Tax Loss Harvesting

One of the few silver linings in a falling stock market is the opportunity to reap a tax benefit from your losses. Tax-loss harvesting is a way to make lemonade when handed lemons, as we have been handed this year.

To harvest a tax loss, you must sell a position that is worth less now than what you paid for it. When you sell a position at a loss, you have “harvested” that loss. A very important note: this technique only applies to taxable accounts; you cannot use it for losses in tax-deferred accounts such as IRAs or 401(k)s.

For example, say you bought an S&P 500 mutual fund a year ago:

- You paid $14,777 for that fund
- It is now worth $8,774, or 41% less
- You have an “unrealized” loss of $6,003

To harvest that loss, you sell the fund, and now have a “realized” loss of $6,003. You can use that loss to benefit you in two ways on your tax return:

- The loss can offset any capital gains you have for the year (from sales of securities that were in gain positions, or capital gains distributions from mutual funds). Any capital gain you offset with a capital loss saves you from having to declare those gains as income on your tax return.
- If you don’t have any capital gains, or, you have more capital losses than capital gains, you can use $3,000 of your capital losses as a deduction against your other income (wages, interest, Social Security, pensions) each year. If you’re in the 33% marginal tax bracket, for example, that $3,000 deduction saves you $990.
- And, if you still have a capital loss, you can carry it forward indefinitely, to be used each tax year to a) offset realized capital gains, and b) offset $3,000 of your other income.

Tax-loss harvesting is an essential technique in managing taxable accounts for maximum tax efficiency. It takes care to implement, however, as there are rules that must be followed. The most important rule is the “wash sale” rule, which requires that in order to use the capital loss, you cannot have purchased the security 30 days before the sale or 30 days after the sale, in any account – not just the taxable account where you’re harvesting.

In any market, but especially this year's volatile market, you don't want to sit on the harvested cash for 30 days. We've had days recently where the market was up 8-10%; it's important not to miss those big up days. To stay in the market, but still harvest tax losses, you can use the proceeds from your tax-loss sale to purchase a similar, but not identical security, that will serve as a proxy for the sold fund for the required 30 day period. You can move forward with the new fund as a permanent replacement, or, 31 days after harvesting your loss, repurchase your original fund without violating the wash sale rules.

As tax-loss harvesting is usually done towards the end of the year, there are a couple of pitfalls to watch out for. One, you don't want to buy into a replacement fund, only to get hit with that fund's year-end capital gain distribution. Two, if the replacement fund is going to issue dividends during the period that you hold it, know that you must meet a holding period requirement in order for those dividends to be taxed at the favorable qualified dividends tax rate (usually 15%) rather than your ordinary income tax rate (usually higher) -- namely, you must hold the fund that issued the qualified dividends for at least 61 days. And, finally, you want to avoid harvesting a loss only to find yourself with a gain when you're ready to sell your replacement fund. Harvesting only big losses, percentage-wise, is one way to mitigate that risk.

This has been a quick intro to this topic; be sure and consult your tax advisor if you're considering tax-loss harvesting. We're doing it in the taxable accounts that we manage for clients right now, and will be unwinding these trades early next year. We know it's small consolation for having big losses in the first place, but taking advantage of the tax code is one positive action we can take in these trying times.

--Karen O'Brien. Posted 11/17/08.