**Stocks and Taxes**
Unlike death, taxation can at least be minimized. In this article, we will examine the basic framework of individual taxation in the United States as it relates to stock investing and review some simple steps you can take to be a more tax-efficient investor.

The information in this lesson is not necessarily exclusive to stock investing; much of it is also relevant to mutual fund investing. Nevertheless, if you are going to invest in any asset class, including stocks, it is imperative to understand exactly how taxes work so you may keep as many dollars as possible in your pocket and away from Uncle Sam.

**Ordinary Income Versus Capital Gains**
Capital gains--the difference between what you sell a stock for versus what you paid for it--are "tax preferred," or taxed at lower rates than ordinary income. Ordinary income includes items such as wages and interest income.

Capital gains arise when you sell a capital asset, such as a stock, for more than its purchase price, or basis. Capital gains are further subdivided into short term and long term. If a stock is sold within one year of purchase, the gain is short term and is taxed at the higher ordinary income rate. On the other hand, if you hold the stock for more than a year before selling, the gain is long term and is taxed at the lower capital gains rate.

Conversely, you realize a capital loss when you sell the asset for less than its basis. While it's never fun to lose money, you can reduce your tax bill by using capital losses to offset capital gains. Also, to the extent that capital losses exceed capital gains, you can deduct the losses against your other income up to an annual limit of $3,000. Any additional loss above the $3,000 threshold is carried over to be used in subsequent years. (Note that due to the IRS' wash-sale rule, you cannot claim a loss if you purchase substantially identical securities 30 days before or after the sale.)

**Jobs & Growth Tax Relief Reconciliation Act of 2003**
Among other things, the 2003 Bush tax cut (known affectionately as JGTRRA) lowered the tax rate for both long-term capital gains and qualified dividends to 15% for most taxpayers, and to 5% for taxpayers whose income placed them in the 10% or 15% income tax brackets. After tax code negotiations at the end of 2012, those rates were made permanent for most investors, but they did go up for high-income earners, defined as individuals earning more than $400,000 in 2013 and married filers earning more than $450,000. Starting with the 2013 tax year, those high earners will pay a top tax rate of 20% on both dividends and long-term capital gains.

Since the basic idea behind the original dividend tax cut was to reduce the burden of "double taxation," or taxation of the same profits at both the corporate and shareholder level, any dividends paid out of profits not subject to corporate taxation will not be considered "qualified dividends" eligible for the reduced tax rate. Therefore, one notable exception is dividends from real estate investment trusts, or REITs, which are typically still taxed at ordinary income rates. In addition, to qualify for the reduced dividend tax rate, you must have held a stock for at least 60 days out of the 120-day period beginning 60 days before the ex-dividend date (the date on which you must be holding a stock to receive the dividend).
Tax-Advantaged Accounts

One easy way to become a more tax-efficient stock investor is to utilize tax-advantaged accounts such as 401(k)s and individual retirement accounts (IRAs). These special accounts allow you to enjoy either tax-deferred or tax-free growth of your investments.

Tax deferral can lead to significant savings over time. Let's assume two investors each start with $10,000 and earn a 10% annual return for 30 years. One has 100% of her gains tax-deferred, while the other realizes the full amount of his capital gains each year and pays a 20% tax on those gains. Under this scenario, the tax-deferred investor ends up with almost $75,000 more at the end than the investor with the taxable gains.

Clearly, it is worthwhile to learn about the types of tax-advantaged accounts available. Below are some of the most popular:

401(k)s. 401(k) plans, so named after a section of the Internal Revenue Code, are set up by employers as a retirement-savings vehicle. The primary advantage of a 401(k) is tax deferral. First, employees can contribute a percentage of their income from each paycheck to their own 401(k) accounts on a pretax basis. This means the amount you contribute to your 401(k) is exempt from current federal income tax. For example, if you are in the 25% income tax bracket, a $100 contribution will reduce your current tax burden by $25. Second, dividends and capital gains earned inside a 401(k) are not subject to current taxation. In short, 401(k) plans allow you to defer taxation on dividends, capital gains, and a portion of your wages until you begin withdrawing from the plan, presumably during retirement, when you may be in a lower tax bracket. (All withdrawals are taxed at ordinary income rates.)

The amount you can contribute to your 401(k) plan is limited to $17,500 in 2013. You also must begin mandatory withdrawals from your 401(k) when you reach age 70 1/2. Withdrawals made before you turn 59 1/2 are taxed as ordinary income, and you may be subject to an additional 10% penalty.

Traditional IRAs. Individual retirement accounts are another vehicle for tax deferral. When you contribute to a traditional IRA, the IRS allows you to take an income tax deduction up to the amount of the contribution, subject to income limitations. In addition, dividends and capital gains earned inside a traditional IRA are not subject to current taxation. However, there are some important limitations to remember. First, you must be age 70 1/2 or younger with earned income to contribute to a traditional IRA. Second, the annual contribution limit is $5,500 in 2013. If you are age 50 or older, you can make additional "catch-up" contributions of $1,000. Finally, like 401(k) plans, you must begin mandatory withdrawals when you reach age 70 1/2. Withdrawals made before you turn 59 1/2 are taxed and may be subject to an additional 10% penalty.

Roth IRAs. These are typically the best retirement account option for many taxpayers. As with traditional IRAs, interest income, dividends, and capital gains accumulate tax-free. However, the main feature of Roth IRAs is that they are funded with aftertax dollars (contributions are not tax
The upside of this is that qualified distributions from a Roth IRA are exempt from federal taxation.

The Roth IRA has the same annual contribution limits and "catch-up" provisions as a traditional IRA, but you must meet certain income requirements to contribute to a Roth IRA. Generally, single filers with income up to $95,000 and joint filers with income up to $150,000 are eligible to make the full annual contribution to a Roth IRA. Contributions to a Roth IRA can be withdrawn at any time without paying taxes or penalties, but withdrawal of earnings may be subject to income taxation and a 10% early withdrawal penalty if made before you turn 59 1/2.

In addition, the distribution must also be made after a five-tax-year period from the time a conversion or contribution is first made into any Roth IRA. So, if you open your first Roth IRA and make your first contribution on April 15, 2013, for the 2012 tax year, your five-year period starts on Jan. 1, 2012. Assuming you meet the other requirements, distributions made in this case after Dec. 31, 2016, from any Roth IRA will receive tax-free treatment.

**Tax Planning 101**

Besides taking advantage of 401(k) and IRA accounts, you can also follow a few basic planning strategies for investments held in taxable accounts. However, you should keep in mind that your goal as an investor should be to achieve the highest after-tax rate of return, not to avoid paying taxes. Taxes are a consideration, but they should not control your investment decisions.

**The Value of Deferral and Stepped-Up Basis**

All things being equal, it is better to pay taxes later than sooner. Therefore, you should endeavor to defer taxation as long as possible. An investor who purchases the shares of sound businesses and patiently holds them will not only enjoy the benefits of tax-free compounding, but will also save on brokerage commissions. At the least, toward the end of the year, you should consider delaying the realization of capital gains until January to defer your tax liability until the following year.

If you are extremely patient and die still owning a stock, your beneficiaries will receive the stock with a "stepped-up" basis, or a basis equal to the market value on the date of your death. Your beneficiaries can then sell the stock and owe no tax on the capital gains accumulated during your lifetime.

**Wait for Long-Term Capital Gain Treatment**

Purchasing a stock on Jan. 1 and selling it for a gain on Dec. 31 of the same year is likely not to be a smart tax move. In this case, your capital gain is short term and taxed at ordinary income rates. Had you sold the same stock a few days later on Jan. 2 of the following year, the gain would have been treated as long term and taxed at lower long-term capital gains rates, and in addition would be delayed another year.

**Take Short-Term Losses**

If you happen to have both short-term and long-term capital gains, you may want to consider realizing short-term capital losses on stocks you have held for less than one year. These short-
term losses will offset your short-term gains, which are taxed at higher ordinary income rates. This will give you the most tax mileage for your capital loss.

**Timing Capital Gains and Losses**
When faced with large capital gains and losses, it may be advantageous for you to realize both in the same year. Suppose you have $30,000 of capital gains and $30,000 of capital losses. If you realize only the gain this year, you will have to pay tax on the entire $30,000. If you decide to realize only your loss, you'd have no capital gains to offset it, and you could deduct only $3,000 against your other income. The remaining $27,000 loss must be carried over into future years. Instead of delaying the tax benefits of your loss, you could choose to realize both the capital gain and loss in the same year. Since they completely offset each other, you would not owe any taxes.

On the other hand, if you do not have a large capital loss to offset, you should generally time the realization of long-term capital gains—which will be taxed at favorable rates—for years when you do not realize any capital losses. Then you can realize your future capital losses in years when you can immediately deduct them against other income that may be taxed at higher ordinary income rates.

**The Bottom Line**
As you can see, taxes can have a meaningful impact on your long-term investment performance. Investing in stocks without regard to the tax impact can greatly reduce your return. But by understanding the basic framework of investment taxation and using a few simple tax-planning strategies, you can work to maximize the only number that matters in the end: the amount of money that goes into your pocket.

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