

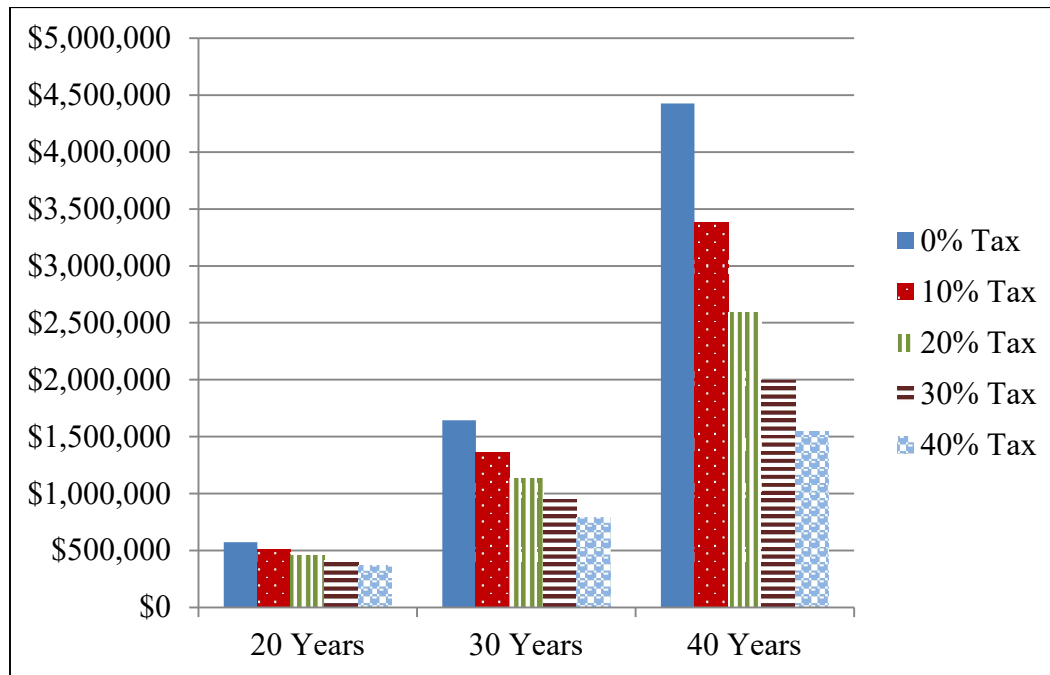
### #3: Harvesting Capital Losses

There is a growing realization among investors that it isn't what you earn that counts, but what you keep after taxes. When the 3.8% tax on net investment income is added, the total tax rate on interest, rents, dividends, annuities, royalties, non-business capital gains and passive activities can be as high as 23.8% for long-term capital gains and 40.8% for ordinary income.

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% <sup>9</sup>	\$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



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

<sup>9</sup> Note that the 10% tax rate reduces the annual growth to 9.0% after tax ( $10.0 \times (1 - .10)$ ). The same equation applies to the growth rate when taxed at the 20%, 30% and 40% rate; i.e.,  $(\text{Growth Rate} \times (1 - \text{Tax Rate}))$ .

alpha was simply to minimize portfolio turnover. However, more recent research indicates that it is not all turnover that reduces after-tax returns, but only net turnover (i.e., capital gains that could not be offset by capital losses).<sup>10</sup> This suggests 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. This is best understood by considering 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<sup>11</sup> 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 in the 23.8% long-term capital gains tax bracket, recognizes \$100,000 of long-term capital gain on Blackacre in 2024. 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 2024 ( $.238 \times \$100,000$ ).

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 2027 and Jill sells it. She recognizes a gain of \$300,000 and pays tax of \$71,400 ( $\$300,000 \times .238$ ).

If Jill had not harvested the loss in 2024 and sold the original shares in 2027 instead, she would have recognized a gain of \$100,000 on Blackacre in 2024 and a gain of \$200,000 on the ABC stock in 2027 ( $\$500,000$  sale price -  $\$300,000$  basis).

Assume that Jill has a 7% opportunity cost of capital. Combining the tax consequences for 2024 and 2027, we get the following results.

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<sup>10</sup> See, for example, Apelfeld, Fowler and Gordon, *Tax Aware Equity Investing*, Journal of Portfolio Management, 1996.

<sup>11</sup> See 26 U.S.C. § 1091.

A. NO LOSS HARVESTING

Year	Gain Recognized	Tax Payable	FV as of 2027 @ 7%
2024	\$100,000	\$23,800	\$33,381
2027	<u>\$200,000</u>	<u>\$47,600</u>	<u>\$47,600</u>
Total	<u>\$300,000</u>	<u>\$71,400</u>	<u>\$80,981</u>

B. LOSS HARVESTING

Year	Gain Recognized	Tax Payable	FV as of 2027 @ 7%
2024	\$0	\$0	0\$
2027	<u>\$300,000</u>	<u>\$71,400</u>	<u>\$71,400</u>
Total	<u>\$300,000</u>	<u>\$71,400</u>	<u>\$71,400</u>

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.

It is also important to recognize that loss harvesting could backfire on a taxpayer if tax rates increase in the future. A higher tax rate might 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 efficient 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 40.8% to shelter a gain worth 23.8%. This results in a 17% 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 thirty 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 he or 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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