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YEAR-END PLANNING FOR CAPITAL GAINS AND LOSSES

Year-end historically has been a good time to engage in planning to save taxes by carefully structuring your capital gains and losses. But it is even more important this year than in past years. That's because the maximum long term capital gain rate was reduced for post-May 5, 2003, gains and this reduction offers a unique opportunity to save tax this year which wasn't available in prior years. All of this is shown in an example below.

But first let's consider some possibilities if you have losses to date. For example, suppose you lost money in the stock market in 2003 and have other investment assets which have appreciated in value. You should consider the extent to which you should sell appreciated assets (if you think their value has peaked) and thereby offset gains with pre-existing losses.

Long-term capital losses offset long-term capital gains before they offset short-term capital gains. Similarly, short-term capital losses offset short-term capital gains before they offset long-term capital gains.

Remember you may use up to $3,000 of total capital losses in excess of total capital gains as a deduction against ordinary income in computing your adjusted gross income (AGI). For 2003 and 2004, individuals are subject to tax at a rate as high as 35% on short-term capital gains and ordinary income. But, post-May 5, 2003, long-term capital gains generally are taxed at a maximum rate of 15% (for pre-May 6, 2003, long-term capital gains the maximum rate is generally 20%). However, the post-May 5, 2003, maximum rate is only 5% (10% for pre-May 6, 2003 gain (8% for property held over 5 years)) to the extent the gain would otherwise be taxed at a rate below 25% if it were ordinary income.

All of this means you should try to avoid having long-term capital losses offset long-term capital gains since those losses will be more valuable if they are used to offset short-term capital gains or ordinary income. To do this requires making sure that the long-term capital losses are not taken in the same year as the long-term capital gains are taken.

However, this is not just a tax issue, you also need to consider investment factors. You wouldn't want to defer recognizing gain until the following year if there's too much risk the property's value will decline before it can be sold. Similarly, you wouldn't want to risk increasing a loss on property you expect will continue to decline in value by deferring its sale until the following year.

To the extent taking long-term capital losses in a different year than long-term capital gains is consistent with good investment planning, you should take steps to prevent those losses from offsetting those gains.

Similarly, if you have long-term capital gains taken into account before May 6, 2003, which are taxable at the 20% rate, you should try to avoid, where it makes investment

sense, having post-May 5, 2003, long-term capital losses offset post-May 5, 2003, long-term capital gains. Where possible, postpone taking the post-May 5, 2003, long-term capital gains until 2004 when they will be taxed at a 15% rate, and use the post-May 5, 2003, long-term capital losses to offset the pre-May 6, 2003, long-term capital gains.

> Illustration: In April 2003, Donna recognized long-term capital gains of $100,000 on the sale of stock. On July 5, 2003, she recognized a long-term capital loss of $100,000 on the sale of other stock. Donna has other stock in ABC Co. on which she would recognize a long-term capital gain of about $100,000 if she were to sell it now. She thinks this stock will increase somewhat in value if she delays selling it until early in 2004. She has no other capital gains or losses in 2003.
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> - If Donna sells the ABC stock at a gain of $100,000 in 2003, that gain will be offset entirely by the $100,000 long-term capital loss on the July 5, 2003, sale of stock. She will pay taxes of $20,000 (20% of $100,000) on the pre-May 6, 2003, long-term capital gain of $100,000 she recognized on the sale of stock.
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> - If Donna delays selling the ABC stock until 2004, her pre-May 6, 2003, long-term capital gain of $100,000 will be offset entirely by the July 5, 2003, long-term capital loss of $100,000. Thus, she will pay no taxes on capital gains for 2003. If she sells the ABC stock at a gain of $100,000 in 2004, she will pay a tax of $15,000 (15% of $100,000) on that gain, or $5,000 less than the taxes she would have paid had she sold that stock in 2003.

If you have no net capital losses for 2003, but expects to realize such losses in 2004 well in excess of the $3,000 ceiling, you should consider shifting some of the excess losses into 2003. That way the losses can offset 2003 gains and up to $3,000 of any excess loss will become deductible against ordinary income in 2003.

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 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, you can't sell stock to establish a tax loss and simply buy it back the next day. However, you can substantially preserve an investment position while realizing a tax loss by using one of these techniques:

- 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.

- For mutual fund shares, sell the original holding and buy shares in another

mutual fund which uses a similar investment strategy.

As we have shown, careful handling of your capital gains and losses can save you substantial amounts of tax.

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