Condominium investment recommendations

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Bernie and Pam Britten are a young married couple beginning careers and establishing a household. They will each make about $50, 000 next year and will have accumulated about $40, 000 to invest. They now rent an apartment but are considering purchasing a condominium for $100, 000. If they do, a down payment of $10, 000 will be required. They have discussed their situation with Lew McCarthy, an investment advisor, and personal friend, and he has recommended the following investments:

- The condominium - expected annual increase in market value = 5%.
- Municipal bonds - expected annual yield = 5%.
- High-yield corporate stocks - expected dividend yield = 8%.
- Savings account in a commercial bank-expected annual yield = 3%.
- High-growth common stocks:
  - expected annual increase in market value = 10%;
  - expected dividend yield = 0.

Calculate the after-tax yields on the foregoing investments, assuming the Brittens have a 28% marginal tax rate (based on Public Law 108-27, The Jobs and Growth Tax Relief Reconciliation Act of 2003). How would you recommend the Brittens invest their $40, 000?

Solution

We use the provisions outlined in The Jobs and Growth Tax Relief Reconciliation Act of 2003 to compute the applicable tax rates to be faced by the Brittens – a married couple subject to a 28% marginal tax rate – for the different investment decisions they will pursue. Given that the tax-free yield for each investment has been provided, we compute for the after-tax yield using this formula:

After-Tax Yield = Tax-Free Yield x (1 - tax rate).

But first, let us determine the tax rate applicable to the Brittens for each of the investments.

A. The condominium - expected annual increase in market value = 5%. The 5% increase in the market value of the condominium is not subject to taxes. While taxes are set at 18%, the Brittens can expense up to $100, 000 of the property pursuant to the Section 179 Expensing and can take advantage of the bonus depreciation. Hence, the tax rate is de minimis, or maybe assumed at 0%.

B. Municipal bonds - expected annual yield = 5%. Any annual yield from municipal bonds is not taxed at the Federal Level.

Municipal bonds are usually-tax exempt. Hence, the tax rate is 0%.

C. High-yield corporate stocks - expected dividend yield = 8%. Dividends received by a stockholder are taxed the same way as capital gain income. The 8% dividend yield, if it qualifies as a qualified capital gain or dividend, will be subject to the 15% tax rate, for the Brittens.

D. Savings account in a commercial bank-expected annual yield = 3%. Savings account in a commercial bank is subject to the Britten’s marginal tax rate, which is 28%.

E. High-growth common stocks - expected annual increase in market value = 10%; expected dividend yield = 0. High-growth common stocks are subject to 15% taxes. While the yield, which is subject to capital gains tax, is 0, any gain from the disposition of stock is considered a “ gross income”, and is considered a capital gain, which is subject to 15% tax.

Using those tax rates, we can compute for the after-tax yields:

-	Pre-Tax Yield	Tax	After-Tax Yield
Condominium	5%	0%	5. 00%
Municipal Bonds	5%	0%	5. 00%
HY Corporate Stocks	8%	15 %	6. 80%
Savings Account	3%	28 %	2. 16%
HG Common Stocks	10%	15 %	8. 50%

Basing from the after-tax yield itself, the best investment for the Brittens would be the High Growth Common stock. The Brittens' 40, 000 dollar investment may grow by 8. 50% if the whole amount is invested in High Growth Common Stock. However, if we take in to account the risks and the degrees of liquidity, or if the investment could be easily turned to cash.

Municipal bonds and savings account (which are guaranteed) for example, while low yield, have low default risks.

High yield corporate stocks, and high growth common stocks, while high yield, are subject to the volatility of the stock market, and are very high risk. Stock prices are fluctuating every day, and the value of the stock would depend upon the company's performance and investor interest in the company. The condominium investment is a medium risk since it is also subject to supply and demand – real estate investments, for example, at these times are subject to risk due to the subprime mortgage crisis.