

THE WALL STREET JOURNAL.

Upside of Down? Selling Stocks for Tax Losses

By: Eleanor Laise
March 11, 2009

Hidden in the market's hideous performance is a unique opportunity for investors to cut their tax bills for years to come.

Investors who sell beaten-down holdings can use those losses to offset taxable gains and often a portion of their income. Any leftover losses can then be carried over to lighten or even eliminate the capital-gains-tax load in future years. Some investors who suffered massive losses -- say they owned several million dollars worth of Bear Stearns or Lehman Brothers or even General Electric Co. -- may not have to pay capital-gains tax for years to come.

The savings associated with tax-loss harvesting, as the practice is known, are "the only gift we're getting from the market right now," says John Osbon, chief investment officer of wealth-management firm Osbon Capital Management in Boston. "And it goes away as quickly as the market goes up."

For now, of course, there are plenty of losses to go around. Between the market's peak in October 2007 and early this month, the value of stocks owned by households outside tax-advantaged retirement plans fell by \$6.9 trillion, according to Boston College's Center for Retirement Research. (Losses in 401(k)s and other tax-advantaged plans typically don't count for tax purposes.)

Though advisers often warn investors not to let tax considerations drive investment decisions, many say this is a rare opportunity to bank significant losses. David Yeske, managing director at financial-planning firm Yeske Buie, typically harvests only enough losses to offset gains and keep clients' asset allocation on track. But late last year, he snapped up 80% or 90% of the available losses, enough to offset taxable gains and have some left over for future years. One reason: He's rebalancing client portfolios more often, which is "one of the most powerful ways to surf this chaos," Mr. Yeske says. And Metamorphosis Money Management, a Denver firm specializing in tax management for money managers, says assets have doubled over the past year in its "Perpetual Harvest" program, which harvests tax losses on a daily basis.

How It Works

Here's how tax-loss harvesting works. Say you paid \$50,000 for shares of Citigroup Inc. that are now worth \$5,000. You sell the shares, realizing a \$45,000 loss, which is your only loss harvested this year. You use some of that loss to offset \$10,000 worth of gains on other investments sold this year, leaving a net capital loss of \$35,000. You can then

subtract \$3,000 of that, or \$1,500 if you're married filing separately, from your wages and other income on your 2009 tax return. The remaining \$32,000 can be carried forward to reduce future years' tax bills. Unused losses can be carried over from year to year as long as you live, but can't be passed on to heirs.

Talk of capital gains may seem odd at a time when U.S. stocks have dropped more than 50% from their 2007 peak. But some investors can still realize gains from selling, for instance, stocks purchased long ago or alternative investments.

Many investors harvest tax losses late in the year when they start fretting about the size of their next tax bill. But given the market's severe losses lately, there's no reason to wait, financial advisers say.

Methodical tax-loss harvesting can significantly boost investors' after-tax returns when the savings are put back into the market. An investor who harvests losses each month over a 25-year period, reinvesting tax savings back into the portfolio, can beat a strictly buy-and-hold investor's returns by about 0.5 percentage point annually after tax, according to a study by First Quadrant LP, an investment management firm in Pasadena, Calif.

One caveat: If you sell an investment for a loss, don't buy a substantially identical investment within 30 days before or after the sale. If you do, you'll violate the so-called wash-sale rule and won't be able to claim the loss to offset gains. If you sell shares of Coca-Cola Co., for example, you should wait 31 days before buying more shares of that stock.

Avoiding Wash Sales

But sitting on the sidelines waiting for the wash-sale period to expire may be dangerous in this market, advisers say. "Traditionally in markets like right now, the rebound comes fast and furious," says Tom Henske, partner at wealth-management firm Lenox Advisors. "You want to be careful about how much time you're spending out of the market." One approach: When you sell a holding at a loss, immediately swap into a similar, but not identical, investment. An investor selling Coca-Cola Co., for example, could buy PepsiCo Inc. the same day without violating the wash-sale rule. Since the rule can get tricky, investors might want to consult a tax adviser.

Before diving headfirst into harvesting, investors should consider the transaction costs, advisers say. These may include commissions to buy and sell stocks and loads on mutual funds. You probably don't want to pay \$20 in commissions, for example, to recognize a \$2 loss. And if you've banked so many losses that you can't realistically expect to use them during your lifetime, there's no point in incurring further transaction costs harvesting losses, says Kaye Thomas, a tax lawyer and author of "Capital Gains, Minimal Taxes." But generally, "it never does any harm to have a capital-loss carryover, and the more the merrier, because you never know if you will have large capital gains down the line," Mr. Thomas says.

It generally makes sense to realize a loss as long as there are equally good or better investment options to replace the holding you're selling, says Diane Park, a financial adviser and manager of tax planning at Wade Financial Group in Minneapolis. But, she cautions, it's important to remain diversified when harvesting tax losses. "You don't want to sell all your small-cap stocks," she says.

Staying Diversified

Many advisers say they're now harvesting losses and rebalancing client portfolios in one step. Say you like to keep 30% of your equities in foreign stocks and 70% in the U.S. market. Your foreign holdings may have declined more sharply than your U.S. stocks, throwing your asset allocation out of whack. You can sell some losing U.S. stocks, moving the money overseas and harvesting losses that can be used for years to come.

Today's market also presents an escape route for investors who are highly concentrated in their employer's stock or in shares that have been handed down for generations. If investors have been hesitant to sell any of those shares because they didn't want to face the tax consequences, they can now offset any gains produced by harvesting losses elsewhere in their portfolio. Often, "people would rather have a highly concentrated, risky position than pay a tax," Mr. Henske says. "Here's the perfect opportunity to do what they should have been doing anyway."