



Carla Pasternak's

Dividend Opportunities

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Beat the Dividend Tax Increase (No Matter Your Income Bracket)

-- By Carla Pasternak

The landscape for income investors is on the cusp of changing. In the next few months, Congress will vote on the 2010 federal budget... which is likely to recommend a provision to increase dividend taxes on some Americans.

If passed, the rule change will require new strategies for income investors. And while some investments will suffer, we found one high-yield investment class that looks even more attractive after the tax hike. (*Full Story Below*)

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Beat the Dividend Tax Increase (No Matter Your Income Bracket)

On May 28, 2003, former President Bush signed into law the *Jobs and Growth Tax Relief Reconciliation Act*. One major provision of this law was to reduce the tax rates on certain dividends from as high as 38.6% down to 15%.

But unless this tax break is extended, which seems unlikely, dividend rates are going up come 2011.

In fact, the Obama Administration submitted its budget blueprint for 2010 just a few months ago. Within it is was a proposal to permanently extend the Bush tax cuts on dividends and capital gains for earners making below \$250,000 (married filing joint returns) and \$200,000 (single). But it also proposed *raising* the tax rate to 20% for those earning above the \$200,000/\$250,000 threshold.

Just to be clear, I'm not taking sides. I'm simply trying to prepare you for what could potentially lie ahead. And it looks the tax rate on dividends for some investors is going to go up.

But that doesn't mean you have to give up income investing if you are in a higher tax bracket -- there are places you can shelter yourself from dividend

Income Notes

Dividend increases have been on the rise over the last several weeks. Names like General Mills (NYSE: GIS), Duke Energy (NYSE: DUK) and Darden Restaurants (NYSE: DRI) have all boosted payments in recent days.

-- Research Staff

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taxes. Best of all, we've found one spot any investor can earn tax-advantaged income... even if they aren't fortunate enough to be earning more than \$200,000.

What Should be Your Strategy Going Into 2011?

With just months left before the potential changes, now is a good time to start planning on a tax-savings strategy.

For starters, if you don't have a tax-advantaged account like an IRA, you may want to consider setting one up in preparation for the higher rates. This account will allow you to take advantage of solid securities that don't offer tax-advantaged dividend income.

And keep in mind that some income investments currently offering tax-advantaged income may lose their appeal as the higher tax rates kick in. Other high-yielding securities that never qualified for the lower dividend rate, like real estate investment trusts, bond funds, or preferred stock, may attract renewed interest.

Tax-Advantaged Yield for a Post-2010 World

But what if you've reached your contribution limit on your tax-advantaged IRA account? Sure, you can load up on tax-exempt municipal bonds and the funds that hold them. But that's not all. You also can turn to securities that pay out large doses of return of capital.

Return of capital is considered simply a return of your original after-tax investment. Therefore, it's not taxed, but it does lower your cost basis. This means you don't have to pay taxes on the income received until after you sell the shares. When you do sell, the return of capital you received is subtracted from your original purchase price.

For example, if you bought a stock at \$20 and received \$5 in return of capital, your cost basis would be \$15. If you sell the shares for \$25 each, you're taxed on the \$10 per share capital gains (\$25 less \$15). Of course, if you sell the shares at a loss below your revised cost basis, you're income isn't taxable.

But where can you find companies that offer returns of capital?

Companies organized as trusts and partnerships generate cash flow that's considered return of capital. These payments reflect depreciation and other non-cash items, so they don't grind down the asset value. Rather, the return of capital payments are simply a way to pass along cash flow to investors.

For income investors seeking tax-advantaged return of capital payments, master limited partnerships (MLPs) like Plains All American (NYSE: PAA) are well worth considering.

Typically, MLPs pay out around 75-90% of their distribution as tax-deferred return of capital. The balance is treated as taxable income, even in an IRA-type of account. For that reason, MLPs are suited for a taxable brokerage account.

The nice thing about these partnerships is that even if you aren't subjected to higher tax rates, you are still able to put off most of the taxes until you sell the security -- so they make a good idea for nearly any income investor.

Good Investing!



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June 10, 2009

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