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Making most of excess capital losses

Here are some ways to create gains through timely sales of fixed-income investments

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Since the market has devastated portfolios, many investors find themselves with substantial capital losses. Some losses are still unrealized, and others have been realized and can be used to offset capital gains.

Unfortunately, capital losses can only be used to offset realized capital gains; they aren't deductible against salary income or interest income. After a $3,000 annual cap, losses are carried forward.

For many investors today, losses can easily exceed any gains expected in the foreseeable future.

Fortunately, investors can tilt their investments to capture more of their income as capital gains and thus more quickly use up the tax shelter afforded by capital loss carry-forwards. While the government (through the conversion rules in Internal Revenue Code Section 1258) doesn't allow an investor to make no-risk investments that turn interest to capital gains, there are still ways to capture more capital gains.

The challenge is to be more tax-efficient without distorting investment goals or returns.

Here are some ways to do that.

First, let's explore how best to manage holdings in bond mutual funds.

Bonds trade with principal and accrued interest accounted for separately; bond mutual funds don't. The net asset value of a bond mutual fund grows each day as interest is earned by the bond portfolio.

Instead of holding a bond fund over the record date and then receiving an interest distribution, we would propose selling before the record date and capturing the portfolio's interest income as increased NAV. This creates a capital gain.

An investor can even buy it right back again in a day or two since there is no wash sale rule for gains, only for losses.

Investors without existing bond- fund holdings should sell their holdings and then choose a fund that has the same credit quality and duration as their fixed-income portfolio. Many people have coined a

label for this strategy — "dancing around the record dates" — and if it is executed with a no-load, low-fee bond fund, it can be most effective without giving up much, if any, return.

Another way to capture capital gains is through the timely sale of bonds. Since interest rates are at all-time lows, bonds purchased when rates were higher should have substantial unrealized gains.

Why not sell taxable bonds (but not munis) at a profit and then buy them back again? (By the way, this won't disturb your alpha in any way.)

Let's say you bought a 6% Treasury bond at par years ago, and it now has one year to maturity. With 12-month interest rates at 1%, 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 bond premiums as an offset against interest income. Now, the investor pays the maximum tax rate on only $1 of interest income instead of $6.

The investor has effectively used a capital loss to offset interest income.

Finally, for the more adventurous who might be interested in leveraged speculation in interest rates, there is another way to seek relief from "too many" losses, while also making a bet that rates will rise. This is done by shorting Treasuries, and in this case we suggest shorting bonds trading at a premium to par.

Let's use the same 6% Treasury bond maturing in one year that we discussed earlier.

If you sell short, you will have a capital gain if the bond declines in price.

As bonds mature at 100 (par), shorting at 105 and holding the bond to maturity creates a built-in, guaranteed $5 capital gain.

What's more, the short seller would be obligated to pay the bond's interest coupon, which he or she could deduct as an interest expense, come tax time.

Hopefully, the short seller will earn enough in interest on the short- sale proceeds to make at least some money on a pre-tax basis. But even if the investor loses money on a pre-tax basis, given today's low interest rates, it would be very difficult to lose money on an after-tax basis using this strategy.

Given the many asset classes available to investors, there are myriad possibilities to explore.

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