The Tools of the Trade

You can help the wealthy fine-tune their tax picture at year's end. These strategies may prove invaluable to your efforts.

By Robert N. Gordon

When the last quarter rolls around, high-net-worth families must make some projections for the year. Specifically, they should estimate their realized gains, realized or realizable losses, deductions for the alternative minimum tax and adjusted gross income. This column will help you by exploring tools that allow for the acceleration or deferral of income.

At the simplest level, the last quarter is the time when high-net-worth investors must avoid buying mutual funds that are about to pay large distributions. It's also the right period to think hard about taking gains that might hold up if the profitable investment is held until January.

For the charitably inclined, there is a limit as to how much you can give away in a year. When gifting appreciated securities, the charitable deduction is limited to 30% of your Adjusted Gross Income (AGI). We've seen numerous families who have found they'd been too magnanimous in a given calendar year. For those in that situation, we suggest entering into an interest rate speculation in government bonds that will also have the effect of increasing AGI without affecting their taxes—except to the extent the speculation makes or loses money.

The family could purchase a U.S. Treasury Note maturing this year. Because this note is a government bond and matures in a short time, a broker will allow a lot of leverage. In fact, a margin deposit of ½% to 1% would not be unusual. The monies borrowed in a repurchase agreement will be charged an interest rate that floats. Whether the client makes or loses money will depend on whether the yield on the bond winds up being more or less than the interest charged in the floating

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rates. Adjusted gross income will be increased by the interest earned on the bond but not reduced by the interest expense. But the interest expense will be deductible against the interest income in computing taxable income.

The same type of interest rate speculation could also be helpful to investors who would like to defer investment income from this year to next. Investment income is defined as short-term capital gains, interest and dividends. By purchasing a Treasury security due next year on heavy leverage, you can create interest expense deductible against investment income earned this year. Individuals are cash-basis taxpayers. The 1 ⅞% U.S. Treasury Note maturing on Jan. 31 will not pay a coupon this year, and so there is no interest income received or taxable this year. Still, by paying the interest expense on the borrowings this year, you can create a current-year deduction.

For those who are subject to the alternative minimum tax this year but perhaps not next year, accelerating income may be an option. This would raise the regular tax up to the AMT without increasing the tax payment, and the corresponding deductions could be used next year. To execute this strategy, we would again use heavy leverage to purchase the 2 ¾% Treasury Note maturing June 30, 2006, and paying a coupon at the end of this year. By not paying the interest expense this year, the investor would forfeit the deduction in 2005, but the receipt of the interest coupon would occur this year. In that scenario, the interest would be included in the investor's 2005 taxable income.

A deferral of realized short-term gains is also possible by purchasing a stock with a record date this year and a payable date next year. Stocks normally go "ex-dividend" and drop by the amount of the dividend. If one purchases shares right before they go "ex-dividend" and sell the next morning, a capital loss would not be uncommon. That loss would be usable this year, although the dividend would not be received or taxable until next year.

A deferral of unrealized short-term gains is possible on up to one-half of any profitable position. In the good old days before the constructive sale rules, it was easy to defer by going "short-against-the-box"—i.e., short a number of shares equivalent to the amount owned. By going short-against-the-box on a profitable position, investors could lock in and defer gains for as long as they wished.

The rules now in place would not allow a permanent deferral but do allow the deferral of up to one-half of a position by utilizing the method of "identifying specific lots of shares." Specifically, the constructive sale rules allow a short-against-the-box to not cause a taxable event as long as the short is "cured" by covering the short before Jan. 31 of the following year. For example, assume you own 100 shares of appreciated stock. You short 50 shares this year, locking in your profits and identifying 50 shares in your account as those shorted against. In January you instruct your broker to take the other 50 shares and deliver them against the short sale made in 2005. This should make the gain realization a 2006 event instead of a 2005 event.

We recommend harvesting unrealized capital losses during the entire year, but most investors only focus on the opportunity at year's end. In past *OWS* columns (December 2003 and November 2004), I have covered a few methods to take losses within the wash sale rule while not materially changing your investment position. These columns covered losses on shares held as well as losses on short sales. In addition, they described a method to convert long-term capital losses to short-term.

Ultimately, many tools can be used to fine-tune the tax picture of the wealthy, but the process takes planning and a working knowledge of the investment tools utilized.

Robert N. Gordon *is the president of Twenty-First Securities Corp., which he founded in 1983.*