

Q4

2007

SC&H | financial perspectives

A quarterly newsletter for the clients and friends of SC&H Financial Advisors, Inc.

Upcoming SC&H Financial Seminars

A series of seminars will be held at our Sparks, MD headquarters at 6:30 p.m.

- Nov. 15 2007
Wealth Transfer
- Feb. 7 2008
Investment Planning

For more information or to register, call Katie Lochte at (410) 785-8052 or visit www.scandh.com/events.

Financial Perspectives will only be available via email beginning in 2008, end your email address to klochte@scandh.com to receive future newsletters.

To schedule a consultation, please contact Greg Horning, Audrey Drossner, Robin Patalon, or Jay Bittner at 410-403-1500.

To Our Readers



In this issue of *Financial Perspectives*, we cover three specific issues related to taxes and investments: The Wash Sale Rules, the "Kiddie Tax," and the deductibility of expenses related to your investments.

Early planning with regard to these and other tax-related topics can have a major impact on your financial position, now and in the future. By looking ahead and being aware of the implications of each change and nuance in the tax code, you can significantly reduce your tax liability even as you improve the value of your portfolio.

This is an area in which the team of experts at SC&H truly excels. Because we are a CPA firm that specializes in tax compliance and consulting, we are staffed with experts who are dedicated to monitoring, interpreting, and creatively applying the latest tax laws.

If you are an SC&H Financial client, you can rest assured that your tax position will be carefully planned to find every deduction, minimize your liability, maximize the value of your investments, and ensure you are compliant with all applicable laws.

As always, please contact us if you have questions regarding these issues, or if we can be of any assistance.

Regards,

~Greg

Greg Horning, President, SC&H Financial Advisors, Inc.

(410) 403-1512, GHorning@SCandH.com.

Wash Sales

We've had a bumpy ride in the stock market this year. After a somewhat slow start many of us saw our portfolios increase significantly during the second quarter only to see the value fall again in recent months.

During those good months, you may have sold some positions and recognized a capital gain. Now, perhaps you have a loss in a stock that you still feel good about and would like to continue holding. You might be tempted to sell the stock, recognize the loss, and then buy the stock back at its new low price. If you think that will work, beware. The IRS has already figured out that trick, and has placed some restrictions on the transactions. These restrictions are called the Wash Sale Rules.

The Rules

A Wash Sale occurs when you sell stock at a loss and buy substantially identical securities within 30 days before or after the sale. The entire restriction period consists of 61 calendar days (the day of the sale, 30 days before the sale, and 30 days after the sale).

Continued on page 2

SC&H
FINANCIAL ADVISORS, INC.

Wash Sales, *continued from page 1*

If you implement a Wash Sale, there are three consequences:

1. You can not deduct the loss on the sale.
2. The loss you could not deduct is added to the cost basis of the newly purchased securities.
3. The holding period of the old security is added to the holding period of the new security.

These rules are designed to eliminate any advantage you might have gained by selling the stock. You'll most likely get your tax benefit, but not in the current calendar year.

Avoiding the Wash Sale Rules

The easiest way to avoid the Wash Sale Rules is to wait 31 days before you buy back the stock. The risk is that the stock could increase in value during that time, offsetting or even eradicating your tax savings. Also, you could purchase the replacement stock 31

days before you sell the old stock. (The last day this year to double-up and have time to sell by year-end is November 30.) If the stock increases, you have a gain, and if there is no change, you can sell the old shares and recognize the loss. If the value of the stock continues to decline, your loss is that much greater.

Finally, you can purchase a stock that is not substantially identical.

Defining Substantially Identical

It is clear that stock issued from the same company will be considered substantially identical. But stock of one issuer is not substantially identical to stock of another issuer. This is true even if the two companies are in the same industry. For example, if your Coca-Cola stock has decreased in value, you can buy stock in Pepsi and avoid the Wash Sale Rules.

The "substantially identical" issue can not

be circumvented by purchasing stock in a related company. If a change in stock price of one company is reflected in the price of another, which is common in mergers, chances are you purchased a substantially identical security.

What about mutual funds?

This area is more nebulous, especially in the area of index funds. Managed mutual funds are normally different enough in their investment strategy, fees, holdings, etc., that a sale of one bond fund at a loss, combined with a purchase of another bond fund from a different fund family, is not considered a Wash Sale. With index funds, it is conceivable that the IRS could consider two S&P 500 Index Funds to be substantially identical, if the

conclusion is made that your position relative to the market has not changed. Also, beware of dividend reinvestments which take place within the 30-day time period.

Wash Sale Rules become even more confusing if options or related parties are involved. If you have

any questions about these transactions, please contact us ♦

The "Kiddie Tax"

Once upon a time, wealthy parents and grandparents could avoid paying income tax on investments, and potentially reduce estate tax upon their death, by transferring the assets to minors. These children were in lower tax brackets; therefore, tax paid on the investments could be substantially reduced. Then the so-called "Kiddie Tax" was introduced, substantially reducing the tax benefits of shifting income to younger generations.

The Kiddie Tax is currently applied to the investment income of a child under 18 years old (however, see final paragraphs for recent changes to this age limit). For 2007, the Kiddie Tax does not apply to the first \$850 of investment income. In addition, the

child is allowed an \$850 standard deduction (or allowable itemized deductions directly connected with investment income, if greater than \$850). Therefore, a child under age 18, with unearned investment income below \$1,700 will pay little or no tax on these earnings.

For example, consider Julie, a 15-year-old girl with 2006 taxable-interest income of \$1,200. After applying the standard deduction of \$850, her taxable income is \$350. At her tax rate of 10%, her tax on the income is only \$35. If, on the other hand, Julie's investment income is \$2,000, \$300 of the income will be taxed at her parents' rate, which could be as high as 35%.

When more than one child in the family is subject to the Kiddie Tax, the tax will be calculated on the combined unearned income of all children added to the parents' taxable income. The incremental tax is then allocated to each child based on their share of the total income.

It is important to remember that the Kiddie Tax only applies to unearned income. If the child has a part-time job, that income will be subject to tax at his or her rate, not the parents'.

There are investments that could minimize the Kiddie Tax. In our example, assuming Julie's investment was earned in a money market account paying 3%, she could potentially be paying only \$35 on \$40,000 of assets.

Municipal bonds, U.S. Savings Bonds, or growth-oriented securities that pay little income might be appropriate investments and also save on the Kiddie Tax. However, as with all investments, taxes are only one area to consider when determining if an investment is suitable for an individual.

Recent Changes to the Age Limit

The 2007 Small Business Tax Act increased the Kiddie Tax age limit to include all children under age 19 and students under age 24, effective for tax years beginning after May 25, 2007 (which, for most individuals, is January 1, 2008).

While this certainly is not welcome news to many of us, it could create a planning opportunity for 2007. Parents should review the accounts of children affected by this new change to see if there are opportunities to recognize capital gains, and pay the lower 5% capital gains tax while it is still an option ♦



Investment Interest and Other Expenses

You might be surprised to learn that some expenses related to your investments are actually deductible. If the expenses are ordinary, necessary, and related to the production or collection of taxable income, they may be deductible, subject to limitations.

Deductible investment expenses may include the following:

- Interest paid on investment debts (investment interest, expense/margin interest - see paragraph below for specific limitations).
- Retirement plan custodial fees, provided they are paid using funds outside the account.
- Wire transfer fees.
- Investment advisory fees.
- Rental of a safety deposit box.
- Newspaper and magazine subscriptions, provided there is a credible relationship between the information in the publication and the actual investment activity.
- Tax-planning fees.

Non-Deductible expenses may include the following:

- Expenses to incur tax-exempt income.
- Costs incurred to actually buy or sell an investment, such as commissions. These expenses are added to the investment cost basis.
- Convention and seminar expenses, unless investing is your trade or business.

Investment expenses are deductible to the extent they exceed 2% of your adjusted gross income (AGI) (when coupled with other miscellaneous itemized deductions). These expenses are not deductible for purposes of calculating alternative minimum taxable (AMT) income.

Investment interest expense—interest you pay on money borrowed to buy investment property, such as stocks and mutual funds—is deductible up to the amount of net investment income you receive. Net investment income is the excess of investment income (interest, nonqualified dividends, short-term capital gains and other capital gains that are taxed as ordinary income) over investment expenses (net investment income = investment income - investment expense). Unlike the investment expenses discussed earlier, allowable investment interest expense is fully deductible from your adjusted gross income. Any excess expense that is not taken in the current year because of the investment income limitation can be carried forward indefinitely.

If you have excess investment interest expense, you can elect to treat long-term capital gains and qualified dividends (both currently taxed at 15%) as ordinary income, which will increase the amount of net investment income you have available for the deduction. Your individual tax situation must be examined to determine if this election would be beneficial to you ♦

IRS Circular 230 Notice:

New IRS rules require us to add certain standard language to many of our letters, memos, e-mails, and other correspondence concerning federal tax matters. This includes written advice concerning any federal tax related to your business or personal affairs. It would also include business and personal-tax planning and preparation, written advice, and written advice pertaining to estate planning or estate-tax matters.

While the specific wording may vary depending on the circumstances, absent the thorough analysis of the facts, you can expect written advice from our firm to contain language similar to the following:

To the extent the information in this newsletter or on our website (including any articles or other materials posted on or linked to from this site) concerns tax matters, it is not intended to be used and cannot be used by a taxpayer to avoid penalties that may be imposed by law ♦



A GUIDE TO COMPLETE FINANCIAL PLANNING:

1. Investment Planning
2. Tax Planning
3. Income Protection and Asset Preservation
4. Retirement Planning
5. Business Planning
6. Estate Planning
7. Insurance
8. Education Planning
9. Special Situations
10. Debt Management



Your *SC&H* Financial Advisors Team



Helping You Meet Your Goals

Contact SC&H Financial Advisors to schedule your estate planning review or financial check-up.

sc&h | financial perspectives

910 Ridgebrook Road
Sparks, MD 21152
FINANCIAL ADVISORS, INC.
SC&H