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Using investment losses to your advantage

While investment losses are never easy, it is important to realize that losses exist only on paper until you sell your shares. That is why many financial advisors counsel their clients to maintain their share balances rather than sell at a low point and realize a loss.

However, there is one distinct advantage to selling low, and that is realizing a capital loss that can be applied against investment gains and, in some cases, ordinary income on your tax return. What follows is a discussion of one such strategy.

The tax-swap strategy

Tax swapping is a tax-planning strategy that, when applied to mutual funds, entails selling one fund and investing in another that is similar. The strategy may allow you to realize a tax loss while retaining essentially equivalent market exposure. For example, an investor may be holding the ABC Municipal Bond Fund whose value has declined substantially. The investor knows that maintaining an allocation to municipal bonds in their portfolio is advisable. So, the investor sells the ABC Municipal Bond Fund, realizing a capital loss, and reinvests the proceeds in the XYZ Municipal Bond Fund.*

Benefits

Tax swapping may be an effective way to modify your portfolio while increasing its after-tax performance. If you are holding a fund that has experienced a "paper" loss, a swap may allow you to realize a tax loss while freeing up the money to purchase another fund that may improve the quality of your overall portfolio. Capital losses realized from a tax swap can be used to offset realized capital gains from other investment sales, or may create a capital loss carryforward that can be used in subsequent years to offset income and capital gains. In addition, up to $3,000 in net capital losses can be used to reduce current taxable income.

*In order to avoid a wash-sale transaction, the securities being considered must not be "substantially identical." According to the IRS, in determining whether stocks or securities are substantially identical, you must consider all the facts and circumstances in your particular case. For more information, consult IRS Publication 550, Investment Income and Expenses.

Considerations

Before executing a tax swap, you should be aware of the potential impact of the "wash-sale" rule. This tax rule prevents investors from deducting losses when they reinvest the proceeds of a securities sale in "substantially identical" securities within 30 days of the original sale.

However, the wash-sale rule may not apply to actively managed mutual funds because of the differing holdings within fund portfolios, depending on the circumstances. By contrast, the wash-sale rule would likely apply to a swap of index funds or exchange-traded funds based on the same index (e.g., two funds that track the same municipal bond index). Since the IRS has not provided a definitive rule on how the wash-sale rules apply to portfolios holding multiple investments, it is important to consult with a qualified tax professional.

Also, if you are considering a tax-swap transaction late in the year, you need to be aware of mutual funds making year-end capital gains distributions. In taxable accounts, investors generally should not invest in a new fund right before it is about to make its year-end distribution. Otherwise, you will effectively be "buying a tax liability." This is because the fund's net asset value declines by the amount of the capital gains distribution, but the distribution is taxable to all current fund shareholders (i.e., shareholders who owned the fund as of the fund's "ex-dividend" date). If you purchase shares immediately before a distribution, you will be taxed on something you did not benefit from in the form of a rising share price.

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