Tax-Loss Harvesting

Overview: Investment losses rarely (if ever) make investors happy. But there are ways to make Uncle Sam share in some of that pain. The following discusses tax-loss harvesting and why it should be considered year-round.

The concept of tax-loss harvesting is simple. By selling an asset at a loss, investors can use those losses to offset gains on other investments for tax purposes. However, many investors (and even some advisors) make the mistake of treating tax-loss harvesting as a once-a-year occurrence.

One reason it is not a good idea to wait until the end of the year to harvest losses is because the losses may vanish by then. Investors may be too happy to notice (since it would mean the market has been going up), but it still represents a missed opportunity to lower the tax bill.

Even those who understand the importance of tax-loss harvesting year-round may miss some of the finer points. Generally speaking, investors should also realize tax losses (as able) when they are substantial and are still short term.

How It Works

Tax-loss harvesting is perhaps best shown with an example. Assume an investor purchased a fund on January 1 for $10,000. On March 1 of the same year, it was trading at $5,000. At this point, the investor has decided to harvest the loss. The loss is characterized as short term, since the fund was held for less than one year. With a 35 percent ordinary federal income tax, this will result in a $1,750 tax savings. Because of this tax savings, the economic loss is $3,250.

What's Substantial?

There are two main things to consider regarding whether a loss is substantial enough to harvest:

- The benefit of the deduction relative to any transactions costs involved
- The volatility of the asset
- The amount of time out of the market

Benefit Vs. Cost

The first point is relatively straight forward. It simply does not make sense to harvest a tax loss if the cost exceeds the benefit.

Asset Volatility
The other two points go hand-in-hand. Volatile assets often incur large gains (or losses) over very short periods of time. For example, the stock market saw 170 months from 1926 through 2008 (17.1 percent) produce returns to the total market in excess of 5 percent. Of these months, 24 had returns in excess of 10 percent, five had returns in excess of 20 percent, and three had returns in excess of 30 percent.

On the other hand, being out of the market for a month meant that there was a 10.3 percent chance (103 months out of 996) of avoiding a loss of at least 5 percent.

Thus, historically, there has been a 66 percent greater likelihood of missing a large gain rather than avoiding a large loss. However, investors have to be cautious because they cannot repurchase the asset they just sold or the IRS will disallow the deduction. (More on this later.) This leads to the third consideration — being out of the market.

Being Out of the Market
There are a few issues with being out of the market. One is mentioned above — the possibility of missing out on large gains in a short amount of time. Another is that investors' asset allocations are thrown off if a single asset is sold to harvest a loss if an immediate substitute is not purchased.

A seemingly simple solution is to sell the fund and buy a replacement. For example, sell one S&P 500 Index fund to buy another one. However, such a move violates the IRS's "wash sale" rule.

The Wash Sale Rule
There are several mutual funds and ETFs that make good substitutes for one another. But keep in mind that, to avoid the wash sale rule, investors cannot sell and buy two investments that are considered "substantially identical" in nature and still claim a deduction. The IRS would disallow the deduction.

It is important to use caution in choosing "similar" funds. For example, selling one U.S. small-cap fund and buying another U.S. small-cap fund could violate the wash sale rule. However, selling a U.S. small-cap fund and buying a tax-managed U.S. small-cap fund may be allowed.

For individual bonds, the replacement bond must be materially different from the one sold. Although the term appears in the tax code and numerous IRS rulings, there are no specific rules defining what makes one bond materially different from another. It is also important to note that when swapping individual bonds for loss-harvesting purposes, there is no need to reverse the swap after 31 days.

Why Are Short-Term Losses More Valuable?
Short-term losses are first deducted against short-term gains that would otherwise be taxed at the higher ordinary income tax rates. Long-term losses are first deducted against long-term gains that would otherwise be taxed at the lower capital gains rate.

For example, before any loss harvesting has occurred, imagine a taxpayer has realized short- and long-term gains and unrealized short-term losses. These losses can be harvested and will reduce the short-term gains that would have otherwise been taxed at higher ordinary tax rates. If the losses

Tel: 805.418.7686 • Fax: 866.279.7711 • ted@fischerinvestmentstrategies.com
870 Hampshire Road, Suite U • Westlake Village, CA 91361
www.fischerinvestmentstrategies.com

were not harvested until they became long term, they would reduce long-term gains that would have otherwise been taxed at the lower long-term capital gains rate.

Summary

Taking a loss on an investment may be a painful experience for investors. But letting that pain stop them from lessening the damage caused by a falling investment just makes the problem worse. Investors should take advantage of the opportunities afforded to them by investment losses and should not just wait to do it once a year.

Tel: 805.418.7686 • Fax: 866.279.7711 • ted@fischerinvestmentstrategies.com
870 Hampshire Road, Suite U • Westlake Village, CA 91361
www.fischerinvestmentstrategies.com