

## Mutual-Fund Losses May Help to Reduce Future Tax Payments

By KAREN DAMATO

'OPPORTUNITY' IS NOT the first word that comes to most investors' minds when they think of mutual-fund holdings that have declined in value since purchase.

But by selling some of those fund stakes by year end, investors can reduce the taxes they will owe next spring or in future years.

This year, mutual funds that are prime candidates for such "tax-loss harvesting" include tech funds and tech-heavy growth funds that investors might have purchased early this year in the wake of their strong 2003 results. Fidelity Select Electronics Portfolio, First-hand Technology Value Fund and Kopp Emerging Growth Fund are down more than 15% after gaining more than 70% last year.

More painfully, investors also may have losses on tech-heavy funds purchased years ago, before the stock market turned down in 2000. The average technology fund is down an average 11% a year over the past five years, according to Morningstar Inc. Among multibillion-dollar diversified funds, Vanguard U.S. Growth Fund and Fidelity Aggressive Growth Fund both are down more than 10% a year over the same period.

By realizing some losses, investors can offset capital gains from other holdings, such as fund positions they have sold or are thinking of trimming back after a strong run. **"The losses provide an opportunity to rebalance with minimal or no [tax] cost" on the appreciated assets, says James Wilson, a financial adviser in Columbia, S.C.**

Losses can offset other funds' year-end capital-gains distributions, although those payments generally aren't expected to be huge this year.

Beyond offsetting gains, investors also can use realized losses to offset as much as \$3,000 of ordinary income on an individual or joint tax return. (The figure is \$1,500 if married and filing separately.) Excess losses can be carried forward to future years, without any time limit.

Say an investor in the top tax bracket has a fund stake that has declined in value to \$17,000 from the \$20,000 cost. By selling the shares and realizing the \$3,000 loss, the investor can reap federal tax savings of between \$450 and \$1,050, depending on other tax-return items.

Tax-loss selling works only with investments held in taxable accounts, not in tax-sheltered portfolios such as 401(k) plans and individual retirement accounts.

An investor can't sell a security at a loss and immediately buy back the same holding. Under the Internal Revenue Service's "wash sale" rules, the loss deduction is disallowed if you purchase the same security or one that is "substantially identical" in a 61-day period that includes 30 days before and 30 days after the sale.

Still, tax-loss selling doesn't have to entail big changes in your portfolio. After selling one position at a loss, you can move the proceeds into another mutual fund that is quite similar to the first. Then, you can either retain the new fund as a long-term holding or shift back to the original fund 31 days later.

One question that investment professionals and tax specialists have wrestled with in the absence of official guidance from the IRS is just how similar the new holding and the old one can be. For instance, can an investor dump an index fund that tracks the Standard & Poor's 500-stock index and buy another S&P 500 fund from another investment manager?

To be conservative, "I would choose a fund that is at least a little different" in its investment mandate, suggests John Battaglia, a tax director with Deloitte & Touche LLP in New York.

Similarly, Morgan Stanley analyst Paul Mazzilli cautions against tax-loss swapping between Standard & Poor's Depository Receipts and iShares S&P 500 Index Fund -- two exchange-traded funds that track the S&P 500 -- and suggests shifting instead to an ETF based on the Russell 1000 index. (ETFs are index-fund cousins that trade all day on

an exchange like stocks.)

In considering tax-loss selling, investors also need to weigh any sales commissions, redemption fees or brokerage-transaction fees they would incur. Such costs are one reason Tom Tracy, a San Francisco financial planner, says ETFs "are marvelous vehicles to swap into," particularly for investors who want to return to their original positions. While investors pay brokerage commissions to buy and sell ETFs, using them avoids the short-term redemption fees imposed by many traditional funds and fund supermarkets.

In looking for tax-loss candidates, remember that your cost basis for a fund isn't just your original purchase price, says financial adviser Dennis Gurtz of Bethesda, Md. If you have reinvested fund distributions over the years, as most investors do, those count as additional purchases that must be added on.

Some fund companies and securities firms regularly show the cost basis on investor statements, Mr. Gurtz says, but many investors may need to figure that themselves.

The actual tax savings produced by selling losing positions depends on the taxpayer's bracket, the holding period and other gains or losses. For a taxpayer in the top federal tax bracket, the losses might offset long-term gains that otherwise would have been taxed at 15% or, more valuable, short-term gains or ordinary income at the maximum 35% rate.

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**MONEY-FUND PURCHASE:** Federated Investors Inc., a leading manager of money-market funds, is getting even bigger with a definitive agreement to acquire Alliance Capital Management LP's cash-management business. Under the deal, as much as \$29 billion in Alliance money-fund assets would be added to the \$125.5 billion that Federated manages in money-market funds and other money-market accounts. Federated is to pay \$25 million in cash upfront, with additional payments over five years that could total \$103 million, based on fees generated by the funds. Alliance said the sale is consistent with its plan to

focus on core operations.

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Corrections & Amplifications

FEDERATED INVESTORS Inc. will pay an initial \$25 million and future payments estimated at \$103 million as part of its planned acquisition of Alliance Capital Management LP's cash-management business. In some editions Friday, the Fund Track column put the estimated future payments at \$93 million, a figure Federated announced and later corrected.

(WSJ Nov. 1, 2004)

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