

2011 Tax Moves You Can Bank On

by Ronald Papa

Year End Tax Planning: As you know, Legacy Advisors is a comprehensive wealth management firm that provides more than just investment and portfolio management advice. The fourth quarter of each year always offers unique tax planning opportunities that may ease the burden we all bear each April 15. Year-end tax management strategies such as actively managing short-term gains, utilizing current portfolio losses and considering accelerating current gains to avoid potential future tax increases, are useful areas to examine to lighten the tax load. Very few people do returns by hand anymore and it's helpful to see what Schedule D actually looks like to understand how gains and losses are added up and how loss carryovers are created.



A few simple concepts...IRS rules require that losses are first used to offset the same type of gain. That is, short-term losses (assets held over 12 months) are used up against any short-term gains and long-term losses (assets held over 12 months) reduce long-term gains. Once you establish whether you have a net short-term gain or loss and if you have a net a long-term gain or loss, you combine the short-term and long-term results. For example, if you have a net short-term gain of \$10,000 and a net long-term loss of \$5,000, then you'll pay tax on \$5,000 to be taxed at your ordinary income tax rate. (Remember, short-term gains are taxed at ordinary income rates and long-term gains are taxed at a 15% maximum rate through 2012.) If you have \$3,000 in short-term gains and \$10,000 in long-term capital losses, you have a net capital loss of \$7,000. You can then deduct \$3,000 from your ordinary income and you retain \$4,000 as a capital loss carryover that can be used in future years to offset gains.

GET OUT OF JAIL FREE CARD

Your tax advisors should evaluate last year's federal and state tax returns to review your 2010 marginal tax rates, whether they were subject to the Alternative Minimum Tax (AMT) and the size of any capital loss carryovers. This may seem complicated, but, it's helpful to see how that worked the previous year and you should demand it.

Capital loss carryovers are a valuable asset, *a get out of tax jail free card* that you have to decide when to play. Some people may have such large capital loss carryovers that they may never use them up in their lifetime. For others, when markets turn positive and they need to liquidate certain holdings for financial needs, loss carryovers could be used in just a few years.

Additionally, many mutual fund investors, with huge capital loss carryovers from the last few years, may be making the serious mistake of thinking they do not need to actively manage short-term gains distributed by their funds. With the increased trading, both from investors and the fund managers themselves, short-term capital gains mutual funds distribute each year get reported as ordinary income on the 1099 involuntarily and without your consent...not exactly efficient investing.

MANAGING SHORT-TERM GAINS

In any market, short-term gains should be carefully monitored and matched up with short-term losses, especially for high income clients in the top tax brackets. Remember, net short-term gains are taxed at ordinary income rates whereas, thanks to *The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010*, net long-term gains are still taxed at just a 15% maximum rate through 2012. Even after the capital gains rates provision of this

tax law expires at the end of 2012, the maximum rate on long-term capital gains will be 20%, still better than the ordinary income tax rate for high income taxpayers.



As many of you know, I have positioned you in some “tax-sensitive or advantaged” portfolios that actively monitor tax trading activity. This year, the domestic market volatility, the fiscal contagion in Europe and low interest rates have pressured me to advise you into making tactical portfolio moves designed to stabilize portfolios. Clients are always looking for me to make moves to either anticipate or to acknowledge what is going on in the market and that is why we discuss this frequently. But, this sometimes results in more frequent trading and adds greater potential to generate short-term gains or losses than with a traditional buy and hold approach in your non-IRA portfolios. If you

manage your funds yourself, are not careful, the taxes due on short-term gains could offset the benefit of their tactical strategies.

This gets more complicated when we factor in the state taxes to contend with. Massachusetts has a 12% tax on short-term capital gains, so we try to avoid short-term gains. If a client in Massachusetts is planning to retire to Florida next year, I may suggest that we wait to take advantage of Florida’s no tax status before taking gains. Conversely, if someone is living in tax-friendly New Hampshire and planning to move to Massachusetts, we might want to realize gains sooner rather than later. We manage what we can. However, if conditions dictate it’s to time to sell, then there is not much choice. Taxes are important, but, not the ultimate determinate of all things.

I will analyze a portfolio’s capital loss carryovers to use up some of the carryover losses when realizing some short-term gains. But, we also need to keep in mind that these carryovers will be even more valuable to offset future gains if taxes increase as we predict. For portfolios with no existing capital loss carryovers, current taxes, especially short-term gains, will become more significant as we contemplate moving assets and the future of sweeping tax law changes.

Please call our office at 781-556-1038 to discuss how some of these year-end tax strategies may lighten that tax burden next April. In next week’s Bulletin, I’ll include some useful information specifically about Tax-Loss Harvesting and another reminder that December 31 is the deadline for Required Minimum Distributions.