Gage Wealth Management Group

Updated June 2014

TAX LOSS HARVESTING

Every Fall, the financial press and industry promote tax loss harvesting as a great idea. Harvested portfolio losses can then be used against realized gains in the same year or carried forward into subsequent years. Both active and passive managers use the strategy with some claiming to add 1% or more to annual returns. But, as is the case with most financial advice, advisory promises and investor results often differ.

On the surface, tax loss harvesting makes sense. Virtually never mentioned though is that harvesting will only be of significant value when the harvested proceeds from the loss are never reinvested again in stocks. And, this isn't usually the way it's done because most investors will reinvest the proceeds in stocks. These, too, will be sold at some point in the future. Typically, harvested proceeds are immediately reinvested into a similar asset class fund or reinvested 31 days later in the same fund in order to avoid violation of the "wash" rule. Harvesting doesn't lower taxes longer term because when the proceeds are reinvested that lowers the cost basis on the asset. Assuming that at some future time the asset will be sold for a profit and future capital gains rates are the same, the future gain on which a tax is computed will be exactly equal to the tax originally saved during the harvesting.

For example, let's assume we hold $1 million in Vanguard's passive equity funds after they have declined $500,000 from an original purchase price of $1.5 million. We'll omit State capital gains taxes since they vary greatly from State to State and don't alter the principles underlying this analysis. We decide to harvest $500,000 in losses, realizing $100,000 of tax losses at the Federal government's current 20% capital gains tax rate. Let's say we decide to sell all of our equity positions at some point in the future after they have risen 50% and are again worth $1.5 million, our original purchase price. We now have an additional $500,000 in capital gains taxes to pay that we wouldn't have had to pay had we not initially harvested $500,000 of losses in the portfolio. Tax loss "harvests" have been exactly offset by additional capital gains when the replacement assets are sold sometime later since the basis has been reset lower.

Most investors will probably use up most if not all of their equities in taxable accounts before they die. Generally, the majority of investors exhaust taxable account assets before tax-deferred assets and harvesting capital losses is unlikely to be of benefit to them. Since capital losses may be applied against up to $3000 of income in any given year, and since the maximum current income tax bracket is 39% and capital gains are 20%, the difference is 20% on $3000 or $600, an insignificant reduction in income taxes. Of course, again assuming that at some future time all equities are sold, when we use up capital losses against income rather than future capital gains, we have fewer losses to apply against future gains and once again end up with no gains from tax loss harvesting.

Loss harvesting also creates other potential difficulties. It incurs transaction costs. If the proceeds are invested immediately, the replacement fund may not track exactly as the harvested fund, producing some loses. If the proceeds from the harvest are kept out of the market for 31 days before being put into the identical fund prices can move upwards, causing underperformance. In our discussions with various IRS representatives, accountants, and tax attorneys we have been told that the IRS makes it clear that the sale of anything solely for the generation of a loss to be used against a future gain is questionable. In passive portfolios, this could become an issue at some point in because it's hard to make the case that a position was sold if the explicit purpose of the portfolio is to practice a "buy and hold" investment strategy. And, future capital gains rates are likely to be higher than today's low rate of 20%; 30%-40% has been the historical average. Thus, delaying capital gains by lowering the cost basis may result in investors paying higher capital gains taxes in the future due to higher tax rates. On the plus side, tax loss harvesting releases some money now through tax savings that will grow over time if invested. It is impossible to know if the growth of the harvested money will offset future increases in taxes.

Unless an investor expects that they will never draw down their equity positions in taxable accounts during their lifetime, it is unlikely tax loss harvesting will end up being of much, if any, benefit portfolios are managed as long as they are constructed using the principles of passive and index investing.