Finding the silver lining to capital losses

2008 was a tough year for investors and 2009 so far is shaping up to be more of the same. Nevertheless, investors should not lose sight of the value of capital losses for tax purposes.

Capital losses can help lessen the sting of the market's decline. Just as the government shares some of your gains by taxing them, it shares some of the losses by allowing certain deductions and carryovers. This article dusts off a handful of capital loss rules that are particularly relevant in today's economy - rules that may have been forgotten over recent years.

We also suggest several tax strategies that investors might want to consider.

THE BASIS RULES

Capital assets yield short-term gains or losses if the holding period is one year or less, and long-term gains of losses it the holding period exceeds one year. he excess of net long-term gains over net short-term losses is net capital gain.

Short-term capital losses, including short-term capital loss carryovers, are applied first against short-tem capital gains. If the losses exceed the gains, the net short-tem capital loss is applied first against any net long-term capital gain from the 28% group (collectibles), then against the 25% group (recapture property), and last against the 15- or 0-% group. Long-term capital losses are similarly netted and then applied against a taxpayer's most highly taxed net gains.

A non-corporate taxpayer offsets losses from the sale or exchange of qualifying capital assets against gains from the sale or exchange of capital assets. If capital losses exceed gains, a non-corporate taxpayer may offset losses against ordinary income to the extent of the lesser of the excess capital loss, or $3,000 ($1,500 for married persons filing separate returns). Although bills have been introduced to raise these dollar levels, which have not been adjusted for inflation for decades, none has yet to see the light of day.

- **Carryovers.** Individuals may carry net capital losses to future tax years but not back to prior years. There is no limit on the number of years to which they may be carried over, as there is with corporate taxpayers. Short-term and long-term capital losses are carried forward and retain their character. Capital loss carryovers that originate in several years are applied in the order occurred.
- **Dividend offsets.** While qualified dividends are taxed at the net capital gains rate, they do not take part in the general computation of net capital gains and, therefore, are not reduced by capital losses, either in the same year or in carried-forward years. However, to the extent that ordinary income is not offset by the maximum $3,000 excess of any net capital losses, qualified dividend income is reduced up to the remainder of the $3,000.

WORTHLESS STOCK

If stock becomes worthless during the year, the loss is treated as a loss from the sale or exchange of a capital asset on the last day of the tax year. As a result, the chances increase that the loss will be considered a long-term, rather than a short-term, capital loss, which may prove less valuable in any net capital loss calculation.

COLLECTIBLES

The rules on gains or losses on collectibles, such as works of art, coins and stamps, can benefit from the general capital gain netting rules. Net long-term capital gains on collectibles are taxed at 28 percent or the taxpayer’s ordinary income rate, whichever is lower. However, under the netting rules, net short-term capital losses may offset net long-term gains from collectibles before offsetting net long-term capital gains from other assets taxes at lower rates.

Selling off collectibles that realize gain, therefore, makes good sense if capital losses from other capital assets are available to reduce that gain. By the same logic, however, if a collectible is to be sold at a loss, matching it with the sale of a collectible at a gain will make full use of the loss to offset the 28% rate gain. Otherwise, the loss may serve to offset only lesser-taxed gains.

WASH SALE RULE

Paper losses are not useful until they are realized and recognized through a sale. The “wash sale” rule prevents capital losses from being recognized if the taxpayer engages in buy and sell transactions of “substantially identical” assets within 30 days of each other.

Strategic to avoid the wash sale rule include buying in the same industry, “doubling down” (buy the same shares first, wait 31 days and then sell the original shares at a loss), or just waiting the 31 days after the loss sale to buy back the same shares.

The current 0-percent long-term capital gains rate for those in the 10- or 15% income tax bracket does not mean that netting capital gains with losses is no longer required. Even though capital gains are effectively not taxed under the zero-rate regime irrespective of whether any capital losses must nevertheless be reduced to the extent of any gain and, consequently, reduced the size of any capital loss carryforward.

OTHER SPECIAL TAXPAYERS

- **Decedents.** A capital loss carryover dies with the decedents, but may be used on returns filed separately for, or jointly with, him. It may not be used separately by his surviving spouse. Surviving spouses cannot carry over and deduct on their separate return a capital loss incurred previously by their deceased spouse on that spouse’s separate property.
- **Divorce.** When spouses have capital loss carryovers from years in which they filed separate returns, they may carry the losses over and use them on their joint return. If capital losses are carried over from a joint return year to a separate return year, short-term and long-term capital losses must be allocated separately to each spouse based on the short-term and long-term losses attributable to each.

KIDDIE STRATEGY

Just as gifts of appreciated stock succeed in transferring the stock's gain onto the donee's tax return when sold, gifts of stock that have declined in value below their purchase price will yield capital losses when sold, Although the focus on tax planning has been on transfers of appreciated property to lower-tax bracket donees, transferring depreciated securities sometimes can work effectively, too.

Under the "Kiddie Tax" rules, net capital gain is taxed at the parent's rate. This treatment, however, does not give any net capital loss to the parent; those net losses continue to belong to the child. For children such as college students with only a few years left to their Kiddie Tax status, net capital loss carryovers might prove very useful as they start working and are able to offset salary income up to $3,000 each year. However, the high-bracket gift-giver may also benefit from selling the stock first, before the gift, to generate a capital loss that may in turn generate a capital loss that may in turn generate a net capital loss carryover. Those carryforwards may suddenly become more valuable if the capital gains rate is allowed to revert to 20% after 2010.

PERSONAL LOSSES

While property held for personal use generally qualifies as a capital assets, a loss from personal-use property is not deductible as a capital loss and is deductible only if it qualifies as a casualty or theft loss. Investment properties such as stocks, bonds, collectibles, however, are considered capital assets, which generate deductible losses from their sale or exchange.

- **Loss on a residence.** Many taxpayers until recently considered a personal residence to be a great investment. Nevertheless, a home has never been considered an investment for capital loss purposes. For that reason, while capital gains must recognized on the sale of residence (to the extent not excluded by the Code Section

121 homesale provision), no loss on the sale of a residence may offset any capital gain elsewhere, whether in the current year or as a carryforward. In doing so, the sale of a residence follows the general rule that personal property sold at a gain is subject to capital gains tax, while the same property (with the exception of certain collectibles) sold at a loss creates no tax benefit.

- **Stock loss due to corporate fraud.** While case law has already decided that general wrongdoing, even theft by a corporate officer, does not transform any resulting deduction in the value of the company's stock from a capital loss to a deductible theft loss against ordinary income, the current financial services meltdown likely will see investors trying to nibble away at this prohibition. In egregious fraud or theft situations, such as the recent Madoff Ponzi scheme, investors have pressed for the ability to win ordinary fraud loss deductions on their lost "investments.".

SHORT-TERM TRADING

Ironically, the tax law's carryover loss rules may accelerate short-term trading (and, therefore, fuel market swings) for the nest several years, despite the tax law otherwise encouraging long-term investment stability through the more favorable long-term capital gains rates. In a volatile market, some investors feel more confident predicting short-term stock fluctuations, rather than identifying long-term values. With capital loss carryovers, they may be able to grab those quick short-term profits at little or no tax cost.

Those who find themselves with net capital loss carryovers must first use them against any similar gains (e.g., long-term, recapture, collectible or short-term), and then may use them to offset dissimilar capital gains. This ordering rule, however, means that net losses generated through long-term capital gains may now offset short-term gains potentially taxed at ordinary income tax rates in future years, provided an investor focuses on short-term trades only. The flip side of this strategy, of course, presents a reciprocal danger: that low-taxed, long-term capital gains, to the extent that they exceed short-term capital gains, will soak up any net capital loss carryovers, irrespective of whether the carryover consisted of short-term and long-term losses.

CONCLUSION

Although losses are never preferred, making the best of a loss by using the tax law effectively can provide a modicum of relief. Positioning the taxpayer to use carryover losses to their maximum advantage can help turn all those losses now glaring up at taxpayers on their 2008 Form 1040 Schedule D appear a little less final when a constructive future use can be found for them through proactive strategies.