



Year-End Tax Planning for Stock Market Investors

The volatile securities markets have likely produced some lemons in the portfolios of many investors. As year-end approaches, investors should consider the following strategies to make the best tax use of the paper and actual losses from their stock market investments to turn these lemons into lemonade.

Investors that have realized gains earlier in the year from sales of stock should take a close look at their portfolio with a view toward selling some of those stocks that now show a paper loss. One strategy is to sell enough of these stocks at a loss to offset gains recognized earlier in the year, plus an additional \$3,000. Selling to produce this amount of loss is a good idea from a tax perspective because the individual would avoid paying taxes on the earlier capital gains. The additional \$3,000 capital loss can be used to offset a like amount of ordinary income each year for federal taxes, but not for New Jersey or Pennsylvania.

Although some stocks have declined recently, these same securities may be an attractive investment worth holding for the long term. However, there is no way to precisely preserve a investment position in a particular stock while at the same time gaining the benefit of the tax loss because of the "wash sale" rule. This rule precludes the recognition of loss where substantially identical securities are bought and sold within a 61-day period (30 days before or 30 days after the date of sale). As such, you cannot sell stock to establish a tax loss and simply buy it back the next day. However, an investor can substantially preserve an investment position while realizing a tax loss using exchange-traded funds (ETFs). These investments are baskets of securities that track an index or specific sector of the market, but trade like shares of stock. Investors can structure their transaction to avoid the impact of the wash sale rules by selling stock or mutual funds at a loss and purchasing ETFs in a similar index or industry sector.

Since gains and losses are not recognized within an Individual Retirement Account ("IRA"), the sharp market decline does not have a current tax impact on pre-

retirement individuals who invest in stocks and mutual funds within their traditional or Roth IRAs. However, there are some tax strategies for owners of traditional or Roth IRAs to consider, whether they are still in their working years or are retired and taking required minimum distributions from their accounts.

A traditional IRA can be converted to a Roth IRA if, for the conversion year, (1) the taxpayer's modified Adjusted Gross Income (AGI), not including the taxable amount of the conversion, does not exceed \$100,000; and (2) the taxpayer is not a married individual filing a separate return (unless he or she lived apart from their spouse for the entire year). Beginning in 2010, the \$100,000 AGI ceiling on traditional to Roth IRA conversions will be removed. The value of the IRA being converted will be included in the taxpayer's taxable income for the current tax year;

however, the 10% premature distribution penalty would not apply. The stock market decline allows an investor the opportunity to convert a traditional IRA to a Roth IRA at a much lower tax cost than would have been possible when the stock market was at a peak.

Taxpayers who convert a traditional IRA to a Roth IRA should avoid taking distributions from the Roth IRA within five years after the conversion. The distribution would not be considered taxable income, but a 10% premature withdrawal penalty would apply if the withdraw was taken within a five-tax-year period beginning with the tax year in which the conversion took place. This penalty would not apply in the event that one of the enumerated exceptions apply (i.e. taxpayer attained age 59 1/2, distributions for higher education or first-time home buying expenses).

Conversely, an investor who converted from a traditional IRA invested in stocks or mutual funds to a Roth IRA earlier this year when the market was much higher will wind up with an artificially high tax bill if the market does not recover quickly. Fortunately, that investor can treat the conversion as if it had never been done by recharacterizing the IRA. This involves transferring the converted amount (plus earnings or less losses) from a Roth IRA back to a traditional IRA through a trustee-to-trustee conversion. This must be done by the due date (including extensions) of the taxpayer's return for the affected year and reported on that year's return. For example, a conversion made in early 2008 may be recharacterized and reported on the taxpayer's return filed on or before April 15, 2009, or October 15, 2009 if a six-month extension is applied for.

Amounts held in traditional IRAs do not grow tax-deferred indefinitely as taxpayers must begin taking required minimum distributions (RMDs) from their traditional IRAs by April 1st following the year in which they attain age 70 1/2. The RMD is generally determined by applying a life-expectancy table factor to the IRA account balance at the end of the previous year, so taxpayers will not be able reduce their 2008 RMDs to account for a drop in the value of their IRAs this year. The amount of each RMD is calculated separately for each IRA. However, the RMD amounts for the separate IRAs may be totaled and the aggregate RMD amount may be paid out from any one or more of the taxpayer's IRA accounts. For example, if one IRA is invested in stocks and mutual funds that have declined in value and another is invested in bonds or money market funds, the combined RMD can be taken from the latter IRA to avoid selling at a market low and losing the potential for future appreciation. This rule permitting amounts in traditional IRAs to be aggregated for RMD purposes applies only to IRAs that an individual holds as an owner. It does not apply to IRAs that an individual holds as a beneficiary or cannot be aggregated with a qualified retirement plan account or a Roth IRA to determine payouts.

These are just a few of the tax strategies that can make a significant difference to investors trying to turn the sour taste of the downturn in the stock market into a pleasant drink when they file their tax returns next April.

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