7 Top Tax Ideas To Use In A Declining Market

The brief 1,000-plus point plunge of the Dow Jones Industrial Average on August 24, 2015, rattled even the most optimistic investors. Whether the meltdown was part of a temporary correction or a harbinger of a bear market, it did serve as a reminder of tax moves that could be helpful when markets decline. Here are seven tax techniques you might consider:

1. Roth conversions. When the value of the assets in your IRAs falls, it may be a good time to convert part or all of the account to a Roth IRA. You'll pay income tax on the amount you convert—and when the account value drops, the amount of tax you owe also will be reduced. And paying tax now on the conversion will allow you to avoid paying it later, when you make withdrawals from a traditional IRA. Future payouts from a Roth will be tax-free if they're made during retirement and according to government rules.

2. Recharacterizations. But what if you recently converted assets in a traditional IRA to a Roth—and paid more in taxes than you would when stock prices are lower? The tax law allows you to "undo" the conversion if it suits your needs. For a conversion that took place in 2015, you have until the tax return due date for the year plus any extensions—so, until October 15, 2016—to recharacterize the IRA. It will be as if the conversion never happened.

3. Loss harvesting. If you're currently holding stocks that are worth less than you paid for them, this could be an optimal time to sell. The resulting capital losses can offset capital gains plus up to $3,000 of ordinary income this year. This could be especially beneficial if you can use the losses to offset short-term gains taxed at ordinary income rates of up to 39.6%. Short-term gains result from sales of assets you've held a year or less. If you have more than $3,000 of additional losses you can carry them over to 2016.

4. Retirement plan contributions. If the stock market is floundering, you can find some relative comfort in your qualified retirement plans. Adding to your 401(k) or other plan, perhaps a pension, or a profit-sharing plan, can help beef up your savings for retirement, regardless of the ups and downs of the market. Since there's no "gain" or "loss" until you actually take distributions, the extra amounts contributed can continue to grow on a tax-deferred basis. Along the same lines, you might benefit from contributions to an IRA (traditional or Roth) to supplement the qualified plans.

5. Gifts of securities. Assuming you don't need the capital losses this year, you might decide to give depressed assets to family members. Under the annual gift tax exclusion, you can give away securities valued up to $14,000 per recipient ($28,000 for a joint gift by a married couple) without any gift tax consequences. That will reduce the size of your taxable estate. And giving away stock when the price is down lets you transfer more shares—whose prices may recover later.

6. Funding a trust. This strategy, too, lets you take advantage of lower asset prices. A grantor retained annuity trust (GRAT) can help you transfer wealth, often a business interest, to younger beneficiaries. With a GRAT, you transfer the assets into the trust but still can take annual annuity payments for a specified number of years. When the term of the GRAT ends, the remainder is distributed to the beneficiaries. And if the assets you transfer are worth less than they had been, any gift tax liability will be reduced.

7. Using an alternative date for the valuation of inherited assets. This postmortem strategy could provide valuable savings for your family. Normally, the value of the assets in your estate for estate tax purposes is established on the day you die. However, an executor can elect to calculate the value of your estate six months after your death. If stocks or other assets have lost value, any estate tax paid by your heirs will be lower, too. Keep in mind, though, that alternate valuation is an all-or-nothing proposition. It can't be used for certain assets in the estate and not for others.

These and other tax moves could help you reduce the impact of a market decline and perhaps turn it to your advantage. ●

a long-term gain. Upper-income investors also may have to pay a 3.8% surtax on some investment income.

"Qualified" dividends from U.S. companies benefit from the same preferential tax rates as long-term capital gains. To qualify, you must have held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date (that is, the first date following the declaration of a dividend on which the buyer of a stock is not entitled to receive the next dividend payment).

Other types of investments, too, may be eligible for favorable tax treatment. For instance, while payouts from employer-sponsored retirement plans and IRAs are taxed as ordinary income, qualified distributions from Roth IRAs are 100% tax-free after five years. The tax law includes other statutory benefits that may apply to real estate, annuities, master limited partnerships, and life insurance.

Tax aspects are a critical part of your investment decisions. If you can learn how they work and what the potential tax impact is, you may be able to keep more of your investing profits. We can help you determine how to proceed. ●