**Oppenheimer & Co. Inc.**
Spencer Nurse
Managing Director - Investments
500 108th Ave. NE
Suite 2100
Bellevue, WA 98004
425-709-0540
800-531-3110
spencer.nurse@opco.com
https://www.oppenheimer.com/spencernurse/

# Tax Planning for Specific Types of Investments

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## Introduction

Investment tax planning can help you maximize after-tax returns on your investments. Tax planning for specific types of investments helps you identify which types of investments are best suited to your unique situation. Because different types of investments produce income or gain that may be taxed differently, you need to know how specific investments attempt to earn money and how those earnings are taxed. You also need to know how to treat any gain or loss when you sell your investments.

### *How do investments earn money?*

Your investments can earn money in two ways: (1) they may generate income (such as dividends, interest, or rent) and/or (2) they may appreciate in value and can potentially be sold at a profit.

### *How are investment earnings taxed?*

Some investment earnings may be tax exempt. Some may be tax deferred. Other earnings may be classified as ordinary income, taxable at ordinary income tax rates. Finally, other earnings may be taxed at the more favorable long-term capital gains tax rates.

***Tip:*** *Long-term capital gains are generally taxed at special capital gains tax rates of 0%, 15%, and 20% depending on your taxable income. The actual process of calculating tax on long-term capital gains and qualified dividends is extremely complicated and depends on the amount of your net capital gains and qualified dividends and your taxable income.*

Generally, long-term capital gains tax rates are more favorable than ordinary income tax rates. Currently, the highest ordinary income tax bracket is 37%, while the highest long-term capital gains tax rate (for most types of assets) is 20%. That's a difference of 17%.

***Tip:*** *Qualified dividends received by an individual shareholder from a domestic corporation (or a qualified foreign corporation) are taxed at long-term capital gains tax rates.*

In addition, the 3.8% net investment income tax applies to some or all of your net investment income if your modified adjusted gross income exceeds $200,000 for single or head of household taxpayers, $250,000 for married filing jointly, or $125,000 for married filing separately. Net investment income can include interest, dividends, capital gains, rents, royalties, non-qualified annuities, and income from trading financial instruments or commodities.

### *How does this apply to specific investments?*

Specific investments and investment vehicles within your portfolio can generate income and earnings that will be taxed in different ways. By looking at the tax ramifications of each, you can estimate the potential total after-tax return on your investments and reallocate assets, if appropriate.

## Cash and cash alternatives

Cash and cash alternatives typically include (1) money market deposit accounts, (2) CDs and other term deposits, (3) money market mutual funds, and (4) U.S. Treasury bills. You may have these types of assets in your portfolio because they are liquid and are considered relatively low risk compared to other types of investment vehicles.

***Caution:*** *Money market funds are neither insured nor guaranteed by the FDIC or any other government agency. Though a money market fund attempts to maintain a $1 per share price, there is no guarantee it will always do so, and it is possible to lose money investing in a money market fund.*

These types of investments generally earn regular interest income. Regular interest income is classified as ordinary income and is taxed at ordinary income tax rates in the year it is earned. You may receive such earnings in the form of a cash payment or a credit to your account, or, in the case of a money market mutual fund, you may be able to reinvest the earnings directly back into the fund. These earnings will be reported to you on Form 1099-INT or Form 1099-DIV. You report such income on Schedule B. From 2018 to 2025, investment expenses relating to the income (e.g., annual fees) may no longer be taken as a miscellaneous itemized deduction, subject to the 2% limit (reported on Schedule A).

Some money market mutual funds may distribute earnings that represent qualified dividends from corporate stock that are eligible for long-term capital gains tax treatment. You may receive the earnings in the form of a cash payment or you may be able to reinvest the earnings directly back into the fund. Either way, you must report the income in the year it is earned. The fund should report any portion of earnings that represents qualified dividends.

Some earnings generated by money market securities may be tax exempt. Money market mutual funds should report the portion or earnings that is tax exempt.

Money market mutual funds may distribute capital gain earnings derived from the sale or exchange of securities within the fund.

The fund must distribute these earnings to shareholders to the extent they are not offset by capital losses. You may receive the earnings in the form of a cash payment or you may be able to reinvest the earnings directly back into the fund. Either way, you must report the income on Schedule D (or directly on Form 1040 if you are reporting capital gain income from distributions only) in the year it is earned.

You may also realize a capital gain (or loss) if you sell or exchange your cash alternative investments. If the capital gain is short-term (the asset was held for one year or less), the income will be taxed at ordinary income tax rates. If the capital gain is long-term (the asset was held for more than one year), the income will be taxed at capital gains tax rates. You may offset capital losses against capital gains (you must follow the netting rules). If you have a net capital loss, you may deduct up to $3,000 ($1,500 if married filing separately) from other income. You may carry forward any excess loss to future tax years until it is all used up (you must use up short-term losses first even if they are incurred after long-term losses). Expenses relating to the capital asset (e.g., commissions, sales fees) are added to the asset's basis (cost).

## Bonds

You may have bonds in your portfolio because they generally carry less risk than stocks and/or because they generate regular income. There are many types of bonds including U.S. government securities, corporate bonds, municipal bonds, agency bonds, mortgage and asset-backed securities, and foreign government bonds. Bonds are debt instruments. They generally pay you regular earnings called dividends, which are really interest, and at maturity you receive the bond's face value.

Some types of bonds generate dividends that are exempt from federal taxation, state taxation, or both, though some tax-exempt bond interest may be subject to the alternative minimum tax. Taxable bond interest will generally be reported to you on Form 1099-INT or 1099-OID.

Expenses relating to bonds are treated the same as expenses relating to cash and cash alternatives (see above). However, if you borrow the money to purchase taxable bonds, interest on the loan can only be deducted to the extent of taxable net investment income. And, if you borrow the money to purchase tax-exempt bonds, interest on the loan is not deductible.

Earnings from international bonds may also be subject to foreign taxes.

### *Bonds purchased at a discount or premium to face value*

Bonds purchased at a discount from par (face) value from their original issuer are called original issue discount (OID) bonds. With OID bonds, you pay tax each year on a portion of the discount amount (which is amortized over the life of the bond). The tax basis of the bond increases over time by an amount equal to OID so that you are not taxed again upon the sale or exchange on the discount amount as a capital gain. OID for tax-exempt bonds is also tax-exempt.

Bonds that are purchased in the secondary market (not at their original issuance) at a discount from face value are purchased at a market discount. Market discount is treated differently than OID. The market discount is applied over the remaining maturity of the bond from the date of purchase and is apportioned as ordinary income and capital gain. Market discount is taxable even for tax-exempt bonds.

***Caution:*** *The rules regarding OID and market discount are complex. For more information, consult a tax advisor.*

If you purchase a bond at a premium to face value (either at original issue or in the secondary market), the premium amount is amortized over the remaining term of the bond and reduces your tax basis when the bond is sold or redeemed.

### *Bonds: capital gains and losses*

If you purchase a bond and hold it until it matures, redemption of the bond does not result in any tax consequences — the amount you receive is a return of capital.

Selling bonds before they mature may generate capital gains or losses (even for tax-exempt bonds). Capital gains and losses for bonds are treated the same as those for cash and cash alternatives (see above). However, bond swaps can be utilized to create capital losses to offset capital gains. And, as described above, if you purchased a bond at a discount from face value the discount may affect the calculation of your gain or loss.

## Stocks

You may have stocks in your portfolio for their growth potential. In general, any increase in the value of stock shares is not taxed until you sell your shares. However, some stocks may make distributions in the form of dividends. Stock dividends are taxable in the year you receive them. They may be treated as ordinary income or they may qualify as dividends eligible for long-term capital gains tax treatment, depending on a number of factors. Sales and exchanges of stock may generate capital gains or losses. The same rules that are explained above regarding capital gains and losses apply to stocks' however, special rules apply to purchases of stock on margin, short sales, wash sales, and stock redemptions. The same rules that are explained above regarding expenses apply to stock.

International stocks may generate earnings that are subject to foreign taxes.

## Mutual funds

You may have mutual funds in your portfolio for diversification and professional management. Mutual funds may consist of stocks, bonds, or both. Thus, mutual funds may pay (1) interest and/or dividends taxed at ordinary income tax rates, (2) qualifying dividends taxed at long-term capital gains tax rates, and (3) net gains (but not losses) that result from the sale or exchange of securities within the fund. The sale or exchange of mutual funds shares may also generate capital gains or losses. Some mutual funds may generate tax-exempt earnings. Some mutual fund earnings may be subject to foreign taxes. The same rules that are explained above regarding expenses apply to mutual funds. Mutual funds are not guaranteed or insured by the FDIC or any government agency, and your shares may be worth more or less than you paid when you sell them.

## Options, puts and calls

An option is the right to buy or sell stock. A call option is the right to buy from the writer of the option, at any time before a specified future date, a stated number of shares of stock at a specified price. Conversely, a put option is the right to sell to the writer, at any time before a specified future date, a stated number of shares at a specified price. The cost of purchasing calls or puts is not deductible, but rather it is a capital expenditure. If you sell the call or the put before you exercise it, the difference between its cost and the amount you receive for it is either a long-term or short-term capital gain or loss, depending on how long you held it. If the option expires unexercised, its cost is either a long-term or short-term capital loss, depending on your holding period, which ends on the expiration date. If you exercise a call, the cost basis of the call is added to the basis of the stock you acquire through exercising the call. If you exercise a put, the amount realized on the sale of the underlying stock is reduced by the cost of the put when figuring your gain or loss.

***Caution:*** *Options involve risk and are not suitable for all investors. Prior to buying or selling an option, a person must receive a copy of "Characteristics and Risks of Standardized Options." Copies of this document may be obtained from your financial professional and are also available at theocc.com.*

## Annuities

Any earnings produced by an annuity grow and compound tax free until withdrawn. Upon withdrawal, the portion classified as principal is not taxed since premium payments are made with after-tax dollars. The portion classified as earnings is taxed at ordinary income tax rates even if the earnings represent dividends from stock that would otherwise qualify for capital gains tax treatment. Premature distributions (distributions made prior to age 59½) incur an additional 10% penalty tax on the earnings.

## Pass-through investments

Pass-through investments generally refer to investments in business enterprises that pass through to you a share of the tax items of the business. This means that you report, on your individual tax return, part of the business's income, gains, losses, and deductions as your own tax items. Types of pass-through investments include interest in sole proprietorships, limited liability companies, partnerships, limited liability partnerships, S corporations, and real estate investment trusts (REITs). Income from pass-through investments may be classified as passive income if you do not actively participate in the business. Passive activity losses can only be used to offset passive activity income.

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Oppenheimer & Co. Inc.
Spencer Nurse
Managing Director - Investments
500 108th Ave. NE
Suite 2100
Bellevue, WA 98004
425-709-0540
800-531-3110
spencer.nurse@opco.com
https://www.oppenheimer.com/spencernurse/


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