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Five Smart Investment Moves to Make Before Year End

Two thousand eight (2008) is shaping up to be one of the worst years for stock market performance in the past century. When all is said and done it may very well be the worst year ever. Most of us would just assume forget it and move on. But simply putting your head in the sand is the wrong thing to do when there are changes that you can make in your portfolio that will make a positive difference now and for years to come.

1. Harvest Tax Losses

   Chances are this extreme bear market has left your portfolio with a number of losing positions. Unless and until you sell these positions, the loss will remain unrealized. One way you can benefit from these losses is to sell them and realize the loss for tax purposes (this only applies to taxable accounts, not tax deferred accounts such as IRAs). You can use the losses to offset gains you may have and save taxes. To the extent that the losses outweigh the gains, you can also shield $3,000 of income. If there are still losses remaining you carry them over to future years to offset gains and income.

   What if you still want to own the positions? You must beware of the wash sale rule which says that if you buy the same security within 30 days of the sale (before or after), the loss is disallowed. It is not lost forever, just deferred until the eventual sale. To avoid the wash sale rule, simply wait 31 days before you repurchase. An alternative to waiting 31 days is to buy a substantially similar position you may also like, such as a stock in the same industry or mutual fund in the same category (i.e. large cap US equity).

2. Gift Appreciated Securities

   Many of us have charitable tendencies, especially at this time of the year. In order to make the most of your donations, gift appreciated securities instead of cash. How does this help? You still get the tax benefit of the full value of your donation, but you do not have to pay capital gains taxes on the security donated. Be sure not to sell the security yourself. Donate shares and let your charity do the selling.

   If you know that you will be gifting a certain amount each year you might consider making multiple years worth of donations at one time to a charitable gift fund. The benefit of this is that you get to deduct multiple years of donations for tax purposes in one year. For this reason, the multiple year strategy may be most effective in a year when you expect your tax burden will be particularly high.

Through the gift fund you still direct the actual gifting of money to your desired charities over time at your discretion. A few things to keep in mind if you go the gift fund route:

- Once you make the donation the money is out of your estate:
- Although out of your estate the money can still be invested (gift funds usually offer various investment options); and
- When you do eventually donate from the gift fund to a charity you do not get to take another deduction for tax purposes.

3. Rebalance Your Portfolio

Most investors target their portfolio to be a certain balance between stocks and bonds. This bear market has certainly caused actual allocations to deviate from the desired target. Rebalancing at this time likely means selling bonds and buying stocks. It can be very difficult to buy stocks in the midst of such a bear market, and yet that is exactly what I am suggesting. Rebalancing forces you to buy low and sell high, and you can't buy low unless there is a low.

4. Avoid Buying a Fund Prior to Year End Distributions

Okay, I've convinced you to rebalance and buy stocks. Before you jump in and buy your preferred mutual fund, be careful. By law mutual funds must pay out most of their capital gains each year, and the bulk of these distributions happen in December. Whether you've owned a fund for 10 years or 10 days, and whether you reinvest the distribution or not, mutual fund distributions are taxable events to shareholders (only for taxable accounts, not tax deferred accounts such as IRAs). To avoid an immediate taxable event just wait to buy until after the distributions. By now most funds have at least a good idea (if not an exact amount and date) when the distribution will occur, and you can find the information on their web site or by calling them.

5. Convert a Traditional IRA to a Roth IRA

First let's discuss the difference between a traditional IRA and a Roth IRA. Both grow tax deferred. Distributions from a traditional IRA are taxable to the extent that the account has grown above the basis (more on that below), and you must take distributions once you reach the age of 70 ½. Distributions from a Roth IRA, on the other hand, are not taxable. Further, distributions are not required from a Roth, making it an ideal account to pass on to future generations.

Contributions to a traditional IRA can either be deductible or non-deductible (the exact rules are beyond the scope of this article). If you have been making deductible contributions to your IRA you have a zero basis. If you have been making non-deductible contributions to your IRA you have a basis in the amount of your contributions.

To be eligible to convert from a traditional IRA to a Roth IRA you must have an adjusted gross income less than $100,000. If not, you'll have to wait until 2010 when there is no income limit for conversions.

Why should you convert now? The amount that you convert from a traditional IRA to Roth IRA is taxable to the extent it is above the basis. With the market so low the amount of this tax is likely to be as low as it is ever going to be. For those that have been making non-deductible contributions there may be minimal or even no tax consequences. After the conversion you will have years of tax deferred growth upon which you will not be taxed. This is especially attractive if you believe, as many do, that tax rates will be higher in the future.

There is one important caveat to this strategy. In determining the taxable amount of a conversion, you must consider all of your IRA accounts together. Perhaps an example will best illustrate this point. Assume you have two IRA accounts: one worth $50,000, into which you have only made pre-tax contributions (i.e. the account has a zero basis); and the other valued at $30,000, with a basis of $25,000. You cannot simply convert the second IRA and have income of $5,000. Instead, you must take your basis of $25,000 as a percent of all of your IRAs. In this case your basis is 31.25% ($25,000 ÷ $80,000) of all your IRAs. Therefore if you convert the $30,000 IRA, the basis is considered to be 31.25% of the converted amount, or $9,375, leaving you with taxable income of $20,625.

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