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Sharing Your Stock Market Losses With Uncle Sam

A lot of people may have large losses in the stock market from last year or early this year. Some of you may have since gained money in the market. You may want to consider selling these gains to offset your losses tax free.

Uncle Sam is always happy to tax you when you make money. But what happens to your tax situation when you experience losses? Not every investment will be a winner, so learning how to take advantage of the tax treatment of capital losses may be as important to you as the recent run-up in the major stock indexes.

Generally speaking, capital gains and capital losses are reported on federal Form 1040, Schedule D, for the year in which the actual sale of capital assets such as stocks, bonds, and mutual funds occurs. A temporary decrease (or increase) in the value of an asset is not reported on your tax return; the asset must actually be disposed of. In the eyes of the federal government, the old Wall Street adage applies: "You don't make a profit or take a loss until you sell."

Net capital gains and losses are aggregated, and up to $3,000 of a net capital loss may be deducted against ordinary income items such as wages, interest, and dividends. Capital losses in excess of $3,000 are carried forward and deducted in future years, subject to the same limitation. As an example, if you had losses from stock sold in January of $20,000 you could now sell stock for $20,000 in gains without having to pay any tax on the gains. This can be a complicated decision because of different rates for short and long term gains.

Gains and losses from the sale or disposition of capital assets are classified as long-term or short-term, depending on how long you held the asset. For example, a long-term capital asset is currently defined as an asset you have held for more than one year. Long-term capital gains generally receive favorable tax treatment. While the top tax bracket for ordinary income items such as wages is 35%, the maximum tax rate for long-term capital gains is capped at 15%. Short-term capital gains are taxed at ordinary income tax rates.

In addition to netting rules that apply when there are both capital losses and gains, you need to understand the "wash sale" loss limits, especially if you engage in frequent or "day" trading. The wash sale rule is intended to prevent you from selling assets to claim a tax loss and quickly reacquiring them. The rule stipulates that your loss will be disallowed if you purchase substantially identical stock or securities, including put and call options, within 30 days of the original sale.

The IRS, of course, is on the watch for wash sale violations. The wash-sale period runs for a total of 61 days -- 30 days before and 30 days after the date of the claimed loss. Year-end sales made in December also do not escape this treatment. Even if the tax year ends during the 61-day wash sale period, the loss will be disallowed if the wash sale period is violated.

For those of you who have overall losses on unsold stock here's a coordinated investment and tax strategy you may want to consider.

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While the wash sale rule prohibits you from reacquiring substantially identical securities during the specified time period, it does not prohibit you from reacquiring comparable securities. For example, you could sell shares of an industrial stock like Caterpillar, claim the loss for tax purposes subject to the rules discussed above, and immediately acquire shares of a comparable security such as Deere. This is known as tax loss swapping. The theory behind it is that if Caterpillar (the security sold at a loss) subsequently rises, so will Deere (the comparable replacement security), giving you both an economic gain and the benefit of the tax loss.

In theory, tax loss swapping is an excellent strategy, but it can prove risky in the real world. For example, the replacement security could go down even if the disposed-of security recovers. On the other hand, the replacement security could increase a small amount, while the disposed-of security enjoys bigger gains. The acceptable risk and return ratio and performance spread for tax loss swapping depends on your tax bracket, liquidity, net worth, and risk tolerance.

Fundamental economics of investment decisions should not be ignored in pursuit of tax benefits. The laws and risks applicable to wash sales and tax loss swapping are complex, and mistakes can be expensive.

We are highly experienced with both issues. Please feel free to call if you have questions about using your capital losses.