Tax Loss Harvesting

WHAT, HOW, AND WHY?

BY **Ben Bremen, CFP®, CPA,** Wealth Advisor
& **Chanel Dorée, CPA,** Wealth Advisor

As long-term value investors, we seek high-quality companies that we are willing to own for many years. We are buying, not renting. Frequently, during the course of the regular market cycle, an asset may temporarily decline in value, resulting in an unrealized capital loss within an investor's portfolio.

When a security loses value, many investors think they have a binary choice: hold on and wait for a recovery, or sell the security and move on. However, tax loss harvesting is a third viable option that we believe makes the loss more palatable and can add real dollars to the bottom line. Tax loss harvesting is the act of selling a security for the purpose of recognizing the loss, as a tax planning strategy.

Let's illustrate with a simple case study.
Assume Jane purchased stock in Cola Corp. on January 1 of this year for $100 per share. If on February 15, Cola Corp. was trading at $80 per share, this price depreciation would have created an unrealized loss for Jane. Let's also assume Jane is a savvy investor who remained confident in the position and the industry as a whole. Seeing an opportunity to utilize tax loss harvesting, Jane sold her stock in Cola Corp. on February 15, and thereby realized a $20 per share loss. She then immediately redeployed the proceeds, buying stock in a similar company, Soda Inc., to stay in the market. After 30 days, Jane sold her Soda Inc. shares and invested again in Cola Corp.

Why did Jane immediately invest in Soda Inc. after selling Cola Corp.?
In managing a diversified portfolio, Jane doesn't want to let the tax tail wag the investment dog. While remaining tax efficient is one goal of the investment portfolio, it should not be at the expense of the asset allocation. To keep the portfolio's allocation and risk in line with her goals, Jane covered her sale of Cola Corp. with a like investment.

Why did Jane wait 30 days to sell Soda Inc. and repurchase Cola Corp.?
As part of the Revenue Act of 1921, Congress enacted IRC section 1091, which put wash-sale rules into place.[1] A wash sale occurs when you sell or trade a stock or security at a loss, and also, within 30 days before or after the sale, you do one of the following:

1. Buy substantially identical stock or securities;
2. Acquire substantially identical stock or securities in a fully taxable trade;
3. Acquire a contract or option to buy substantially identical stock or securities; or
4. Acquire substantially identical stock for your individual retirement account (IRA) or Roth IRA.

Given these parameters, Jane did not violate the wash-sale rules because the two stocks are not substantially identical. Specifically, each stock is issued by a separate company. It is also considered a wash sale if you sell stock and your spouse or a corporation that you control buys substantially identical stock.[2] So, in our example, if Jane and her husband John did not have an open line of communication about their day-to-day investment decisions, and John had purchased his own shares of Cola Corp. on February 20, they would have inadvertently created a wash sale. In this instance, the loss harvested by Jane would have been disallowed and then added to the cost of the new stock to determine her cost basis. The repercussions of this can be messy and burdensome, so it's critical that both spouses communicate buying and selling decisions to each other in real time.

How did this activity lower Jane's tax bill?
Capital losses harvested from Cola Corp. offset tax-generating capital gains from appreciated assets that Jane sold throughout the year. Offsetting short-term gains (gains from the sale of assets owned for one year or less) amplifies »

the potential tax savings in a given year, as short-term gains are taxed at ordinary income rates while long-term gains are subject to a reduced capital gains rate (Exhibit 1).

EXHIBIT 1 2019 TAX RATES

Single	Married Filing Jointly	Ordinary Income Rate
$0 - $9,699	$0 - $19,399	10%
$9,700 - $39,474	$19,400 - $78,949	12%
$39,475 - $84,199	$78,950 - $168,399	22%
$84,200 - $160,724	$168,400 - $321,449	24%
$160,725 - $204,099	$321,450 - $408,199	32%
$204,100 - $510,299	$408,200-$612,349	35%
$510,300 or more	$612,350 or more	37%

Source: IRS

2019 CAPITAL GAINS RATES

Single	Married Filing Jointly	Long-Term Capital Gain Rate
$0 - $39,374	$0 - $78,749	0%
$39,375-$434,549	$78,750 - $488,849	15%
$434,550 or more	$488,850 or more	20%

Source: IRS

What if Jane had more losses than gains?

In that scenario, Jane could have applied up to $3,000 or the total net loss, whichever was less in that tax year, against ordinary income. Because capital losses can be carried forward indefinitely, she could continue to do this each year until her losses are reduced to zero.

What is the effect on Jane's future tax bills?

Jane sold Cola Corp. at a depreciated price and, with conviction, repurchased the asset after 30 days at a per-share price lower than it was when she originally invested, effectively lowering her cost basis in the position. Assuming that Cola Corp. will appreciate to its earlier value of $100 and beyond, Jane will have additional unrealized gains in future years. Again, those gains can be offset by losses harvested in those years or carried over from previous years.

At RMB, we consistently monitor clients' portfolios, looking for opportunities to harvest tax losses. These opportunities often present themselves during periods of market volatility – specifically, when the price of a security drops substantially but our investment thesis has not wavered. This ongoing evaluation is critical to optimizing the tax loss harvesting strategy; it's not something that should be relegated to an annual, year-end activity, as the opportunities are not ever-present. If you have any questions about tax loss harvesting, please contact your wealth advisory team. ■

1 *"Evaluating the Tax Deferral and Tax Bracket Arbitrage Benefits of Tax Loss Harvesting," December 3, 2014, https://www.kitces.com/blog/evaluating-the-tax-deferral-and-tax-bracket-arbitrage-benefits-of-tax-loss-harvesting/.*

2 *"2019 Federal Income Tax Brackets | 2019 Tax Brackets & Rates." February 07, 2019. https://taxfoundation.org/2019-tax-brackets/.*