Let's Talk About Capital Gains

In a down market, things are a little different- and some investors may qualify for a tax break.

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For seasoned investors, the end of the year equals loss-harvesting time. The classic tactic works like this:

1. You sell some losers to offset some winners, i.e., you sell some securities that are worth less than what you originally paid to counterbalance capital gains you accumulated earlier in the year.
2. With your net gains at $0, you can then harvest up to another $3,000 of capital losses to offset up to $3,000 worth of ordinary taxable income.
3. Beyond that, you can carry over additional capital losses to the following tax year. (smartmoney.com/personal-finance/taxes/a-down-stock-market-offers-tasty-tax-breaks/)

Well in 2008, we have a different situation on our hands. You might have little or no capital gains this year. Should you sell your losers even when you don't have many winners?

Why you might think about selling while the market is down. By taking a bunch of losses this year and carrying over excess losses into 2009, you can potentially shelter some (or maybe even all) of your long-term and short-term gains next year. This means you have the capability to shelter winners you've held in your portfolio (even for less than a year) from being taxed at up to 35%. (smartmoney.com/personal-finance/taxes/a-down-stock-market-offers-tasty-tax-breaks/)

Capital gains taxes could soon increase for some investors. As you may have heard, President-elect Barack Obama has stated his desire to increase the long-term capital gains tax rate for Americans making over $250,000 a year from 15% to 20%. Should you fall into that demographic, you might think of triggering excess capital losses in 2008 and using the losses to shelter future long-term capital gains that could be taxed at a higher rate during the next administration. (But this is still just talk, not a certainty.) (blogs.abcnews.com/politicalradar/2008/08/obama-clarifies.html)

What if your fund actually had capital gains this year? Believe it or not, some funds are producing them. How could that be?

When a big market downturn prompts shareholders to flee a mutual fund, you have a wave of redemptions. How does a fund manager handle that? There are two choices: raise cash or sell assets. This year, the mass of shareholders leaving mutual funds was so large that some fund managers actually had to sell securities in the red on the funds' books, with capital gains potentially resulting for remaining shareholders. (smartmoney.com/investing/mutual-funds/some-funds-may-pay-capital-gains-in-2008/)

If a fund's net asset value (NAV) has fallen in 2008, it is still possible that securities sold by the fund this year can trigger capital gains, even if your account balance has decreased in value. For example, the fund could have purchased a security three years ago at $8 per share

and sold it this year at $13 per share for a $5 capital gain. A fund's NAV differs from a fund's cost basis - and your cost basis is not the fund's cost basis, because you don't own the actual securities, just shares in the fund.

So it is possible that you could see capital gains in your mutual funds this year. (Talk about adding insult to injury.) Of course, you have the option of liquidating your mutual fund shares before the capital gains distributions occur in December.

With an exchange-traded fund, things are different: when shares are sold, that usually just means a taxable event for the selling investor, not other shareholders. Also, many ETFs perform in-kind redemptions to circumvent year-end capital gains distributions. (investors.com/etf/etfEArt02.asp)

Watch out for the wash sale rule. You can't sell a security and immediately purchase the position back at a lower price just to realize a capital loss and tax deduction. IRS rules prohibit this – it's called a "wash sale". You violate the wash sale rule if you buy a "substantially identical stock" within 30 days of the sale of the original security (that's before or after such a sale).

But wait, there's a new wrinkle to the "wash sale" rule this year: Revenue Ruling 2008-5 says you can no longer use an IRA to acquire "substantially identical" securities within the 61-day wash sale window – and you can't boost your tax basis in said IRA by the amount of the disallowed loss. (smartmoney.com/personal-finance/taxes/A-Sneaky-New-Twist-on-the-Wash-Sale-Rules-23611/?page=all)

0% capital gains tax for lower-income investors. If you're in the 10% or 15% federal income tax bracket for 2008, you won't have to pay capital gains at all. Are you a single filer whose 2008 taxable income will total $32,550 or less? Are you a married couple whose 2008 taxable income will total $65,100 or less? Then you can sell assets that you've owned for more than one year during 2008 without paying capital gains taxes on the sale. You get that tax break in 2008, 2009, and 2010. Previously, you faced a 5% capital gains tax. (bankrate.com/brm/itax/news/taxguide/review-rates2.asp?caret=7 , usatoday.com/money/perfi/taxes/2007-06-15-mym-capital-gains_N.htm)

If you sell, just be sure you don't generate so much additional income that you end up in a higher tax bracket. Taxpayers in the 25-35% tax brackets will pay a 15% capital gains tax rate in 2008, 2009, and 2010. (usatoday.com/money/perfi/taxes/2007-06-15-mym-capital-gains_N.htm)

As you think about short-term moves, keep long-term goals in mind. If history is any guide, this recession should in the near future, and the market should recover. So as you ponder any short-term moves, keep an eye on your long-range financial plan, and consult your financial advisor.

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