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Tax Free versus Taxable Investing

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The debate about how to invest in taxable versus non-taxable accounts is endless, but clearly there are differences worth exploiting. At Baltimore Capital Management, we do differentiate between these accounts and try to take advantage of the tax differences.

With the current tax laws, now more than ever; it pays to hold equities for at least a year. The benefit is two-fold. If a gain is realized after a year the tax rate is a low 15%, versus 35% or more for a short term (less than one year) holding period. Additionally, if the stock pays a dividend, the tax on the dividend for a stock held more than a year is also 15%, rather than the investor's regular income tax rate. These are two good reasons to hold equities for at least a year.

In a tax-free account, like an IRA, the length of holding period does not make any difference. If a stock reaches a target or becomes fully valued in less than a year, there is no reason not to sell it and move on to a more timely investment.

There are other issues to consider in tax-free accounts. Some are obvious, like not buying municipal (tax-free) bonds in tax-free accounts. One mistake we see frequently is the use of annuity products in IRA accounts. While the brokers selling these products enjoy the high commissions annuities produce, the client is paying high fees to put an already tax- advantaged product in a retirement account.

Where the debate becomes more challenging is the issue of which type of bond is more appropriate for retirement accounts. While it is obvious that tax-free bonds should be in taxable accounts, it is less well known that US Government bonds are free of state taxation. While this is of no benefit in states without income taxes, most states do have income taxes and some are high. State taxes of 5% are not unusual.

The use of corporate bonds in taxable accounts makes less sense, as these bonds are fully taxable at the investor's regular state and federal income tax rates. These bonds are more appropriate for tax-free accounts. In taxable accounts, it may make more sense to buy dividend-paying stocks that are taxed at 15%, in order to achieve a higher after-tax return.

While these are some useful guidelines, at the end of the day the debate of stocks versus bonds remains the most important one. Bonds are a static investment without the growing dividend that stocks can provide. The only upside from bonds is in a declining interest-rate environment. With declining interest rates, bonds can increase in value. This is not the investment situation we are in now, or likely to be in for several years.

Equities, on the other hand, can provide a growing dividend stream and upside from earnings growth. As pointed out above, they are also tax-advantaged under current federal tax rates. While I may be biased, I have always felt that the risk reward of stocks versus bonds almost always favors stocks. John Templeton, one of the world's best-known investors, once aptly captured the difference by asking if a person would rather loan money to a supermarket (a bond) or own the supermarket (a stock). The preference would almost always be to own the supermarket!

While most money managers are just as happy not to differentiate between taxable versus tax-free accounts, at Baltimore Capital Management we think being aware of the differences and using them to our clients advantage is worth the extra effort.

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