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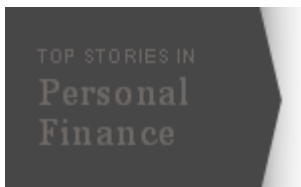


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Making the Best of a Bad Year

Everything you need to know to use your losses to cut taxes

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By TOM HERMAN

With New Year's Day less than a month away, it's time to consider converting investment lemons into lemonade.

For most investors, this has been an abysmal year. But if you're stuck with hefty losses, here's a way to help soften the blow: Take a fresh look at what's left of your wounded portfolio, dump losers you were thinking of ditching anyway and use your losses to cut your taxes for this year.

The Journal Report

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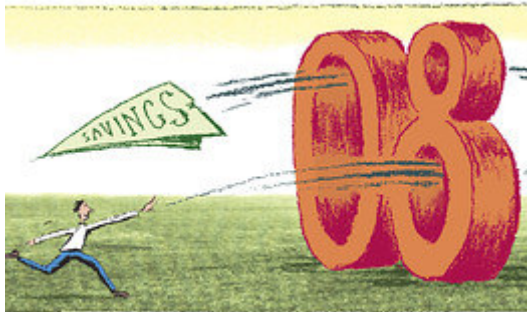
investments, it certainly can help fatten your wallet at tax time next year -- and possibly in future years, too. "It's a great year to tax-loss-harvest," says Lawrence Glazer, managing partner of Mayflower Advisors, an investment advisory firm based in Boston.

The basic tax rules are fairly simple. But in your haste to save taxes, try to avoid wrong turns. For example, steer clear of a painful pothole known as the wash-sale rule, says Bob D. Scharin, a senior tax analyst at the tax and accounting business of Thomson Reuters in New York.

Here is a summary of the basic rules of the road, a few twists and turns to watch out for, and advice from investment and tax professionals.

- **THE BASICS:** Although losing money is painful, you can use capital losses to soak up an unlimited amount of capital gains. If your capital losses are bigger than your gains or you don't have any gains at all, you typically can deduct as much as \$3,000 of net losses from wages and other income. The limit is \$1,500 if you're married and filing separately from your spouse, says Mr. Scharin.

Additional net losses get carried over onto your federal returns in future years, which can mean tax savings for years to come. However, capital-loss carryovers survive only as long as you do. You can't leave them in your will for your heirs.



Daniel Baxter

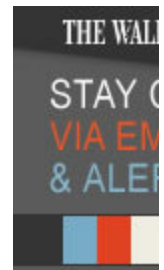
whether he favors this idea.

Tax professionals refer to this as "tax-loss harvesting." While it may not make you feel much better about those ill-starred

Naturally, paper losses don't count. To be able to use your capital losses for tax purposes, you have to actually sell the investments.

These rules aren't limited to stocks. They also apply to bonds and other securities.

During this year's presidential campaign, Sen. John McCain proposed increasing the \$3,000-a-year limit to \$15,000 a year. President-elect Barack Obama hasn't said



Video



■ **IT'S A WASH:** A "wash sale" typically happens when someone sells a stock or some other security at a loss and then buys the same stock, or something "substantially identical," within 30 days of the sale. That means 30 days before or after the sale -- not just 30 days after. Break this rule, and you aren't allowed to deduct your loss. Instead, you add the disallowed loss to the cost of the new stock; that becomes your basis in that stock.

Thus, if you sell a security at a loss and want to be able to deduct that loss, don't buy the same security, or something "substantially identical," within the banned period. What does "substantially identical" mean? It can be a gray area, says Gregory Rosica, tax partner at Ernst & Young LLP in Tampa, Fla. The IRS says it depends on the facts and circumstances of your particular case, and the issue can get surprisingly tricky.

The safest bet: Wait until after the banned period to purchase the security -- or buy something completely different. For more details, see IRS Publication 550, or check with a trusted tax expert.

Dumping Losers

Admitting defeat isn't easy. But selling deeply depressed stocks and other securities now trading for less than you paid for them can be a smart tax-saving technique. Keep these general tax principles in mind:

OFFSETS: You can offset gains and losses, with no limit on the dollar amount. Example: You sold a stock early this year for a \$10,000 profit. This month, you sold another stock for a \$10,000 loss. Those are your only two transactions this year. Result: Your loss wipes out the gain -- and that means no capital-gains tax on that gain.

NET LOSSES: Suppose you have no gains, and you now sell a stock at a \$10,000 loss. You typically can deduct as much as \$3,000 of your net loss (or \$1,500 if married and filing separately from your spouse) against wages and other ordinary income. Excess amounts are carried over into future years.

WASH SALES: If you sell a stock at a loss, don't buy the same stock within 30 days. That means 30 days before or after that sale. Otherwise, you can't deduct the loss.

Source: WSJ Reporting

programs, such as Intuit Inc.'s TurboTax. For more details, see IRS Publications 550 and 564, available on the IRS Web site (irs.gov).

During the presidential campaign, Sen. Obama called for raising the top long-term capital-gains rate on stocks and other securities to 20% -- but only for households making more than \$250,000, or individuals making more than \$200,000. He also indicated he might delay the idea of raising taxes next year if the economy is weak.

If you sell art, jewelry or other collectibles for a profit, the top long-term capital-gains rate is 28%.

The IRS has finally answered a separate question that lawyers and accountants had debated for years: Could an investor dodge the wash-sale rule by selling a stock at a loss in a taxable account and then buying it back a few minutes later for an IRA or some other tax-advantaged account? The IRS said no: That would violate the wash-sale rule.

■ **TAX RATES:** Under current law, the top rate on long-term capital gains on stocks, bonds and other securities is 15%. "Long term" means something you've owned for more than a year. If you sell an investment you've owned for a year or less, that's a short-term gain, and it's usually subject to tax at ordinary income rates. There's also a capital-gains rate of zero -- yes, zero -- for people in the lowest brackets, but it's complicated. To see if you qualify, consider buying inexpensive tax-preparation software

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■ **TAX TRAP:** With stock prices down sharply, many investors may be looking for opportunities to jump back into the market and scoop up bargains. But if you're thinking of buying stock mutual funds this month for a regular taxable account, do some homework first. Otherwise, you could get hit with a large tax bill that could easily have been avoided.

This is the time of year when mutual funds typically make their required capital-gains distributions. Those payouts are taxable -- unless you're investing for a tax-advantaged account such as an IRA. Thus, before investing in a fund, be sure to contact the fund and ask whether it's planning a distribution, how much and when it will be paid, says Mr. Glazer of Mayflower Advisors. If getting a large distribution would have a significant impact on your taxes, consider deferring your investment in that fund until shortly after the date to qualify for the payout -- or pick another fund, Mr. Glazer says. Otherwise, you'll essentially be getting back part of your own investment and owing taxes on it, which would be "adding insult to injury," he says.

It may seem this couldn't possibly be an issue this year since most funds have lost money. Logical -- but wrong. Not every fund is going to have a distribution, but many will this year despite the decline of your investment, Mr. Glazer says.

■ **STRATEGIES:** Don't ever sell a stock solely for tax reasons. But if you're considering selling something for solid investment reasons, be sure you at least consider the tax consequences.

Many investors who have ordinary income and who also are stuck with investments that are underwater routinely try to arrange their affairs so that they take full advantage of the net capital-loss rules. That typically means taking enough losses during the year so that they wind up with at least \$3,000 in net realized capital losses, which can be used to offset ordinary income. This can be especially helpful for upper-income investors since ordinary income-tax rates range as high as 35%.

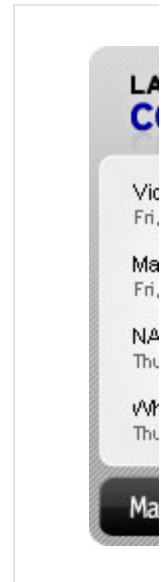
Considering giving away stock to charity? If so, don't donate stocks that are selling for less than you paid for them. Instead, sell the losers so that you can claim a loss that can help you cut your taxes. Then, if you wish, donate the proceeds to charity. If you want to donate stock, donate shares that have gone up significantly in value and that you've owned for more than a year.

When making your decisions, take a look at all your investments, not just your deeply depressed stocks. For example, a friend is thinking of selling the New York City apartment that he and his wife have lived in as their primary residence for many years. They expect to make a profit well in excess of \$500,000.

Under current law, joint filers who sell their primary residence typically can exclude a gain of as much as \$500,000 if they've owned it -- and lived there -- for at least two of the five years prior to the sale. (For most singles, the limit is \$250,000.) Gains of more than that are subject to capital-gains taxes.






So how could this New York couple avoid those taxes? They could sell their apartment and also get rid of stocks or other securities at a loss to reduce or even eliminate the excess gains on the apartment sale.

—Mr. Herman is a Wall Street Journal staff reporter in New York.



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