

Tax tips in a falling stock market

In a period of declining stock prices, tax benefits may not be foremost in your mind. Nevertheless, you may be able to salvage some benefits from the drop in values. Not only can you reduce your taxable income, but you may be able to move out of unfavorable investments and shift your portfolio to investments that you are more comfortable with.

First, you should keep in mind that gain and loss on a sale of stock or mutual fund shares depends on the fair market value of the shares when sold or disposed of, compared to the cost basis of the stock. Your investments may have lost substantial value over recent periods. Nevertheless, if the stock's value when sold is higher than the basis, you still have a gain.

Example. You purchased X Corp stock in 2004, when it cost \$5. At the end of 2007, the stock is worth \$12. In November, 2008, you sell the stock when its value is \$8 a share. Even though your investment has declined in value by 33 percent, you have a gain of \$3 a share on the sale (\$8 sales price less \$5 cost).

The same tax-basis situation that may cause capital gain on the sale of shares that have dropped significantly in value over the past year also is causing many owners of mutual funds that have declined in value to be surprised with a capital gains distribution notice from their fund managers. If you own the mutual fund shares at the time of the capital gain distribution date, you must recognize the gain. Of course, that gain may be netted against your losses from stock or other capital asset sales.

If you realize a profit on a stock sale, the long-term capital gains tax is a maximum of 15 percent, while taxes on wages and other ordinary income can be taxed as high as 35 percent. For taxpayers in the 10 or 15 percent rate brackets, there is no capital gains tax. These reduced capital gains rates are scheduled to expire after 2010. Short-term capital gains (investments held for one year or less) are taxed at ordinary income rates up to 35 percent.

Capital losses can offset capital gains and ordinary income dollar for dollar. Capital gains can be offset in full, whether short-term or long-term. Ordinary income can be offset up to \$3,000. If net capital losses (capital losses minus capital gains) exceed \$3,000, the excess can be carried forward without limit and can offset capital gains and \$3,000 of ordinary income in each subsequent year.

Because a capital loss can offset income taxed at the 35 percent rate, it can be advantageous to sell stock that yields capital gains in one year, while delaying the realization of capital losses until the following year.

Example. Mary has two assets. One asset would yield a \$6,000 long-term capital loss when sold. The other would yield a \$6,000 long-term capital gain. If Mary sells both assets in the same year, she has a net capital gain of zero. If she realizes the gain in 2008 and the loss in 2009 (by selling the assets in different years), she will increase her 2008 taxes by a maximum of \$900 (\$6,000 X 15 percent), but will reduce her taxes in 2009 and 2010 by a maximum of \$2,100 (\$3,000 X 35 percent X 2 years). She will reduce her taxes by \$1,200 merely by shifting the timing of the sales.

Worthless securities. You can write off the cost of totally worthless securities as a capital loss, but cannot take a deduction for securities that have lost most of their value from stock market fluctuations or other causes if you still own them and they still have a recognizable value. You do not have to sell, abandon or dispose of the security to take a worthless stock deduction, but worthlessness must be evidenced by an identifiable event. An event includes cessation of the corporation's business, commencement of liquidation, actual foreclosure and bankruptcy. Securities become worthless if the corporation becomes worthless, even if the corporation has not dissolved, liquidated or ceased doing business.

If you would like to discuss these issues, please contact our office. We can help you consider your options.

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