SMALL BUSINESS REVIEW Resources for Successful Small Business Owners

YOUR MONEY:

Year-End Investment Strategies

Balancing your portfolio and taking advantage of tax-reduction strategies can pay off.

December 2007, by Guy McPhail

While 2008 is just around the corner you still have time to look for tax-saving opportunities before year-end. Today, let’s look at tax loss harvesting from the taxable portion of your investment portfolio.

Have you analyzed your portfolio to get a view of your 2007 gains and losses? This is an important task that you should pencil in on your annual financial to-do list every December. If you have gains for the year in your investment portfolio, you should seriously consider the tactic of “tax loss harvesting.”

Tax loss harvesting is simply selling assets that have fallen below their purchase price before year-end to offset your annual capital gains, thereby reducing the amount of taxes you will have to pay.

This investment strategy is often overlooked, but can prove quite beneficial. In fact, a Fidelity Institute study found that 67 percent of households do not take full advantage of their unrealized losses. Of the 252,000 taxable accounts held by the surveyed households, the Institute found that about 26 percent of them had sufficient losses to take full advantage of the $3,000 maximum allowable deduction.

Wash Away Your Underperformance Blues

This year may look particularly inviting to take advantage of losses in your taxable investment portfolio. The stock market has given investors a bumpy ride in the second half of this year. The subprime mortgage mess in the credit markets is a key culprit causing the increased price volatility in the stock and bond markets. The subprime situation has cost some big banks and brokerage firms billions in losses this year. As of this writing, the CEOs of two of the biggest of these firms have lost their jobs; and these businesses will likely be writing off quite a few billion in losses for 2007.

While a typical individual investor is unlikely to have a high level of exposure in his portfolio to companies holding billions in questionable subprime debt, his or her investment portfolio is still likely impacted. Marketplace nervousness about the credit markets crunch has dragged down the stock prices of numerous companies, many of which have nothing to do with making or holding subprime loans. You may be directly holding many such stocks in your portfolio.

Can you turn this situation to your advantage? Yes. As most CPAs know there is a rule called the “wash sale.” This rule prohibits an investor from claiming a capital loss for tax purposes if the investment in which the loss originated is repurchased within 30 days.

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If you now sell a position to create the tax loss, you are precluded from buying it back for 31 days. As an unintended result you may miss out on appreciation if part of the market in which your portfolio was allocated happened to swing up during that period.

There is a strategy to overcome this obstacle: Buy a stock that is similar (just make sure it isn't too analogous per IRS regulations). Say you sold your Merck stock at a loss. If you wanted to maintain a pharmaceuticals allocation you could buy Pfizer. Or, you could buy the Pharmaceutical HOLDR (PPH), which is an exchange-traded fund that tracks the shares of 21 of the world's largest drugmakers. What would work best for you? Your investment advisor can help by revisiting your intended portfolio allocations and weightings, and evaluating which substitute investment vehicle makes the most sense for your portfolio goals.

One pitfall to look out for is in the area of mutual funds when you are doing tax harvesting. Mutual funds frequently make year-end capital gains distributions that can wreak havoc on your strategy. For example, if you're planning to sell a mutual fund with gains to use up some of your loss carryforwards, do it before the fund makes it's the year-end distributions that are required by law. That lets you control your gains and losses. While it may be too late for you to take advantage of this tactic this year, make yourself a financial to-do note for next October to reexamine your mutual fund holdings in your taxable portfolio and look for this type of opportunity.

Think carefully before you purchase a mutual fund at this time of year, too. Wait until after its year-end distribution. Otherwise, you'll get caught having to pay taxes on gains that only the fund's older shareholders realized.

Planning for a Healthy Investment Year

Take some time before year-end to see if your portfolio allocation is properly positioned or to rebalance it if you have not done so within the last year.

Be smart and reduce your taxes—and at the same time balance your portfolio. These issues are complex so please find an excellent investment advisors and CPA to help guide you through these strategies.

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