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TAX LOSS HARVESTING: A DOUBLE-EDGED SWORD

Clients sometimes request that sale transactions in taxable accounts be handled on a tax-sensitive basis. If a security is to be sold, the transaction should recognize as little taxable gain as possible. This asset-management strategy is commonly called "Tax Loss Harvesting."

HOW DOES IT WORK?

You buy an investment for $50,000 and one year later its market value is $42,000. If you do nothing, the investment may recover and eventually show a profit. However, if you sell the investment for $42,000 and invest the sale proceeds in a suitable replacement,[1] you will have the tax benefit of an $8,000 recognized investment loss to offset other taxable income when you file the current year's tax return.[2]

The basic principle behind the strategy is to take advantage of the free option offered to taxable investors by the U.S. Tax Code. This is the option to postpone tax on unrecognized gains by deferring asset sale or transfer, while simultaneously locking in a tax benefit by accelerating sale of investments having a current fair market value less than their tax cost basis.

NOT EVERY TAXPAYER WILL BENEFIT

Each time SC harvests a loss, an investment transaction cost (e.g., custodial trading fee) may be generated. In some cases, the trading costs may outweigh the tax benefits. For example, taxable investors with substantial existing long-term loss carry forwards may not value capturing additional losses. Likewise, investors in low tax brackets may not benefit from loss harvesting. An investor will not wish to harvest a tax loss if the benefit of the loss [(amount of loss) x (investor's State & Federal marginal tax bracket)] is less than the cost of the investment transaction.

HIGH TAX BRACKET INVESTORS

Why would a high bracket investor not wish to elect tax-loss harvesting? Given that the current federal tax rate schedule is extremely low, some economic research papers argue that tax loss harvesting provides only minimal long-term benefits.

Consider, for example, the following fact pattern:

- Year 1: purchase of investment for $10 per unit
- Year 2: sale of investment for $8 per unit (i.e., capture of $2 per unit tax loss) and reinvestment of the sale proceeds in a similar-but-not-identical investment.
- Year 5: sale of investment for $20 per unit.

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[1] You cannot buy the same investment that you just sold because of special "wash sale" rules in the U.S. Tax Code. The "Wash Sale" provision of the Internal Revenue Code prohibits investors from claiming a tax loss deduction for investments that are purchased and sold within a 60 day window of time (30 days before and after a transaction date) if a substantially equivalent investment is purchased or sold within this period. Although SC evaluates the merits of tax-loss sales with the "Wash Sale" provision in mind, SC cannot guarantee that all transactions will be in compliance. For example, although most tax commentators argue that a sale of an open-ended Mutual Fund followed by the purchase of an Exchange Traded Fund (or visa versa) probably does not violate Wash Sale rules, SC is not aware of a specific IRS ruling on this matter. Investors should consult IRS Publication 564 [Mutual Fund Distributions] regarding the rules for Sales, Exchanges and Redemptions of Mutual Funds.

[2] SC does not offer legal, tax or accounting advice. Please consult with your professional advisors regarding the likely consequences of financial transactions or the suitability of tax or legal strategies to your personal financial circumstances.

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If the tax loss harvesting sale had not occurred, the taxable gain to the investor is $20 - $10 = $10. Capturing the loss, however, lowers the tax basis of the replacement investment to $8 per unit. This means that total taxes payable are $20 - $8 = $12; or $2 more than if no intermediate transaction occurred.

In this fact pattern, the benefit of a sale is the value of a $2 certain tax loss deduction today, versus the future value of an uncertain $2 tax gain recognition. Some commentators suggest that a bird in the hand is worth two in the bush; however, if tax rates increase in the future, the conventional wisdom may fail.[3] A number of commentators suggest that tax *gains* rather than tax *losses* should be harvested in this historically low tax regime.

OPERATIONAL ISSUES

As you know, SC does not accept discretion in its portfolio supervision activities. Consequently, SC cannot execute trades without the portfolio owner's prior approval. This is a critical factor because tax losses are very time sensitive. Some capital markets can generate large upside moves very quickly thus eliminating an embedded and heretofore unrecognized tax loss. If tax basis is reasonable close to fair market value, a tax-loss trade analysis may become outdated with blinding speed. This, of course, is an additional risk for the investor.

For those interested in tax loss harvesting, we recommend the following steps:

1. Consult with your CPA or tax advisor to ascertain if you are likely to benefit from capturing tax loss opportunities;
2. Follow the advice of your tax advisor concerning his or her preferred approach to dealing with the "Wash Sale" rules. A common and straightforward approach involves the sale of investment A (e.g., an open ended mutual fund tracking index X) followed by an immediate purchase of investment B (e.g., an exchange traded fund tracking index Y, where Y is comparable but not substantially identical to X). A more conservative approach is the sale of investment A followed by placement of proceeds in a money market for a 31 day interval prior to either repurchase of A or purchase of B.
3. Inform SC of [a] your tax advisor's opinion and preferences; and, [b] your interest in tax-loss harvesting opportunities. If you elect a conservative approach, SC will prepare an amendment to your IPS to reflect your decision to place sale proceeds into money market funds.

To reiterate, SC does not provide tax, legal or accounting advice. It is important that you consult with your tax advisor *prior to* communicating your interest to SC.[4] We recommend that you email this document to your tax advisor to assure that all parties are communicating effectively. A hasty action taken to secure tax losses can be a double-edged sword.

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3 A more technical observation is that elderly taxable investors will generally wish to take losses now and defer taking gains because most future embedded gains can often be eliminated by electing a step-up in tax basis at the time of death.

4 It is also important to determine your tax advisor's preferred method to identify the basis of your share holdings. There are three calculation methods in common use: (1) specific share basis identification; (2) first-in first-out basis identification; and (3) average basis identification. Current tax rules obligate each taxpayer to track both share basis established at the time of purchase, and adjustments to basis from ongoing events such as receipt of taxable dividends. SC commonly identifies tax loss harvest opportunities by using the method determined by your custodian [Fidelity / TDAmeritrade/Schwab/etc.]. For mutual fund transactions, this is usually the average basis calculation method. Exchange Traded Funds ETFs, however, do not use the average cost basis method. If your tax advisor / tax preparer does not utilize an average basis calculation methodology, you may elect to have SC use the specific share basis identification method. However, the IRS does not allow you to switch your basis-calculation methodology. Once a decision is made, it becomes irrevocable. The IRS regulation applies separately to each mutual fund holding (e.g., fund A's basis can be tracked on an average basis methodology, while fund B's basis can be tracked by specific share identification); however, the constraints of the SC data base mean that we must track every fund under the same basis calculation methodology. Practically, this means that if you have ever sold, exchanged, or redeemed shares of a mutual fund in an SC-supervised portfolio, you must continue to elect the average basis methodology for tax calculation purposes for all funds within that portfolio. ETFs allow for a wider set of basis calculation methods. These include average cost, lot-specific, and first-in/first-out.

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