Year-End Tax Planning for Investors

Stocks performed reasonably well for much of 2011 but fell precipitously after the downgrading of the United States' credit rating. As of this writing, the investment outlook for 2011 is quite uncertain. Despite that fact, there are things you can do with your portfolio by year-end to reduce the tax you'll owe for 2011.

Start by reviewing Schedule D of the federal income tax return you filed for 2010. See if you are carrying over any net capital losses from previous years. The next step is to tally your trading activity for 2011 so far. You can determine if you are in a net capital gain or loss position for the year to date.

Example 1: Jane Collins is carrying over $10,000 worth of net capital losses from prior years. So far this year, her securities trades have generated a net gain of $18,000. If Jane takes no further action, she can use her loss carryover to offset part of this year's gain and wind up with an $8,000 net capital gain. If those gains are all long term, meaning that Jane held the securities for more than a year before selling them, she will owe $1,200 in tax, at a 15% rate.

Learning to love losers

To reduce her tax bill, Jane can take capital losses before year end. If she takes $8,000 worth of losses, for example, Jane will have a $10,000 net gain for 2011: her previous $18,000 net gain minus $8,000 in year-end losses. With a $10,000 net gain for 2011 and a $10,000 loss carryover from her 2010 tax return, Jane will have neither net gains nor net losses. Therefore, she'll owe no tax on her trades for her 2011 tax return. If Jane takes $11,000 worth of losses by year end, she will have a $3,000 net capital loss to report for 2011. That amount is the largest capital loss you can deduct on your tax return each year.

If Jane is in a 25% federal income tax bracket and reports a $3,000 capital loss, she will save $750 in tax-25% of $3,000. On the other hand, if Jane takes no year-end losses she will owe $1,200 in tax, as explained in example 1. Altogether, Jane improves her tax position by $1,950 (going from a $1,200 tax obligation to a $750 tax savings) by taking $11,000 in capital losses by year end. Reducing her adjusted gross income (AGI) by going from a net capital gain to a net loss also might help her use other tax deductions and tax credits.

When you do your year-end tax planning for capital gains and losses, remember to include capital gains distributions from mutual funds. If you hold the funds in a taxable account, you'll owe tax on those distributions, even if you reinvest the distributions in the same fund. Your fund's website should post 2011 distribution information by November or December. If you have 1,000 shares of ABC Fund, for instance, and the fund announces a $1 per share capital gains distribution, you'll know that you'll be reporting $1,000 of taxable gains.

Reinvestment rules

If you sell securities to generate capital losses, you'll receive cash. You may want to maintain the shape of your portfolio; however, you can't immediately purchase the same security you've just sold. Such a transaction, called a "wash sale", disallows your capital loss.

There are three ways to keep your portfolio on track yet avoid a wash sale:

1. **Double up.** To use this tactic, you might begin the process before the end of November. You buy an additional amount of the securities you wish to sell, wait more than 30 days, then sell the original holding for a capital loss.

Example 2: Ken Larsen bought 200 shares of XYZ Bank Corp. a few years ago at $80 a share. XYZ now trades at $50 a share. On November 23, 2011, Ken buys another 200 shares of XYZ. On December 27, 2011, which is more than 30 days later, Ken instructs his broker to sell the original 200 shares at $50 apiece. He takes a capital loss of $30 a share, or $6,000 on the 200 shares.
With this tactic, Ken avoids a wash sale. He also maintains his position in XYZ Bank Corp., which Ken believes is undervalued at $50 a share. As you can see, Ken has invested another $10,000 in XYZ, so he stands to gain more if the stock price moves up or lose more if it keeps falling while he is holding the additional 200 shares. If this approach appeals to you, double up before the end of November so you can wait more than 30 days and still claim a capital loss for 2011 with a year-end sale.

2. Hold your cash. You also can avoid a wash sale by holding onto the sales proceeds for more than 30 days before reinvesting. If Ken sells his original lot of XYZ Bank Corp. for $6,000 capital loss on November 23, he can park the money he receives in a bank or brokerage liquid account for more than 30 days. Then Ken can repurchase 200 shares of XYZ without losing his capital loss. In this scenario, Ken takes the risk that the trading price of XYZ will move sharply higher while he sits on the sidelines.

3. Buy something similar not identical. Ken does not want to be out of the market for more than a month, he can take the $10,000 he receives for selling 200 shares of XYZ on November 23 and immediately buy another bank stock or a fund that holds many bank stocks. Such investments may rise or fall with the industry outlook, just as XYZ would, but they won't jeopardize a capital loss. After more than 30 days, Ken can repurchase XYZ if he wishes. In the interim Ken takes the risk that the replacement holding might not perform as well as XYZ.