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Tax Alpha: Year-End Tax Loss Harvesting

By Chad Smith

As 2014 winds down with typically divergent returns on various asset classes, you may be able to help your clients kill two birds with one stone by combining routine portfolio rebalancing with tax loss harvesting. Helping clients to mitigate the annual federal and state tax bite while managing their investments can only strengthen your relationship and help it withstand periods of market turbulence, according to Chad Smith, a wealth management strategist at HD Vest Financial Services®.

Whether you are rebalancing a portfolio simply to reset the asset allocation to a predetermined mix, or making tactical or strategic adjustments, you are bound to have both gains and losses to deal with. Offsetting capital gains with losses not only reduces the pain come April 15, but can result in more after-tax cash to re-invest that would otherwise go to Uncle Sam.

The strategy is equally applicable to individual stocks, ETFs and mutual funds, although mutual funds have more complicated tax characteristics since gains, losses and income are passed through to investors annually. Collectibles and qualified small-business stock fall under different rules.

THE BASICS ...

As a reminder, short-term (i.e., up to one year) capital gains are taxable at the taxpayer's marginal ordinary income tax rate, which can be as high as 39.6 percent. Also, the 3.8 percent Medicare surtax may kick in for certain high-bracket taxpayers. Capital gains on assets held longer than one year (i.e., long-term) are significantly lower, with the top bracket paying 20 percent on long-term gains (and possibly the 3.8 percent Medicare surcharge).

All of these tax rates, however, apply to net capital gains. Taxpayers can offset long-term gains with the sum of long- and short-term losses. Short-term gains, however, can only be offset by short-term losses, and given the higher tax rate on short-term gains, it makes sense to focus on offsetting them first.

Keep in mind that the "wash sale rule" prevents you from using tax losses on a security sold at a loss, then repurchased within 31 days, Smith warned. However, if there is another security with similar characteristics to the one you want to sell, you effectively avoid the impact of the wash sale rule by buying that other security, since your asset allocation remains essentially unchanged.

There is no loss sale rule applicable to capital gains. That means you can sell a security at a gain, have that gain offset by losses incurred elsewhere in the portfolio, then repurchase the security immediately -- assuming it's one you want in your client's portfolio.

... AND THE BASIS

The effect of doing so would be to raise the taxpayer's basis in that security, so that if and when it is sold again at a gain, the higher tax basis will reduce the taxable gain. That might come in handy if there are no losses that year to offset the gain.

However, the flip side of that logic can apply to selling a security at a loss to offset gains, waiting out the 31-day holding period to avoid the wash sale rule, and then repurchasing it. "If you think that security will be going back up, you are setting the stage for a bigger capital gain than you otherwise would have, since the investor's basis in the repurchased security is based on a lower purchase price than it was originally," Smith said.

There are times when it just makes sense from a purely investment perspective to take more losses than can be offset by gains. However, "You can 'bank' a loss on each sale indefinitely," Smith added -- that is, the loss carryforward rule allows you to keep those losses available to offset future gains, when the time is right.