Utilizing Capital Loss Carry-Forwards

By Robert N. Gordon

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The current market environment has devastated most portfolios and many investors find themselves with substantial capital losses. Some losses still are unrealized and others have been realized and could be used to offset capital gains. Unfortunately, investors have become acutely aware that the government is your partner when you win but you are on your own when you lose. An investor who realized $100,000 in gains in 2007 and then realized $100,000 in losses in 2008 is far from even.

Unfortunately capital losses are not deductible against salary or interest income; capital losses can be used to offset only realized capital gains and cannot be carried back. A $3,000 annual deduction against ordinary income is allowed, but after that losses not used to offset gains are carried forward. For many investors today, losses realized easily can exceed the amount of gains expected in the foreseeable future.

Investors can tilt investments to capture more income in the form of capital gains and thus more quickly use up the tax shield afforded by capital loss carry-forwards. The government, through the Conversion Rules in IRC Section 1258, doesn't allow an investor to make an investment that has no risk and turn what would have been interest to capital gains. But there still are ways to capture more capital gains without deviating from your investment objectives. The challenge is to be more tax-efficient without distorting investment goals or returns.

Investing in Bond Funds with Losses in Mind

Let's first explore how best to manage your holdings in bonds. Bonds trade with their principal and their accrued interest accounted for separately, but bond mutual funds do not. If interest rates are unchanged, a bond mutual fund's net asset value (NAV) grows each day with the interest earned by the bond portfolio. Instead of holding a bond fund over the record date and then receiving an interest distribution, investors with capital loss carry-forwards should sell before the record date and capture the portfolio's interest income as increased NAV. This creates a capital gain that should be earned free of tax due to the loss carry-forward. You can even buy it right back again in a day or two because there is no wash sale rule for gains, only for losses.

Investors without existing bond-fund holdings should choose a fund that has the same credit quality and duration as their current fixed-income portfolios. We've dubbed this strategy "dancing around the record dates," and if executed with a no-load, low-fee bond fund it can be most effective without giving up much, if any, return.

Harvest Gains on Taxable Bond Holdings

Interest rates are at all-time lows and that means that bonds purchased when rates were higher could have substantial unrealized gains. Why not sell your taxable bonds (not municipals) at a profit and then buy them back again (not disturbing your alpha in any way)? The reinvestment doesn't have to be in the same bonds to capture the strategy's benefit, but using the static portfolio is best to illustrate the power of taking gains on taxable bonds.

Let's say you bought a 6-percent Treasury bond at par ($100) years ago and it now has one year to maturity. With current 12-month Treasury interest rates at 1 percent, the bond is trading at $105. If you do nothing you will receive $6 in interest income in the next year and pay the maximum tax rate on that income.

Instead, sell the bond for $105, realizing a $5 gain that will cause no tax pain (because of your losses). Then repurchase the bond at $105, a $5 premium over its maturity value. Under IRC Section 171 investors can elect to take a bond premium as an offset against interest income. Now the investor pays the maximum tax rate on only $1 of interest income instead of on $6 of interest income (the $6 in interest received having been reduced by the $5 of amortization). The investor has effectively used its capital loss to offset interest income it is about to receive.

Leverage

Many investors possessing investment income would like to leverage a transaction that produces capital gain to increase capital loss utilization. The borrowings would create interest expense that could reduce the amount of investment income that would have been taxes, while any gains will be shielded from tax by the carry-forward.

Investors in Real Estate Investment Trusts (REITs) have found that historically a portion of the distributions received are not currently taxable, but instead are a return of capital. Any REIT return-of-capital distribution reduces an investor's cost basis and creates gains on sale. Another part of a REIT distribution can be from capital gains taken by the REIT. These two factors made up around one third of *all* REIT distributions and would be captured tax free by those with capital losses. What the REITs invest in seems to drive the difference. REITs with lots of depreciation would sport higher return-of-capital percentages, some as high as 100%. An Equity REIT would have more return-of-capital than a Mortgage REIT though both can throw off capital gains. REIT preferred stock's dividends are taxed in the same proportionate manner. Thus REITs bought on margin conceivably could create both currently usable interest expense deductions and tax-free capital gains (by utilizing the carry-forward). This would have the effect of turning unused capital losses into interest expense. Be aware that interest expense is solely deductible against investment income (not salary).

Other opportunities allow the investor to perhaps plan on a stream of capital gains. Mutual funds, when liquidating, pay interest dividends that aren't taxed as interest but are taxed as return of capital during the 12-month liquidation cycle. Time Warner just paid a $10.27 "dividend" of which only 30-35 percent will be taxed as a dividend; the rest will be a return of capital.

Preferred stocks of closed-end funds also may be attractive to those with capital loss carry-forwards. Although the preferred stock is a fixed-income vehicle, these preferreds' dividends are usually part capital gain. By law, mutual fund distributions are taxed the same to all holders; the owner of the common share receives the same tax treatment as a preferred holder upon receipt of a distribution. If 70 percent of a fund's realized income is capital gain, then 70 percent of that fund's payouts will be capital gain regardless of the share class owned. These preferred stocks usually are rated AAA because of their first claim on the fund's assets and can be attractive to those with loss carry-forwards.

Any of these vehicles bought on margin/leverage would leave the possibility of creating both tax-free capital gains (sheltered by losses) and interest expense deductible against investment income.

Short Sales

Another method of creating interest expense and capital gain is through the utilization of short sales. When an investor is short a stock (or a bond for that matter) the short seller must pay out all dividends or other payments that the shareholders normally would receive. This dividend equivalent payment is an interest expense just like any other interest expense. Take care because a 46-day holding period is necessary to allow for the short dividend expense to be a current deduction [IRC Section 263(h)]. This 46-day short holding period is only necessary when shorting stocks; bonds don't have such a holding period requirement. If an investor can find debt instruments that trade like stocks (without accrued interest) then the investment will drop by the interest payment after a distribution has been made. This interaction would make it possible for a one-day short sale to create both short expense and capital gain by virtue of the investment going "ex-dividend" by the amount of the payment.

Debt that trades like stock, without accrued interest, is uncommon but not unheard of. Monthly income preferred stocks (MIPS) aren't preferred stock at all, they are debt. Shorting MIPS over a record date could be such an opportunity. Some bonds trade "flat" (without accrued interest); some trade flat because their payment history is checkered, others trade flat by design. The Australian government bond market trades "flat" by convention. All these are possibilities for turning capital losses into interest expense in a very short time if the investor is willing to take the overnight risk.

Bubble

Many investors believe we are seeing a bubble in the price of U.S. Treasury securities. For the more adventurous that do leveraged speculation in interest rates, there is also relief from "too many" losses. To bet on the bubble bursting, an investor would short Treasuries or Treasury futures; when you short a bond you are betting on rates increasing. We would suggest that the investor not just short any Treasury; we suggest that the investor instead short a Treasury sporting a high coupon that is trading at a premium price to par. Here is an opportunity to bet on rates rising while at the same time turning capital losses into interest expense. As an example, let us use the same 6-percent Treasury bond discussed above that matures in one year. When shorting this bond the investor creates short-sale proceeds that will earn interest on a floating-rate basis; thus the speculation of borrowing fixed at the yield of the bond and earning at a floating rate on the short sale proceeds.

If you short, you are going to make a capital gain if the bond declines. Bonds mature at $100 (par). If you short the 6-percent bond at a price of $105 and hold to maturity, the short sale would have a built-in guaranteed $5 capital gain. A short seller would be obligated to pay out the interest coupon on the bond and could be able to deduct that 6-percent interest cost as an interest expense at tax time. Through this transaction the investor has effectively converted a capital loss carry-forward into an interest-expense deduction.

Note: You cannot do the same by purchasing Treasuries at less than par if

Continued on page 21

[6] $500 per occurrence for 2009 only, returning to $100 after 2009.

[7] A "qualified investor" is defined in Section 7701(a)(30) as a person that: (i) generally qualifies to deduct theft losses under Section 165 and Section 1.165-8 of the Income Tax Regulations; (ii) that did not have actual knowledge of the fraudulent nature of the investment arrangement prior to it becoming known to the general public; (iii) with respect to which the specified fraudulent arrangement is not a tax shelter, as defined in Section 6662(d)(2)(C)(ii); and (iv) that transferred cash or property to a specified fraudulent arrangement. A qualified investor does not include a person that invested solely in a fund or other entity (separate from the investor for federal income tax purposes) that invested in the specified fraudulent arrangement. However, the fund or entity itself may be a qualified investor within the scope of Revenue Procedure 2009-20. Thus, in order for a person that invested in a fund or other entity that invested in the specified fraudulent arrangement to receive benefits from the safe harbors of Revenue Procedure 2009-20, the fund or entity must elect to apply the safe harbor treatment and then the fund or entity must follow the appropriate entity procedures to pass the benefits of the safe harbor treatment to the investor.

[8] A Madoff Securities investor who does not pursue any potential third-party recovery is entitled to deduct, in 2008, 95 percent of its Madoff Securities losses, less actual recovery or potential recoveries under insurance policies or amounts payable from the Securities Investor Protection Corporation.

[9] A Madoff Securities investor who pursues or intends to pursue any potential third-party recovery is entitled to deduct, in 2008, 75 percent of its Madoff Securities losses, less actual recovery or potential recoveries under insurance policies or amounts payable from the Securities Investor Protection Corporation.

[10] If a taxpayer (i) chooses not to apply the safe harbors of Revenue Procedure 2009-20 and (ii) files or amends federal income tax returns for years prior to the discovery year to exclude amounts of fictitious income reported to the taxpayer from the investment arrangement, then such taxpayer must establish that the amounts sought to be excluded in fact were not income that was actually or constructively received by the taxpayer. Although it may be clear for Madoff Securities investors that no income was actually or constructively received, it may not be as clear for investors in other Ponzi-style frauds.

[11] For taxable years in which the period of limitation on filing a claim for refund under Section 6511 has expired, the taxpayer will need to establish that the amount of fictitious income from the investment arrangement that was reported and included in the taxpayer's gross income is consistent with information received from the specified fraudulent arrangement.

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Gordon

Continued from page 11

you think interest rates are going to drop. IRC Section 1276 recharacterizes market discount realized as gains from selling bonds as interest, not as capital gain.

A Wasting Asset

There are myriad ways to tilt your investments to capture capital gains with confidence. Investors with large capital loss carry-forwards owe it to themselves to explore the possibilities. Each year a loss isn't utilized is an opportunity foregone; if losses are carried forward until death, the loss carry-forward expires worthless. I&W

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