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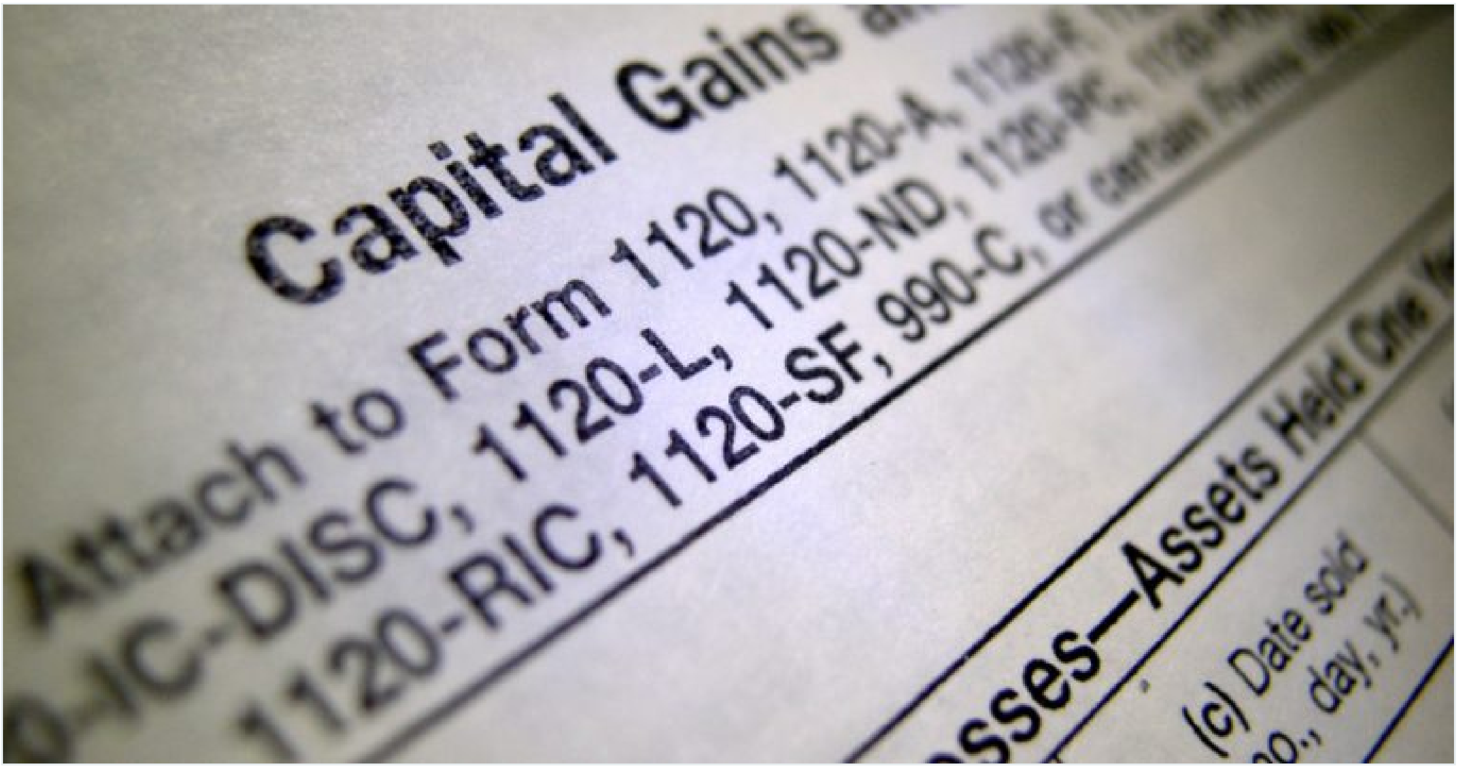
Ken Berry, JD • Oct. 21, 2014



[This is the third article in a special series designed to maximize tax benefits and minimize tax pitfalls at the end of the year.]

The end of the year often turns into "harvest time" for tax-savvy investors. By harvesting either capital gains or capital losses from securities transactions, depending on their situation, they can reap tax rewards when they file their returns. However, recent changes in the tax landscape may affect year-end decisions.

Here's the lay of the land: All other things being equal, you can use capital gains and losses realized at year-end to cancel each other out, either eliminating or reducing tax liability. Traditionally, investors have looked to harvest losses to offset prior gains in the year. As a bonus, a loss in excess of gains offsets up to $3,000 of ordinary income, which is currently taxed at rates up to 39.6%, before being carried over to the

the lowest two ordinary income tax brackets of 10% and 15%. This opens up more planning opportunities for low-bracket investors or those who are showing a smaller-than-usual income this year due to circumstances like a large business loss.

Yet that's not the end of the story. In addition to the regular tax rules for capital gains and losses, a 3.8% surtax applies to the lesser of "net investment income" (NII) or the amount by which modified adjusted gross income (MAGI) exceeds $200,000 for single filers and $250,000 for joint filers. The definition of NII includes capital gains resulting from securities transactions. In other words, a short-term gain in 2014 might result in income taxed at a combined federal income tax rate of 43.4%!

Keeping these points in mind, here are four basic examples that show how investors may harvest capital gains or losses at year-end. (For simplicity, we'll ignore any related transactional fees and the 3.8% surtax.)

Example 1. John, a 39.6% bracket investor, is showing a net capital loss of $10,000. If he harvests a short-term capital gain of $7,000 at year-end, the gain is completely absorbed by the prior loss, plus he can offset $3,000 of high-taxed ordinary income.

Example 2: Mary, a 39.6% bracket investor, is showing a net capital gain of $10,000. If she harvests a $10,000 capital loss at year-end, the prior gain is completely absorbed by the loss.

Example 3: James, a 15% bracket investor, is showing a net capital loss of $5,000. If he harvests a $8,000 long-term capital gain at year-end, $5,000 of the gain is absorbed by the prior loss and the remaining $3,000 of gain is taxed at the 0% rate.

Example 4: Susan, a 15% bracket investor, is showing a net capital gain of $5,000. Instead of harvesting a $3,000 loss at year-end, she can postpone the loss transaction until next year, so her $5,000 gain is taxed at the 0% rate.

Naturally, real-life situations are usually more complicated than this, but these

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