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Preserving Profits in a Falling Market

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IT is still early, but the way things are going, it's quite possible that 2008 will turn out to be just the 15th year of declining stock prices since 1945, as gauged by the Standard & Poor's 500-stock index.

Investors can alleviate whatever pain the market may cause by paying attention to tax issues as the year progresses. By the final weeks of the year, it may be too late to make adjustments that would minimize or defer tax bills.

It's also not too early to start thinking about how the election this November may lead to changes in the law. Indeed, legislative action is needed to prevent the current maximum rate of 15 percent on capital gains and most dividends from rising to 20 percent after 2010, when the Bush administration's tax cuts are set to expire. It is possible that these rates could rise even sooner.

"They both could be in jeopardy," said Tom Ochsenschlager, vice president for taxation at the American Institute of Certified Public Accountants in Washington.

The basic rule, of course, is never to allow taxes to dominate investment decisions. But there are various tax-related points to keep in mind when deciding when or what to buy or sell.

Because overall stock prices rose every year from 2003 through 2007, most portfolios still contain shares that have appreciated even though profits have recently been slipping away.

To a bearish investor, this raises the hard question of whether to sell a stock held for less than a year and have the profit taxed as ordinary income or to hold onto the stock for more than a year, risking further erosion, in the hope of paying a lesser tax on a capital gain.

The tax rate on ordinary income is currently as high as 35 percent while the maximum rate on capital gains and most dividends is 5 percent or 15 percent. The capital gains rate is zero, however, for low-bracket taxpayers for 2008 through 2010, prompting some people to shift assets

to their children, who typically have few gains of their own. (That treatment for children under the so-called kiddy tax now applies to those under 19 or, for full-time students, under 24.)

The question of whether to hold on or bail out allows only rough answers.

“If you’re eight months into it and you think it’s the investment time to get out, I don’t think you want to decide to hold on for 12 months to get the lower rate,” suggested Greg Rosica, a partner at Ernst & Young and an author of its annual tax guide. “But if you’re sitting at month 11 or 11 1/2, then probably it is something that makes sense to try to ride it out.”

It would be helpful, of course, if there were practical ways to transform short-term capital gains into long-term ones. But such methods no longer exist.

“Most of the mechanisms that have been discussed that try to make that change either have been attacked by the I.R.S. or put you at least at some risk of the I.R.S. raising their eyebrows at you,” said Mel Schwarz, a partner in the Washington office of Grant Thornton. “You convert short-term to long-term by holding on.”

Besides being patient — and perhaps losing some sleep — you can take a few steps to preserve profits while reducing the tax bite. One maneuver, though much more restricted than it once was, involves selling borrowed securities substantially identical to those already held.

This provides a kind of hedge, but it must be closed out within a month of the end of the tax year and you must keep the profitable shares for at least two months after that.

OF course, you can simply sell shares short — selling borrowed ones and replacing them later at what you hope will be a lower price. But keep in mind that any gain will be taxed at short-term rates regardless of how long the position is held. On the other hand, a bearish investor who buys put options — the right to sell a specified block of shares within a specified time at a predetermined price — can produce either long-term or short-term profits (or losses) depending how long the put or the underlying stock is held.

Another way to deal with a falling stock market is to write covered call options, selling somebody the right to buy your holdings, presumably appreciated, at a specified price. This produces income from the premium received, protects your profit and, if the expiration date of the call is next year, lets you defer the gain.

Selling calls seems a better bear-market strategy these days than buying puts, which have become quite expensive amid the market turmoil, said Gordon B. Fowler Jr., chief investment officer at Glenmede Trust in Philadelphia. “You want to be selling rather than buying insurance right now,” he said.

Of course, the November elections will bear watching, analysts said, because of the tax cuts for capital gains and dividends that expire at the end of 2010; significant increases could be in the works as early as next year.

Because the market is always looking ahead, impending tax changes will likely affect prices. Mr. Schwarz suggested, “You want to make your move with respect to your stocks before enough of the public begins to factor that in.”

More specifically, this may mean taking gains before taxes go up or putting less emphasis on stocks with hefty dividends. “There is a risk to higher-yielding stocks,” which would presumably become less appealing if the maximum 15 percent tax on dividends were raised, Mr. Fowler said.

In case you want to sell only a portion of a profitable block of shares, it is generally advisable to sell the highest-cost ones first, though in some cases you would fare better by selling less costly shares if they qualify for long-term capital gains treatment.

Losing stocks held for a short period, however, are to be unloaded first; short-term losses are generally most valuable because they can offset short-term gains that would otherwise be taxed as ordinary income.

Up to $3,000 a year of all capital losses can offset ordinary income, even though the tax code sets no limit on how much gain is subject to tax. Losses of more than $3,000, however, can be carried forward indefinitely.

If you decide to take tax losses but still like the investment, you need to pay attention to the timing of your trades. You are forbidden under the “wash sale” rules from buying the same shares within 30 days before selling at a loss as well as rebuying them within 30 days after such a sale.

“Be careful if you’re harvesting losses at the same time” you go hunting for bargains, counseled Mr. Ochsenschlager of the accountants group.

If the stock slide continues, the perennial late-year trap into which many mutual fund investors fall — buying shares just before a capital gains distribution on which taxes are due on early-year gains — may be especially pernicious this year.

Falling prices may prompt a fund's investors to redeem shares, perhaps forcing the fund's managers to sell shares to meet the withdrawals.

"Frequently they end up liquidating stocks in which there is a gain," Mr. Schwarz said, "so you could find yourself in a situation where the value of your holdings falls precipitously and at the same time you're going to get a 1099 showing significant gains distributions."

AND if you are among the many people who have been tempted to invest in hedge funds because they have lowered their investment minimums, you should recognize that they can prove a tax and paperwork headache, Mr. Rosica said.

Hedge funds tend to trade even more actively than mutual funds and with less regard for taxes while paying out relatively little cash, he noted, and it can be many months before the fund's tax forms are delivered to investors, delaying their ability to file returns.

Hedge funds "sometimes have challenging tax ramifications," Mr. Rosica said. "Know what you're getting into."