Santa Barbara Independent
WHO. WHAT. NOW.

Tax Harvesting

Making Lemonade Out of Capital Losses

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Some people make small fortunes — by starting out with large ones.

Recently a prospective client came into our office looking for a second opinion. He was not certain that his financial advisor had placed him in the right investments and he felt that he might be paying too much in taxes.

What we discovered was not pretty.

This unfortunate individual had sold a house in the beginning of the year for a handsome profit. He enjoyed $750,000 in capital gains, the first $250,000 (he is single) of which was exempt from capital gains tax with the rest taxable as a capital gain. Altogether, he ended up with a million dollars in cash. Not unusual in a housing market like Santa Barbara.

He then invested the $1,000,000 in the stock and bond markets. The stock market experienced declines, and by the end of 2008 he had an unrealized loss (otherwise known as ‘paper loss’) of nearly $450,000. After January 1 of 2009, he found himself in an unenviable position. Capital gains taxes due on $500,000 from the sale of the house--and an investment account valued at $550,000.

Let’s assume that his combined federal and state taxes due on the gain from the sale of the house equal 20%. $500,000 at a 20% tax rate would result in taxes due of $100,000.

Now let’s do the math; $550,000 (in the investment account) less $100,000 (in capital gains taxes) leaves him with $450,000 after tax in his investment account.

$1,000,000 in cash in early 2008 had shrunk to $450,000. Large fortune, small fortune.

What could he have done differently? Investments will fluctuate and we are all aware that 2008 was an abysmal year for most investors. But how could his financial advisor have saved him close to $100,000? He could have used a simple technique called tax harvesting.

Tax harvesting is when an investor sells investments at a loss, then uses those capital losses to offset gains taken on other investments, and enjoys the benefit of a lower overall tax bill on April 15th. The investor can even purchase the same investment back again 31 days after the sale without losing the benefit of the tax loss. The key is that the investment must be sold, which is how the loss is “realized” for tax purposes.

Our investor did not sell, but held on to his investments past the end of the year. What could he have done?

Our friend could have sold his investments before December 31 of 2008 and realized the loss for tax purposes. By realizing the $450,000 capital loss, he would have offset nearly all of the tax due on the gain from the house. Easy. Inexpensive. But he didn’t do it. Sadly, no one told him about this basic tax saving strategy.

What does this mean for you? While we all scramble to find last minute deductions just before April 15th, why not start planning now for your 2009 tax bill?

This information is not intended to be a substitute for specific individualized tax, legal or investment planning advice. I suggest that you discuss your specific tax issues with a qualified advisor. If you do, be certain they’re proactive. Tell them you expect to hear ideas before year’s end. It’s your money and ultimately, you are responsible.

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