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Harvesting Capital Losses

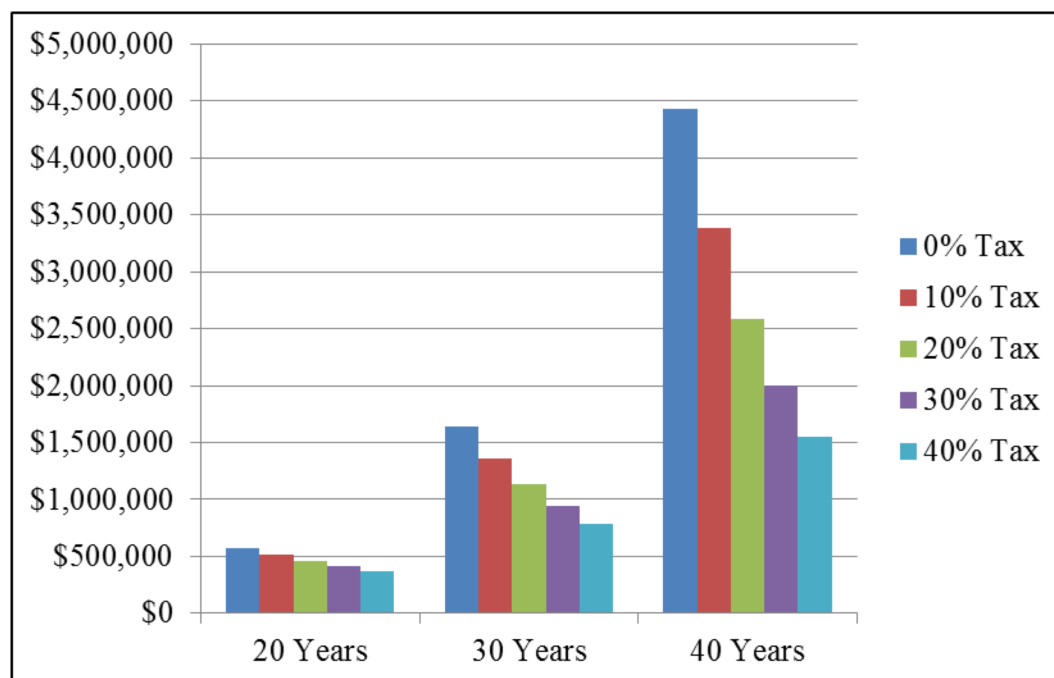
By Robert S. Keebler, CPA/PFS, MST, AEP (Distinguished), CGMA

The recent volatility in the stock market should reinforce the idea that it's not what you earn that counts, but what you keep. In 2013 the top tax rate on dividends and long-term capital gains increased from 15% to 20%. When the 3.8% surtax on net investment income is added, the total tax rate on interest, rents, dividends, annuities, royalties, non-business capital gains and passive activities can increase the total tax rate to as much as 23.8% for long-term capital gains.

Over time, taxes can have a profound effect on the amount of wealth that can be accumulated. Consider the following example.

> ***Example 1.*** Taxpayer (T) invests $10,000 per year for 20, 30 or 40 years. The following chart shows the amount of wealth accumulated by the end of each period given a 10% pre-tax rate of return and various effective tax rates.

Tax Rate	20 Years	30 Years	40 Years
0%	$572,750	$1,644,940	$4,425,926
10%[1]	$511,601	$1,363,075	$3,378,824
20%	$457,620	$1,132,832	$2,590,565
30%	$409,955	$944,608	$1,996,351
40%	$367,856	$790,582	$1,547,620



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The increased value created in an investment portfolio by using tax saving strategies is referred to as "tax alpha." Early researchers on tax-aware-investing assumed that the best way to create tax alpha was simply to minimize portfolio turnover. However, more recent research indicated that it was not all turnover that reduced after-tax returns, but only net turnover (i.e., capital gains that could not be offset by capital losses)[2]. This suggested that a multi-manager core and satellite approach might produce the best results. This strategy started with a passively managed, buy and hold, core portfolio and then added smaller satellite portfolios actively managed by other managers. The core portfolio maximized tax alpha and the satellite portfolios maximized pre-tax returns with active management, but aggressively harvested losses to minimize risk drag.

Quantifying the Tax Benefit of Loss Harvesting

Loss harvesting means selling assets at a loss and using those losses to offset capital gains realized on other assets. On the surface, it might appear that loss harvesting produces an economic benefit equal to the tax saved in the current year. It is important to recognize, however, that assuming tax rates stay the same, loss harvesting provides only a timing benefit. To see this, it is necessary to look at the overall transaction and not just the initial loss harvesting. Taxpayers who sell stocks to harvest losses typically wait 31 days to avoid the wash sale rules[3] and then reacquire the stock. While this reduces or eliminates current capital gain, it also gives the taxpayer a lower basis in the replacement shares and, thus, increases the gain recognized when these shares are later sold. The total gain recognized is the same, but loss harvesting creates tax deferral as shown in the following example.

Example 2. Jill, a high income taxpayer, recognizes $100,000 of long-term capital gain on Blackacre in 2013. To net out the gain, she sells 1,000 shares of ABC stock with a basis of $300,000 for $200,000. The $100,000 loss eliminates the capital gain and saves her $23,800 in 2013 (.238 x $100,000).

Jill waits 31 days and repurchases 1,000 shares of ABC stock at $200/share, giving her a total basis of $200,000 in the shares. The value of the ABC stock increases to $500,000 in 2018 and Jill sells it. She recognizes a gain of $300,000 and pays tax of $71,400 ($300,000 x .238).

If Jill had not harvested the loss in 2013 and sold the original shares in 2018 instead, she would have recognized a gain of $100,000 on Blackacre in 2013 and a gain of $200,000 on the ABC stock in 2018 ($500,000 sale price - $300,000 basis).

Assume that Jill has a 7% opportunity cost of capital. Combining the tax consequences for 2013 and 2018, we get the following results.

A. NO LOSS HARVESTING

Year	Gain Recognized	Tax Payable	FV as of 2018 @ 7%
2013	$100,000	$23,800	$33,381
2018	$200,000	$47,600	$47,600
Total	$300,000	$71,400	$80,981

B. LOSS HARVESTING

Year	Gain Recognized	Tax Payable	FV as of 2018 @ 7%
2013	$0	$0	0$
2018	$300,000	$71,400	$71,400
Total	$300,000	$71,400	$71,400

By loss harvesting, Jill pays $9,581 less tax in future value terms than she would have paid without loss harvesting ($80,981 - $71,400). Note that the amount of the tax savings depends on (1) the time period between the two sales and (2) the taxpayer's opportunity cost of capital. The longer the time period and the higher the opportunity cost of capital, the greater the economic benefit of tax harvesting will be.

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It is also important to recognize that loss harvesting could backfire on a taxpayer if tax rates increase in the future. The higher tax rate might be more than enough to offset the timing advantage, depending on the magnitude of the rate increase and the length of the deferral period.

In general, capital losses are more tax effective if they can be used to offset income taxed at higher tax rates (i.e., short-term capital gains and ordinary income). Thus, long-term losses used against short-term gains are more tax-efficient than short-term losses being used against long-term gains. The last thing you want to do is use a short-term loss carry forward and harvest long-term gain. That translates into using an asset that is potentially worth 43.4% to shelter a gain worth 23.8%. This results in a 19.6% negative arbitrage.

	Short-Term Gain	**Long-Term Gain**
Short-Term Loss	NEUTRAL	INEFFECTIVE
Long-Term Loss	EFFECTIVE	NEUTRAL

Caveat: Wash Sale Rules

IRC § 1091 denies a deduction for losses incurred in a wash sale. A wash sale occurs when a taxpayer sells stock or securities at a loss and within 30 days before or after the sale buys substantially identical stock or securities. Thus, a taxpayer must wait at least 31 days before repurchasing the stock that was sold. This subjects the seller to the risk that the price of the stock or security could increase substantially during the time she is out of the market. There are a number of strategies that can be used to mitigate this risk, like purchasing similar but not identical stock after the sale.

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Robert S. Keebler CPA/PFS, MST, AEP (Distinguished), CGMA is a partner with Keebler & Associates, LLP and is a 2007 recipient of the prestigious Accredited Estate Planners (Distinguished) award from the National Association of Estate Planning Counsels and has been named by CPA Magazine as one of the Top 100 Most Influential Practitioners in the United States. Mr. Keebler is the past Editor-in-Chief of CCH's magazine, Journal of Retirement Planning, and a member of CCH's Financial and Estate Planning Advisory Board. Mr. Keebler frequently represents clients before the National Office of the Internal Revenue Service (IRS) in the private letter ruling process and has received over 150 favorable private letter rulings. Mr. Keebler is nationally recognized as an expert in family wealth transfer and preservation planning, charitable giving, retirement distribution planning and estate administration and works collaboratively with other professionals on academic reviews and papers, as well as client matters. He can be reached at (920) 593—1701 or at robert.keebler@keeblerandassociates.com.

Citations:

[1] Note that the 10% tax rate reduces the annual growth to 9.0% after tax (10.0 x (1 -.10)). The same equation applies to the growth rate when taxed at the 20%, 30% and 40% rate; i.e., (Growth Rate x (1-Tax Rate)).
[2] See, for example, Apelfeld, Fowler and Gordon, *Tax Aware Equity Investing*, Journal of Portfolio Management, 1996.
[3] See 26 U.S.C. § 1091.

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