Tax tips for investors in securities or real estate

Let tax-favored capital gain help you build your wealth. Historically, investing in the stocks of good, growing companies is the best way for investors to build wealth. There's also a tax advantage. While dividends are taxed as income even when reinvested, federal income tax on growth of share value is deferred until the shares are sold. And even then, gains from investments receive tax-favored treatment.

Take tax losses to offset gains

Even the most carefully chosen securities or mutual funds have their ups and downs. But downward market fluctuations do have a silver tax lining. If you choose to sell an investment whose market value has dipped, you can use the realized loss, dollar for dollar, to offset realized gains.

A $5,000 realized loss, for example, can make $5,000 of realized gain tax free.

What happens if you realize losses in excess of your realized gains? You can write off the excess losses against up to $3,000 of your regular income for the year. Any unused loss, however, must be carried forward for use in future years.

Watch the wash sale rule

If you sell to realize a tax loss but buy the same security within 30 days before or after the sale, the loss won't be recognized for tax purposes. The IRS will treat the two transactions as a "wash." To avoid running afoul of the wash sale rule, an investor must either "double up" and buy the same security more than 30 days before the sale or wait more than 30 days after the sale before repurchasing the security.

A practical alternative is to realize a loss, then immediately purchase a similar but not identical bond or stock. For example, a bond investor can take a tax loss, then buy another issuer's bond of similar maturity, without triggering the wash-sale rule. Similarly, an investor may take a tax loss in one mutual fund, then immediately reinvest the sales proceeds in another fund with similar objectives.

Some real estate investors can deduct "passive losses"

As a rule, investors in "passive activities" (once known as tax shelters) may write off their passive losses only against income from passive activities. Investing in rental real estate is considered a passive activity. Nevertheless, in some cases investors can still write off losses from rental real estate against other income, such as salary or dividends.

• Investors who actively participate in the management of their rental real estate may write off as much as $25,000 of loss annually, *if* their adjusted gross income is $100,000 or less. The $25,000 allowance phases out for investors with higher incomes. When adjusted gross income is $150,000 or more, no rental losses may be deducted from other income.

• Real estate professionals—people who work more than half the time (and at least 750 hours a year) in the real estate business— may deduct real estate losses against income from other sources regardless of their overall income level.

Tax-free exchanges

Real estate investors (but not investors in securities) can avoid or at least defer realizing a taxable gain by swapping one property for another of "like kind."

Example: Jones wants to sell a rental property that has an adjusted basis of $50,000 and is now worth $150,000. Instead, Jones swaps her rental property for a $150,000 condo owned by Smith. That way Jones avoids realizing her $100,000 capital gain. Her basis in the condo will be $50,000, not the current market value of $150,000.

Some realtors specialize in arranging tax-free exchanges. Note that if you swap real estate with a close relative (brother or sister, parent or grandparent, child or grandchild), the exchange won't be recognized as tax free.

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