Be specific: Calculate your gains carefully
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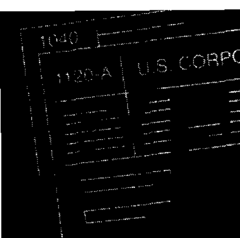

Taxes

Anthony P. Curatola, Editor

BE SPECIFIC: CALCULATE YOUR GAINS CAREFULLY

With the new tax law giving taxpayers lower taxes on capital gains, never have the words of a high school English teacher rung more true, "Be specific in what you say or write!"

Unless you have inherited or been gifted shares of stock or mutual funds, the capital gain or loss on the sale of shares is calculated by subtracting what you paid for your investment from the sales proceeds. This seems simple enough unless you made multiple purchases or reinvested your dividends. If this is the case, the question becomes, "Which shares were sold?"

Tax Relief Act of 1997. As was discussed in the September 1997 tax column, the new law gives investors real incentives to hold their shares of stock or mutual funds for more than 18 months. Shares held one year or less will have their gains taxed at the same tax rate as their wages and other income. These rates range from a low of 15% to a high of 39.6%. Gains on shares held more than 12 months and not longer than 18 months will be taxed up to a maximum of 28%. Gains on shares held more than 18 months will be taxed at a 20% rate for those in the 28% rate or higher and at 10% for those in the lowest bracket of 15%. Also, in the year 2001, another set of rates, 8% and 18%, come into play for shares held more than five years. Different holding requirements must be met depending if you are in the 15% bracket or higher.

Which shares did you sell? If you purchased shares of stock or reinvested dividends at different times, calculating your gain is not so easy. There are two methods one can use to determine the cost of shares—the "specific ID" and the "first-in, first-out" or "FIFO" methods.

The "specific ID" method requires investors to specify which shares they want sold. Investors can "choose" the cost of the shares they want to sell and can thus control the amount of gain or loss on their sale. Adequate documentation and confirmation from your broker or fund manager is needed. IRS Publication 564, Mutual Fund Distributions, provides details of these two methods.

The "FIFO" method is the method an investor must use if no other method is chosen. It is assumed that the earliest shares purchased are the first ones sold. Under "FIFO," the investor loses control over which shares are sold and thus whether losses or gains are recognized.

Mutual fund shareholders have available to them another way to calculate the cost of the shares that they sell—"average basis." Some mutual fund companies, among them American Express, Kemper, and Alliance Funds, provide year-end statements that calculate your gains and losses using "average basis." The "average basis" has two different methods to calculate an individual's average cost per share, the single-category and double-category (which should be known and applied as a multiple-category method because of the new law, but the 1997 Publication 564 does not make any distinction in the different capital gain brackets). Only one of these ways of calculating your average cost can be used if you determine your average cost. IRS Publication 564 provides the details on the mechanics of each calculation, each of which is cumbersome to do. While it is nice that your mutual fund may provide you with gain and loss calculations, as with FIFO, an investor loses control over whether sales generate gains or losses. You are not required to use "average basis" in determining gains and losses. In fact, to use "average basis," you decide to use it by electing "average basis" on your tax return for all transactions of that fund in the current and future years.

Take control; be specific. To maintain control over taxable income and income tax liability, the specific ID method should be used. With the specific ID method, taxpayers can have some control over their tax situation. For example, to minimize the current year's tax burden, the taxpayer can sell those shares that are held more than 18 months. Another way one can minimize tax liability is by offsetting shares sold with a gain held less than 12 months by selling another investment held less than 12 months that has a loss, trying to eliminate the tax on your gain. Your individual tax situation will dictate the decisions you make.

To substantiate the cost of the specific investments you sell, keep confirmations for stock purchases made from a broker and all year-end statements from the company's reinvestment plan that show additional shares acquired by reinvesting your dividends or making direct purchases. For the mutual funds you own, keep all your year-end statements.

Remember your English teacher; be specific. By specifying the shares you sell, you will have the flexibility of when and which shares of your investments you should sell and can control the gains and losses you recognize on your tax return.—*David M. Smith*

David M. Smith is an assistant professor of accounting at Metropolitan State University.
Anthony P. Curatola is the Joseph F. Ford Professor of Accounting at Drexel University.

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