

PERSONAL FINANCE



## What Investors Need to Know About Taxes

[By Dan Caplinger]

Taxes have come a long way in 95 years.

In 1913, the income tax was simple, with a one-page form. Taxes ranged from 1% to 7%, and less than 1% of the population made enough money to have to pay the tax.

Now, there are different rules for various types of income. Deductions and credits are available for certain activities. It's tough to keep it all straight. The goal of this simple guide is to give you a brief overview of the taxes that affect the most investors.

### Capital gains

When you sell an investment at a profit, you usually get taxed. If you sell within the first year you own an investment, you'll pay tax at ordinary rates as high as 35%. But the tax code encourages longer-term investments, so if you've held on longer than a year, you'll pay a lower rate — a maximum of 15% for most stocks and funds.

In addition, you'll also pay capital gains tax on some mutual fund distributions, even if you don't sell shares of the fund. When the fund itself sells some of its holdings, the taxable gains are passed on to you.

Special rates apply on other types of investments. Homeowners pay no tax on profits from selling their primary residence, up to \$250,000 for single filers and \$500,000 for couples. Collectibles, such as gold coins or antiques, have a higher maximum rate of 28%. Futures contracts have more complicated rules that tax part of your gain

at long-term rates, even if you only hold them for a short time.

### Dividends and other income

In addition to profits from selling investments, you'll pay tax on any interest, dividends, or rental or other income you receive. Here again, however, the tax code encourages some investments over others. Qualified dividends on stocks and stock mutual funds are eligible for the same lower maximum 15% rate.

In contrast, interest on bonds, income from rental property, and most other investment income typically gets taxed at higher ordinary rates. One exception is interest from municipal bonds, which is tax-free on your federal returns and can offer state income tax benefits as well.

### Tax breaks for tax-favored accounts

Investors can take advantage of a wide array of special types of accounts to get additional tax breaks. Traditional IRA and 401(k) contributions can reduce your taxable income and give you tax-deferred growth, where you'll only pay tax when you take money out. Roth IRAs impose no tax on interest and dividends as long as you

follow the rules.

Investments for other purposes get tax treatment as well. Health savings accounts let you invest tax-free for medical expenses. You can get tax-free treatment for college costs with 529 plans. Many of the same financial institutions that offer IRAs give you access to these accounts as well.

### Capital losses

Inevitably, you'll have to take a loss on an investment. Generally, you can claim losses against any capital gains you have. If you have more losses than gains, you can usually take \$3,000 of losses against other types of income, including your wages.

Harvesting losses is a common technique late in the tax year. But be careful of the wash sale rules, which can take away your deduction if you try to buy back what you've sold within 30 days.

This is just a sampling of the many tax laws that apply to investments. Because your own situation is unique, it always makes sense to consult with a tax professional. Nevertheless, a basic understanding of taxes on investments can help guide how you put together your portfolio to minimize the amount of tax you have to pay.

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To learn more about saving money on your taxes, find out:

lower taxes create more growth; Why last-minute changes in the law may make you

wait for your refund; and What to do to get your withholding right.

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