SilverOak
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Tax Loss Harvesting

What is Tax Loss Harvesting?

Tax loss harvesting is a strategy in which certain investments held in a taxable investment account that are currently at a loss are sold in order to reduce the tax liability for the year. These tax losses can be used to offset realized capital gains or mutual fund capital gain distributions. Tax losses can also be used to offset up to $3,000 in ordinary income in a given year, thereby lowering income and taxes.

Losing money is not anyone's goal in a long-term investment plan, but even in a well-diversified portfolio there will be times that investments will lose value, at least in the short-term. Selling investments that are under water and recognizing the loss to offset other investment gains could be a silver lining in an otherwise disappointing situation. Tax losses do not "expire" so if there are not enough gains in a given year, the losses can be carried forward indefinitely.

How Tax Loss Harvesting Works

Inherent in any successful tax loss harvesting strategy is having investments with significant gains which have been sold for a profit in a given year or having capital gain distributions. In the below example, Investment #1 has been sold for a $70,000 gain. Investment #2 is also sold, but in this case, there is a $25,000 loss recognized from the sale. The net capital gain for both sales results in a $45,000 gain. However, the tax savings generated is dependent on whether the gain is long-term (held for greater than one year) or a short-term (held for one year or less). For a long-term capital gain, an investor who is subject to the maximum federal capital gains tax of 23.8% (including the 3.8% Net Investment Income Tax) would generate tax savings of $5,950. For short-term capital gains, the tax savings is higher because short-term capital gains are assessed at a higher marginal income tax rate. In this example, the investor is subject to the 40.8% federal tax rate (including the 3.8% NIIT) so the tax savings is $10,200.

Example – Tax Loss Harvesting

	Short-Term Cap Gain	Long-Term Cap Gain
Sales Price of Investment #1	$ 100,000	$ 100,000
Less: Cost of investment #1 (i.e. basis)	$ 30,000	$ 30,000
Capital Gain Recognized On Sale Investment #1	**$ 70,000**	**$ 70,000**
Tax Loss Harvesting Strategy (Selling investment #2 at a loss)		
Sales Price of Investment #2	$ 75,000	$ 75,000
Less: Cost of investment #2 (i.e. basis)	$ 100,000	$ 100,000
Capital Loss Recognized On Sale Investment #2	**$ (25,000)**	**$ (25,000)**
Net Capital Gain on Sale of Investments #1 & #2	$ 45,000	$ 45,000
Federal Tax Rate	40.8%	23.8%
Federal Tax on Sale of Investments #1 & #2	$ 18,360	$ 10,710
Tax savings from tax loss harvesting	**$ 10,200**	**$ 5,950**

Be Careful of Wash Sales

The IRS imposes rules on the sales of investments so that investors cannot create "phantom" losses to provide tax benefits. The IRS "wash sale" rule disallows the recognition of the loss on a sale if the same security or a "substantially identical" security is purchased within 30 days of the transaction that resulted in the loss. This includes either 30 days before the sale or 30 days after the sale and also covers options contracts on the same investment. Because of this rule, investors cannot recognize the loss from the sale of a security and then immediately buy it back and still get the immediate tax benefit from the loss.

The "wash sale" rule makes tax loss harvesting a bit more tricky, but certainly not impossible. The solution to avoiding "wash sales" requires a two-step process. First, the loss security must be identified, which is the easy step. The more difficult second step is finding a replacement security to purchase. If a replacement security is not purchased, the proceeds from the tax loss sale would sit in cash, exposing the investor to opportunity costs if the security sold rebounded during this 30-day period. Most investors do not want to be exposed to this risk, so they typically find a replacement security that is similar to the original investment sold, but not "substantially identical". For example, if an individual stock was sold, another stock from within the same industry could be purchased. If a mutual fund position is sold, another mutual fund within the same sector but from a different mutual fund company could be purchased. In addition, an index fund that is similar to the investment that was sold can be utilized as the replacement investment.

Challenges in Implementing Tax Loss Harvesting

While tax loss harvesting is a well-documented tax deferral technique, and sounds easy enough when described in an article, it is much more difficult to actually implement. For many, it should only be utilized with the help of an investment professional with a deep understanding of income taxes. Even with professional assistance there can be significant challenges in implementing tax loss harvesting strategies. One of the biggest is determining the "thresholds" that should be utilized to determine whether the tax benefit is worth the effort. Here are some items to consider:

Losses have to be significant enough: The first threshold to consider is whether a loss is large enough to recognize, both on a percentage basis and an absolute dollar basis. Recognizing a 20% loss is more meaningful than recognizing a 3% loss, but considering the dollar amount of the loss is also critical. While a 20% loss might be significant, if the dollar amount of the investment and investment loss is relatively small, it might not be worth the effort. Recognizing a $10,000 loss is much more meaningful than the benefit from a $1,000 loss.

Tax bracket: Not surprisingly, the higher the tax bracket, the higher the tax benefit. Obviously those in the 20% federal capital gains tax bracket benefit more than those in the 15% bracket. In addition, investors whose capital gains are subject to state taxes also benefit more.

Finding a replacement investment: Because of "wash sale" rules, unless an investor wants to be exposed to market risk, a replacement investment will be purchased from the proceeds of the investment sold at a loss. On paper, it seems easy to find a replacement, but it can actually be quite complicated. For example, a chosen replacement generally might be "good enough," but not as good as the investment sold. Sometimes there can be significant performance differentials that occur between the two investments. This differential is called tracking error.

Potentially alters the portfolio for longer periods of time: In addition to potential tracking error, another risk is that the replacement investment appreciates in value during the 30-day wash sale period. As a result, selling the replacement investment would trigger short-term capital gains, which could negate the original tax benefit received. If the replacement security is retained for at least a year in order to receive the more favorable capital gains tax

treatment, tracking error risk occurs for a longer time period. At the end of the year, if the replacement investment significantly underperforms the original investment, the opportunity cost could be more significant than the cost of paying taxes on short-term gains. In either scenario, the original portfolio has been altered for a tax benefit that could be less appealing than the long-term performance from the original portfolio.

Considerations

While for many investors the challenges of tax loss harvesting might outweigh the benefits, there are some circumstances in which tax loss harvesting could make sense. These benefits are not based on the thresholds discussed in implementing tax loss harvesting, but more on some unique individual circumstances of the investor and their long-term investment strategy.

Mutual fund capital gain distributions: These are gains that are generally unavoidable and in many years can be significant. To the extent that there are other investments with a loss in the portfolio, if sold, they can lessen the sting from the capital gain distributions.

Discipline to reinvest the "tax savings": In the short-term, tax loss harvesting can add to the portfolio return if the "tax-savings" are reinvested in the portfolio. The tax loss is created now and produces additional dollars to invest, while the recovery in the investment and the future gain from this incremental investment will be taxed in the future. Essentially, the IRS is providing an interest-free loan to use for a potentially long period of tax deferral. Unfortunately, most investors pocket the tax savings vs. reinvesting these dollars.

Legacy portfolio: If the portfolio is not needed to fund current needs but is being invested for future generations, the lower cost basis that can be created by tax loss harvesting does not have an adverse impact due to the future step-up in basis upon the death of the grantor. Any losses can be harvested for the immediate tax benefit and reinvested into the portfolio while potentially increasing long-term investment returns.

Gifting to charity: If the investment is eventually going to be gifted to charity, the lower cost basis created by tax loss harvesting will not be an issue. The investor receives the immediate tax benefit from recognizing the loss and also eventually receives the tax benefit from gifting the appreciated stock in the future.

Conclusion

At the end of the day, tax loss harvesting can be a useful tool when used in the right set of circumstances. However, making investment decisions that are solely tax-based is letting the "tax tail wag the dog." While it might be satisfying to sell investments with losses to recognize the tax losses and receive the short-term tax benefit, it is more important to evaluate whether the investment continues to be appropriate as part of the long-term investment strategy. If it is appropriate, then tax loss harvesting is likely not the right answer in the long-term as it is merely a tax deferral strategy and the challenges likely outweigh the short-term tax benefits.

Disclaimer:

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Investment decisions should be made based on an investor's specific circumstances taking into account items such as, risk tolerance, time horizon and goals and objectives. All investments have some level of risk associated with them and past performance is no guarantee of future success.

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