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TAX PLANNING WITH A VOLATILE STOCK MARKET

Individuals who lost money in the stock market in 2007 may have other investment assets that have appreciated in value. These taxpayers should consider the extent to which they should sell appreciated assets (if their value has peaked) and thereby offset gains with pre-existing losses.

Long-term capital losses are used to offset long-term capital gains before they are used to offset short-term capital gains. Similarly, short-term capital losses must be used to offset short-term capital gains before they are used to offset long-term capital gains. Individuals may use up to \$3,000 of total capital losses in excess of total capital gains as a deduction against ordinary income in computing adjusted gross income.

For 2007 and 2008, an individual is subject to tax at a rate as high as 35% on short-term capital gains and ordinary income. On the other hand, most long-term capital gains are taxed at a maximum rate of 15%. However, for 2007, the maximum rate is only 5% to the extent the gain would otherwise be taxed at a rate below 25% if it were ordinary income.

Maximum tax benefit is achieved by reporting long-term capital gains in one year and capital losses in a different year. However, this is not just a tax issue. As is the case with most planning involving capital gains and losses, investment factors need to be considered. A taxpayer will not want to defer recognizing gain until the following year if there is too much risk that the value of the property will

decline before it can be sold. Similarly, a taxpayer will not want to risk increasing the loss on property that he expects will continue to decline in value by deferring the sale of that property until the following year.

If a taxpayer has no net capital losses for 2007, but expects to realize such losses in 2008 well in excess of the \$3,000 ceiling, he should consider shifting some of the excess losses into 2007. That way the losses can offset 2007 gains and up to \$3,000 of any excess loss will become deductible against ordinary income in 2007.

How to preserve investment position after recognizing gain or loss on stock. For the reasons outlined above, paper losses or gains on stocks may be worth recognizing this year in some situations. But suppose the stock is also an attractive investment worth holding onto for the long term. There is no way to precisely preserve a stock investment position while at the same time gaining the benefit of the tax loss, because the so-called “wash sale” rule precludes 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). Thus, a taxpayer cannot sell the stock to establish the tax loss and simply buy it back the next day. However, he can substantially preserve an investment position while realizing a tax loss by using one of these techniques:

- ...Double up. Buy more of the same stocks or bonds, then sell the original holding at least 31 days later. The risk here is of further downward price movement.

...Sell the original holding and then buy the same securities at least 31 days later.

...Sell the original holding and buy similar securities in different companies in the same line of business. This approach trades on the prospects of the industry as a whole, rather than the particular stock held.

...In the case of mutual fund shares, sell the original holding and buy shares in another mutual fund that uses a similar investment strategy.

...Sell put options in the stock sold.

The wash sale rules apply only when securities are sold at a loss. As a result, a taxpayer may recognize a paper gain on stock in 2007 for year-end planning purposes and then buy it back at any time without having to worry about the wash sale rules.

When deferring gain may be appropriate. An individual's net capital gain is taxed at a maximum rate of 15%. However, if such net capital gain would otherwise be taxed at a rate below 25% if it were ordinary income, it is taxed at a 5% rate this year, but will be subject to a zero percent rate for 2008 through 2010. A taxpayer whose top dollars will not be taxed at more than 15% this year or next, and who is considering the sale of appreciated capital assets before year end, should instead defer the sale until next year. By doing this, the taxpayer could end up paying zero tax on his gain if the taxpayer's income

is low overall, instead of paying 5% if he sold this year. This should be done only if (1) deferring the sale is not likely to result in a reduced sales price, and (2) the taxpayer is over age 18 and not a dependent of his parents.

Shifting capital gain to children. Because of the lower tax rates on long-term capital gains, some parents were shifting stocks to their children and then selling the stock. The child would typically be in a lower tax bracket and perhaps a zero tax bracket in 2008 on capital gains. Congress changed the law with the *Small Business and Work Opportunity Tax Act of 2007* to prevent such a tax maneuver.

What the *2007 Small Business Act* does do is prevent any tax savings when long-term capital gains are shifted from the parents to child after 2007, in cases where all of the following apply:

- ... the child turns age 18, or if a full-time student turns age 19-23, before the close of the tax year;
- ... the child's earned income for the tax year does not exceed one-half of his or her support;
- ... the child has more than roughly \$1,700 of unearned income;
- ... the child has at least one living parent at the close of the tax year; *and*
- ... the child does not file a joint return for the tax year

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