

Make the Most of Capital Losses

Here are some strategies to unleash the value of this hidden asset.

By Robert N. Gordon



Many of your clients may be sitting on significant investment losses. These can present a real challenge because losses can be offset against capital gains and then against \$3,000 per year of ordinary income — not dividends, interest or other forms of investment income.

Yet there are ways to unleash the value of this hidden tax asset. Let me explain two kinds of strategies that can deliver an attractive rate of return in the form of capital gain or, if leveraged, convert a capital loss into deductible investment-interest expense.

The first strategy allows income that would have come as interest capital gain to be treated as capital gains ordinary income, and may appeal to investors with significant amounts of cash. (Investors and advisors should be aware of the potential application of the “conversion rules” of Section 1258 to any investment where returns are locked in and substantially all of the expected return is attributable solely to the time value of money.)

Here’s how it works: Using open-end bond funds, an investor captures “predictable” capital gains by purchasing and selling shares within a dividend cycle. For example, suppose a fund pays a dividend on the last day of each calendar quarter (which is also the record date). The investor would purchase shares on the first day of the quarter and sell them the day before the dividend record date. As the fund’s NAV increases during the quarter, due to the accruing interest, that increase would be realized as capital gain. By selling the fund shares before waiting to collect the dividend, the investor has achieved his goal.

There are a number of funds that seek to exploit this opportunity by declaring and paying a dividend only once each year. An investor must exercise care in selecting an appropriate fund, because the permitted investments of these funds may or may not be “loan-like.” Permitted portfolios include short-term U.S. Treasuries (90 days or less), longer-term U.S.

Governments with options on Governments, and short-term A-rated corporate bonds.

The second type of strategy should interest investors who have capital losses and significant amounts of investment income, but not lots of cash. These strategies use leveraged transactions to produce capital gains and interest expense that can be deducted against investment income.

Here’s an example: Using the short sale of a bond trad-

ing like a stock (without accrued interest) to convert a non-deductible capital loss into a deductible investment-interest expense. The transac-

tion involves the short sale of a “flat” bond over the record date for a coupon payment. The short seller is required to make an “in lieu of” payment equal to the coupon to the lender of the bond. The bond price should drop by a corresponding amount (plus or minus any movement in market price), creating a short-term capital gain.

Section 263(h) requires capitalization of dividend “in lieu of” payments made in connection with short sales of stock that has not been held open for more than 45 days. With a bond, however, there is no requirement that a short position be held open for at least 46 days. A holding period of as little as one day could suffice to allow the deduction. Thus, the “in lieu of” payment should constitute deductible investment-interest expense.

Some debt securities that trade on U.S. stock exchanges without accruing interest are Monthly Income Preferred Securities (MIPS). Outside the U.S., the most liquid equity-like debt securities trade in Australia.

In any case, by speculating on the price of debt trading without accrued interest, an investor with existing capital losses can potentially generate an economic profit while creating tax-free capital gains and currently deductible investment-interest expense. **OWS**

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