an IRA or 401(k) plan.

Taxable events can work both ways. They can trigger a tax liability — in which case you owe taxes — or they may enable you to claim a tax loss — in which case you may be able to deduct all or part of that loss in the coming year or even future years.

The following are the most typical taxable events:

- **Dividend distribution**
  Periodically, usually once a quarter, corporations may pay dividends to shareholders. Regardless of whether you receive a dividend or have it automatically invested back into the stock, the distribution is reported as income. Qualified dividends are currently subject to tax at a maximum rate of 15%. Non-qualified dividends are subject to ordinary tax rates.
- **Short-term capital gains**
  A short-term capital gain is the profit from the sale of shares you've owned for one year or less. Short-term gains are currently subject to ordinary income tax rates.
- **Long-term capital gains**
  A long-term capital gain is the profit when you sell shares you've owned for more than one year. Long-term gains are currently subject to a maximum federal tax rate of 15%.

If any of these events occur with an investment you own in a tax-advantaged account, your tax liability may be postponed.

Minimize investment taxes (continued)

Calculating gains and losses

When you sell shares, generally you incur either a gain or loss. Your gain or loss is the difference between the security's selling price and the security's cost basis. The cost basis is the purchase price plus any fees or commissions.

Gains occur when you sell shares for more than you originally paid, and are subject to capital gains taxation. Losses are incurred when your selling price is less than what you originally paid, and, in some circumstances, can be deducted from the current year or future year's capital gains liability.

Mutual Funds

Mutual funds have many advantages including professional money management and portfolio diversification. Keep in mind though, when you own mutual funds, your investment may be subject to taxable events. The following information regarding taxable events only refers to mutual funds that you own in taxable accounts, and not in tax-deferred accounts such as an IRA or 401(k) plan.

Taxable distributions

A mutual fund company generally does not pay taxes on your behalf, so it's important to monitor your account, and report all taxable distributions when you file your income taxes each year. A mutual fund company will send you a Form 1099-DIV that summarizes the taxable distributions it made to you during the year (if any).

Taxable distributions include:

- **Dividend distributions**
  Fund portfolios may hold securities that pay dividends. A fund company passes these dividends, minus fund expenses, on to the fund's shareholders. A portion of these dividends may qualify for special tax treatment (maximum rate of 15%) but other portions may not qualify. You may elect to have dividends reinvested to purchase more shares of the fund at the time of the distribution, but reinvesting dividends does not change your tax liability.

  Note: Some funds, such as municipal bond funds, invest in municipal debt securities, which may provide income that is exempt from federal income tax and, in some cases, state income tax as well. Before you invest in a municipal bond fund, you should read the prospectus carefully to see if the tax benefits from the fund may be appropriate for your situation. Please keep in mind that you may be subject to state and local taxes.

- **Capital gains distributions**
  Mutual funds purchase and sell investments on behalf of the fund's shareholders. When the fund sells investments for a long-term gain, it may treat a portion of its dividend as a capital gain distribution, taxable to you at a maximum rate of 15%. As with dividends, you may generally elect to have capital gains distributions reinvested. And, as with dividends, capital gains distributions you receive from a fund will be taxable.

Minimize investment taxes (continued)

Capital gains from the sale of mutual fund shares

In addition to any capital gains distributions you may receive while you own a mutual fund, you may also sell shares of a fund for a capital gain or a capital loss. You will generally realize a capital gain if you sell your fund shares for more than you paid for them, taking sales charges into account. This capital gain is taxable.

Short-term and long-term capital gains are subject to different tax rates. Check the Web sites of the IRS and your state government to learn more.

To calculate your capital gains, you may choose from one of the following methods: First In First Out (FIFO); Specific Shares Method; Average Cost Per Share, Single Category Method; Average Cost Per Share, or Double Category Method. Ask your tax advisor for details.

Avoid Double Payment

If you automatically reinvest your dividends and capital gains distributions, you should keep all your statements for accurate records when it comes time to sell. That's because you have already paid taxes on your reinvested dividends, so you can subtract both your original contribution plus the total amount of reinvested money from the market value of your investment. This will reduce your capital gains tax liability. Investors who forget to do this may end up paying double taxes on their reinvested dividends, first in the year the dividend is paid and then again when they sell the mutual fund shares.

Bonds

Interest income

In general:

- The interest paid from bonds is taxed at your ordinary income tax rate.
- The interest from U.S. Treasury bonds, bills, and notes is exempt from state and local taxes.
- The interest from some Municipal Bonds is exempt from federal taxes and from state and local taxes for residents of the state where the bond was issued.

Capital gains

- Since bond prices fluctuate, you may sell your bond for more than you paid for it. If this is the case, any profit other than interest income is taxed as capital gain.
- The short-term capital gains rate is the same as your ordinary income tax rate. Profits from bond investments bought and sold within 12 months or less are taxable as short-term gains.
- The long-term capital gains rate—15% for most investors—is applied to bond investments bought and sold for a profit in a period greater than 12 months.
- If you own any kind of bond mutual fund, you may also receive capital gains distributions taxable at the long-term capital gains rate.

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