The New Three-Legged Stool ... Update

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Tax Loss Harvesting

There are a variety of techniques that can be used to make a portfolio tax efficient. Perhaps the most effective is tax-loss harvesting. Essentially, this means selling securities to realize a capital loss and then using the loss to offset realized gains.

The fourth quarter of each year is traditionally known in the financial planning profession as harvest season... not crops from the field, but tax harvest season for investors. Before the end of the year, investors with taxable accounts should be totaling their realized gains for the year-to-date with an eye toward offsetting those gains by selling assets in which they have losses.

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Do you have a plan to turn your lemons into lemonade?

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Mutual Fund Taxation

Calculating the tax due from the sale of mutual fund shares does nothing to heighten the enjoyment that comes with spring and tax-time. As a matter of fact, as popular as they have become as an investment vehicle, mutual funds can be downright scary at tax time.

The owners of mutual funds have little control over the tax implications that come with owning a fund. Funds are managed by managers who have been given discretionary authority by the shareholders of the fund to buy and sell the securities within the fund. Their actions, completely outside the shareholder's control, create the tax consequences.

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Financial Planning Involves More Than Just Investments!

- Personal Goals
- Asset Allocation
- Tax Planning
- Tax Projections
- Estate Planning

Tax Loss Harvesting (continued from page 1)

Unrealized gains that exist only on paper are not taxable until realized, or sold. Realized gains and losses result from selling activity for individual securities, but they also come from realized gain distributions from mutual funds. The latter can catch the unwary by surprise.

Mutual funds are required to distribute 90% of their realized gains during the year. Even if this distribution is reinvested into the mutual fund in the form of additional share purchases, it counts as a realized gain and is taxable. That's the bad news. The good news is that this adds to the cost basis so when the fund is eventually redeemed, the increased cost basis minimizes the final gain on the sale.

In cases where the investor does not have a realized capital gain but does have losses in a portfolio, the tax code allows a $3,000 deduction in capital losses to be deducted from ordinary income each year. That's worth a possible $1,050 (35%) federal and/or state tax savings. Losses in excess of the $3,000 may be carried forward indefinitely … an important planning tool for future portfolio strategy moves.

Some investors are reluctant to sell a losing position for any number of reasons. They are free to buy it back … providing they wait 31 days from the date of sale to do so. Otherwise they run afoul of the wash sale rule, which states if the asset sold is replaced by the identical position, either within 31 days before or after the date of sale, the tax loss is voided.

Since it is only September, it is possible to double up a losing position by buying before the sale and still be able to count for this year as a loss. That way you don't lose your position in the security while you wait for the 31 days to pass before buying it again. As an example, if you have 1,000 shares of General Electric at a loss, you would buy another 1,000 shares today. After 31 days, you can sell your original 1,000 shares to realize the loss. This technique allows you to maintain a position in General Electric at all times.

Another strategy would be to buy a similar security in the same industry when you sell the first security for a loss. An investor holding Proctor & Gamble at a loss might by Colgate at the time of sale to maintain a position in a similar security. This avoids leaving the portfolio uncovered in a particular sector or industry.

Yet another possible solution would be to use ETFs, or exchange traded funds, to fill the void. Selling a losing emerging-market stock or fund could be offset by the IShares Index MSCI Emerging Market Trust (Symbol – EEM). Also, losing ETF positions can be treated as any other security for purposes of loss recognition.

If a losing position has been acquired at different times and at different costs, partial positions may be sold to take advantage of the differing costs. If the portfolio needs more losses … sell the tax lot with the greatest loss, or the highest gain, if the reverse is true.

Know when to harvest losses!

Finally, if the investor does annual gifting to charitable organizations, more tax benefits come from gifting highly appreciated stock, verses selling the stock, being taxed on the gain and gifting cash. If the stock is a losing position and earmarked for a gift, sell it first, take the loss and give the cash.

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Mutual Fund Taxation (continued from page 1)

Mutual funds generate liabilities three ways for investors. First, if the fund collects interest (non tax-exempt) or dividends they must pass through the realized interest and dividends to the shareholders at least once a year. These are taxed at ordinary income tax rates.

Second, if the fund buys and sells securities during the year, the fund creates short and long term capital gains or losses. Again, these must be passed through yearly to shareholders.

In these two cases, even if the fund shareholder elects to use the distributions to buy additional shares, the distributions are still taxable.

Finally, if the shareholder sells shares, and a gain or loss is realized by selling for more or less than the cost basis, the shareholder may have either short-term, if the shares sold were held for less than 12 months, or long term gains or losses.

Now for the scary part...it is possible to purchase a mutual fund one-day, and get hit for a big tax bill the next, if the fund has realized significant tax gains during the year and not done anything to offset the gains with losses. This situation is known as "buying the distribution." This happens when new investors get stuck paying a tax bill on investment gains in the fund that they weren't around to enjoy.

For example, suppose an investor buys a fund that invests in small companies. If the fund manager holds these stocks for several years, allowing the companies to grow, at some point he will sell the stocks, since the companies have outgrown the investment objectives of a small company fund. When this occurs, whoever owns the fund at the time of year the fund makes its taxable distribution gets stuck with the reported tax gain.

Therefore, an investor could buy one day and shortly thereafter get hit with a large taxable gain. To add insult to injury, even if the value of the investment falls due to lower share prices, the gain from the distribution is still taxable.

The good news is that this unfortunate situation can easily be avoided by purchasing the shares after the record date. Many fund families will begin posting preliminary distribution estimates (based on Sept. 30 data) next month on their Web sites. For most funds, final figures will be based on Oct. 31 data and will usually be available by early November. Alternatively, you can make a quick call to the fund's customer service line to confirm that you're in the clear.

If you sold shares during the year, you will need to determine your gain or loss by subtracting your cost basis from the sales proceeds. The IRS allows three methods for determining the cost basis—First In, First Out (FIFO), Average Cost, and Specific Identification. The Average Cost method, which is the most commonly used, requires you to determine the average cost per share—total dollars invested divided by the total number of shares held.

Keep detailed records!

The Average Cost approach has two variations: double-category and single-category. With the former method, you divide your shares into two groups: those held longer than one year (long-term shares) and those held one year or less (short-term shares). Then, figure the average cost per share for each group. With the single-category method, you figure the average cost per share for all shares held in the account, and any shares that are sold are considered to be those held longest in the account.

I predict that relatively few funds will issue sizable year-end distributions this year. In fact, most won't issue any at all. You can thank the 2008 bear market for that. The fact is, many funds will be carrying forward losses reaped during 2008 for some time. They can use these losses to offset realized gains until they are used up.

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Regardless of which method you choose, you need to keep copies of your year-end statements or confirmations to accurately calculate your cost basis.

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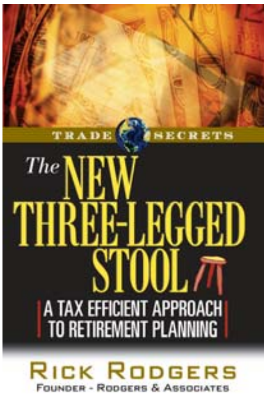

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Rick's Tips

In my last newsletter, I talked about steps you could take to reduce your taxable income this year in order to be eligible for converting an IRA to a Roth. Not everyone will be eligible for Roth conversions, but everyone can benefit by reducing their taxable income in 2009. In this newsletter, I wanted to look closer at some year-end planning techniques that can save money on taxes this year and help make your investments more tax efficient in future years.

Tax efficiency should be an integral part of any investor's strategy. Reducing potential capital gains can often add a few percentage points to the overall performance of your portfolio. After the horrible market return of 2008, adding a point here or a point there can help recoup some of last year's losses through tax savings.

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Call to schedule your evaluation.

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