

Capital Pains: Rules for Capital Losses

By Julian Block

Article Highlights

- Tax rules limit the deduction for net capital losses at \$3,000 per year.
- Losses on investments can be used to offset gains on the sale of other assets.
- Investors can carry forward unused losses over \$3,000 into 2011 and succeeding years.

When securities markets swoon and apprehensive investors bail out of their holdings, they console themselves with deductions for capital losses when it comes time to file taxes.

But long-standing rules limit deductions for losses on sales or redemptions of shares of individual stocks, bonds, mutual fund shares and exchange-traded funds (ETFs).

The big hurdle is Internal Revenue Code Section 1211, which caps the deduction at \$3,000 for both married couples and single filers. (Married couples who file separate returns are limited to a maximum deduction of \$1,500 per person.) These dollar limits haven't been revised upward since they went on the books in 1978, when Jimmy Carter was in the White House.

In my experience, many individuals focus just on the \$3,000 ceiling and forget that the tax code authorizes them to be resourceful when they incur capital losses. Section 1211 allows capital gains on investments to be fully offset by capital losses on other investments. There is also another significant break that investors fail to take advantage of: Losses on sales or redemptions of stocks, bonds, mutual funds or ETFs held in taxable accounts can be used to offset gains on sales of capital assets other than stocks, bonds, etc. This opens up many possibilities—for instance, profits on sales of collectibles, vacation homes, undeveloped land, active farms, commercial property of all kinds, and rental property.



Take, for example, the case of Marilyn Paul. Marilyn plans to sell her personal residence and anticipates a capital gain greater than the exclusion amount of up to \$500,000 for married couples filing jointly or \$250,000 for singles and married couples filing separate returns. Marilyn should consider realizing losses on, say, shares of stock or mutual funds to offset the taxable part of her gain.

Prohibited Offsets

Marilyn cannot use losses on assets held in traditional IRAs, 401(k)s, Keogh plans and other tax-deferred retirement accounts to offset her gains. Capital gains and losses in these retirement accounts are not taxed.

Income from qualified dividends cannot be offset by capital losses, either. Although qualified dividends are taxed at the same tax rate as long-term capital gains in 2010, fine print buried in the tax code bars this offset. It matters not that the tax rate for qualified dividends is the same as that for capital gains.

Another constraint prohibits offsets of capital losses against income from conversions of money moved out of traditional IRAs into Roth IRA accounts or income from required minimum distributions from traditional IRAs and other retirement plans. Simply put, losses from a taxable account cannot be used to reduce the taxes owed from the withdrawal of funds from a tax-deferred account (such as a traditional IRA or a 401(k)). In the same way, losses in tax-deferred accounts are not allowed to be used to offset gains

Table 1. Calculating Carryforward Losses

Long-Term Capital Losses for 2010	\$60,000
Long-Term Capital Gains for 2010	\$40,000
Long-Term Capital Losses Applied to Capital Gains	\$40,000
Unapplied Losses	\$20,000
Section 1211 Deduction Applied to 2010 Taxes	\$3,000
Losses Eligible to be Carried Forward	\$17,000

in taxable accounts. It's neither here nor there that the retirement accounts swelled only because the securities they held appreciated.

How Much Can Be Deducted?

Capital gains can be offset by capital losses realized during the same tax year, up to the total amount of capital gains. It does not matter whether the gains and losses are a mixture of short- and long-term, a capital loss can be used to offset a capital gain. If net capital losses exceed capital gains, how much tax relief becomes available for 2010? Section 1211 blesses offsets of net losses against as much as \$3,000 of ordinary income—a wide-ranging category that includes salaries, pensions, interest and “dividends” (considered interest) earned on savings accounts, certificates of deposit or similar savings vehicles, Roth conversions and required distributions from tax-deferred plans. If necessary, however, investors can carry forward unused losses over \$3,000 into 2011 and succeeding years.

An example: Joe and Barbara Fontana expect to have long-term losses of \$60,000 and long-term gains of \$40,000, resulting in a net long-term loss of \$20,000 for 2010. On Form 1040's Schedule D, they subtract \$3,000 of their loss from ordinary income, leaving them with a carryforward of \$17,000 from 2010 into 2011. On the Fontanas' 2011 Schedule D, they use the remaining loss (unless offset by capital gains) to trim ordinary income by up to \$3,000, leaving them with a carryforward of \$14,000 from 2011 to 2012. Table 1 shows the math.

Another state of affairs includes

a married couple I'll call Rudolph and Flavia Colman. Rudy is a 30-something investor with an unshakeable faith in the “market-timing fairy.” Alas and unsurprisingly, Rudy relied on a seer who was no Nostradamus. [The 16th century French astrologer is still renowned for his prophecies of events far in the future, many of which, arguably, proved accurate.]

In 2000, a few days before the prices of technology stocks crested, Rudy moved money into mutual funds that invested in dot-com ventures—despite his mate's prescient demands to buy bond funds instead. Fortunately for Rudy, Flavia persuaded him to place ownership of the fund shares in both their names.

The Colmans suffered losses of \$90,000 when the dot-com bubble burst. In the event that the couple realizes no future capital gains and the cap stays set at \$3,000, it will take 30—count 'em, 30—years to write off all of their losses. (Remember, the maximum annual deduction is \$3,000 and they have \$90,000 worth of capital losses.)

What if Rudy passes away before they're able to deduct the entire \$90,000? Will this be a problem for Flavia? Not at all, provided she lives long enough. After filing their last joint 1040 form, she just continues to claim unused losses in subsequent years on her own returns, whether filed singly or—should she remarry—jointly with her next husband.

So why was it wise for the shares to be owned jointly? Had Rudy been the sole owner at the time of his death, Flavia's carryforward would have been derailed. This is so even when the couple's final return is a joint one, and for the two years after Rudy's death

that surviving spouse Flavia qualifies for joint return rates because she has a dependent child.

Section 1211 imposes no time limit on using up carryforward losses. All the same, the Colmans must use their carryforwards as soon as possible. Like other investors, they can't forego a carryforward deduction in a lower-bracket year and save it for a higher-bracket year. Another stipulation prevents them from claiming losses on sales of assets held primarily for personal purposes, such as year-round homes, automobiles or furniture.

Worthless Stocks

To compound the Colman's tax travails, some of their stocks or bonds became worthless, thanks, perhaps, to the increasing number of corporate bankruptcies. To nail down their loss deduction, they must be prepared to show that the shares of stock had some value at the close of 2009 and only became entirely worthless during 2010. It doesn't matter that the shares are no longer traded on a market and are—for all intents and purposes—practically worthless. If the IRS audits their return and questions the loss, the burden is on them—not the IRS—to establish that there's no current liquidating value, as well as no potential value.

When are they entitled to “recognize”—that is, write off—their loss? On the last day of the year in which the shares become worthless. To support their deduction, they should obtain a statement confirming worthlessness from a broker, bankruptcy court or the company that issued the shares.

Wash Sales

The Colmans need to be mindful of wash-sale rules designed to bar losses that are more form than substance. These frequently missed limitations would apply when the couple sells shares of stock (including shares of a mutual fund) to establish a tax loss, but still wants to maintain an identical or essentially the same economic position in the same company or fund. A cur-

rent deduction for their loss can only be taken on the tax return if they repurchase more than 30 calendar days (not trading days when the market is open) before or after the sale of the original stock—a total period of 61 days. True, a hiatus of 30 days exposes them to an adverse move in the stock price; but in tax avoidance, as in life, there's almost never a free lunch.

There are several ways for them to sidestep the wash sale restriction and realize their loss. The easiest way is to buy shares of a comparable company, so the Colemans are never out of the market for 30 days. An example would be to replace one media conglomerate with another one—without any diminution of the amount invested or unbalancing their portfolio.

The couple can forget about running afoul of the wash-sale rule in the event they need to sell a stock they like in order to register a capital gain. This strategy is one that they might want to implement before 2010 closes if their losses surpass the \$3,000 cap on the deduction against ordinary income. A sale that results in a profit leaves them free to immediately reinvest in the same stock. In this case, the couple realizes a profit for the purpose of creating a taxable event to apply the \$3,000 carryforward

against. At the same time, the couple repurchases the position, establishing a new tax basis in the stock. They just need to be careful not to realize a loss in this stock for at least 30 more calendar days.

If shares in the same company were purchased at the different prices and at different times, Rudy and Flavia should make sure to clearly indicate to their broker which shares of stock they want to sell. Otherwise, they might not reap the most favorable gain or loss on a sale of only part of their holdings. To create the biggest loss, they should sell the shares bought for the highest prices.

Year-End Transactions

Suppose the Colmans decide to sell some appreciated shares on Friday, December 31, 2010. They won't receive payment until the first week of January. The reason this kind of sale straddles two years is because the New York Stock Exchange and other securities markets generally require 24 hours from the trade date to settle the trade. The "trade date" is when the couple orders the sale to be executed; the "settlement date" is when the couple receives the sales proceeds and has to turn over the shares.

At one time, the law allowed reporting the gain from a last-week-in-

December sale either in the year of the trade date or the year of the settlement date. Now, however, there's no choice. The IRS insists Rudy and Flavia report the profit in the year the trade takes place, regardless of when the settlement takes place. To shift the gain from 2010 to 2011, they should delay the sale until January 3, 2011.

As for capital losses, the rules are uncomplicated: Report the loss in the year the trade occurs.

State Income Taxes

In most states with income taxes, there are no breaks for long-term capital gains and dividends. States like California and New York tax these kinds of income at the same rates as salaries and business profits. Nearly all of these states face significant budget shortfalls and, unlike the federal government, are prohibited from running deficits. At the same time, their tax collections are declining, with collections on capital gains particularly battered, and they must deal with increasing expenses for items like health care and prevention of terrorist attacks. Consequently, even states whose returns generally conform to the federal rules are unlikely to reduce their rates for capital gains and dividends. ▲

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