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## **The Upside of a Down Market: Top Four Tax Planning Opportunities**

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Your portfolio has been hammered. News that you are in good company does not make you feel any better or make your newly postponed retirement any closer. The risks of doing or not doing something can be paralyzing. It's time to convert misfortune into an opportunity with a little help from Uncle Sam. We do caution that you tread carefully, since there are plenty of potential traps, but here are our top four tax planning opportunities you can capitalize on in a down market:

### **1. Harvesting Losses**

Speak to your investment advisor about harvesting losses from your portfolio before year end. You should trigger enough losses to eliminate capital gains recognized (remember those?) earlier in the year before the implosion. You should also ask your advisor to take into account potential capital gain distributions from mutual funds, since it is likely that significant gains will arise in December due to investors fleeing such funds in the past couple of months. It may make sense to sell these funds if you have an unrealized loss position. Warehousing losses in excess of the projected gains for the year is also a good idea, since these can be carried forward indefinitely.

Be careful to avoid the "wash sale" rules which disallow losses if you purchase substantially identical securities within the period 30 days before or after the sale. This creates an investment dilemma, since you do not want to be out of the market if it pops during the wash sale period. The tax savings could be greatly outweighed by the missed opportunity of participating in a recovery. Consider "doubling down" on favored securities or investing in SPDRs or ETFs for the asset classes within which you would like to participate, during the wash sale period.

You will need to have your advisors coordinate the loss harvesting process if you have multiple brokers using different platforms, since the wash sale rules must be applied in the aggregate, not by account. Also, you cannot avoid the wash sale rules by using your IRA to repurchase particular securities. And, the IRS may even attack the use of related entities if they are used to game these rules.

Loss harvesting is not limited to publicly traded securities. Investments in private companies may also have become worthless. Consider selling these to an unrelated party or abandoning them back to the company to secure a current year deduction, rather than battling it out with the IRS to prove worthlessness. Some of these investments may generate ordinary rather than capital losses, if they qualify for Section 1244 treatment.

### **2. Estate/Gift Planning**

While we do not know when or if we have hit bottom, values and interest rates have not been this low for years. Direct gifts, gifts to GRATs and sales to intentionally defective grantor trusts (IDGTs) can shift significant wealth out of your estate. There is more than a decent chance that selected stocks or even a slice of an entire portfolio will outperform GRAT hurdle rates and the interest rate charged on installment sales to IDGTs. Using family LPs or LLCs to make gifts can create even more gift leverage due to the use of valuation discounts.

Be very careful to avoid gifting a security whose tax basis exceeds its value at the time of the gift- a very common situation right now. The donee must use the lower of the fair market value or tax basis when determining loss from a future sale of such security resulting in "disappearing basis". You are better off

selling such securities and gifting the proceeds to avoid this harsh result. The same advice applies to charitable contributions- sell the losers, take the tax loss and contribute cash rather than making the contribution in kind. Or, even better, contribute securities that have been held long term and have significant appreciation, in order to avoid recognizing capital gains on such securities in the future.

### **3. Exercising Stock Options**

By exercising nonqualified stock options when values are depressed, you can lock in lower compensation and convert future appreciation into long term capital gains if you anticipate a significant recovery in your employer's stock performance. This strategy is particularly effective when there are low strike prices which reduce the out of pocket cost of exercising. You will also be shifting compensation income into what are likely to be much lower tax rates in 2008 than what the new Congress is likely to impose in future years.

Another benefit: You will avoid Social Security taxes if you have already exceeded the Social Security base in 2008. The cap on that base could potentially be removed as has been proposed by the new Administration, resulting in unlimited Social Security taxes on income from future exercises.

### **4. Roth Conversions**

Converting a traditional IRA to a Roth IRA could produce significant future tax savings, if your adjusted gross income (AGI) for 2008 will not exceed \$100K (without regard to the conversion income) . The lower values will reduce the current income tax on conversion and the lack of capital gains might reduce your AGI to below the income threshold to qualify for a conversion in the first place.

Distributions from Roth IRAs are generally tax free while those from traditional IRAs are fully taxable and remain taxable even to your heirs. This can result in huge tax savings. You can unwind a Roth IRA conversion made earlier this year when values were high and reconvert after meeting certain waiting periods when values are lower.

You may also be able to roll over a company plan into a traditional IRA to execute a Roth conversion.

Advanced planning is essential to secure the desired tax results and there are many traps and special rules beyond the scope of this article. Please call us at 781-937-5300 if you would like more information regarding these down market planning strategies.