The Economics of Tax-Loss Harvesting

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’Tis the season when many financial services professionals look at the best way to offset the taxable dividend distributions their clients might be receiving, using, losses that can be ‘harvested’ by selling under-water investments and booking the losses on taxable (that is, not IRA or Roth) accounts. This is not always a trivial exercise; a website called Capital Gains Valet reports that, last year, 34 different mutual funds distributed more than 30% of their total value in the form of taxable distributions.

The tax-loss harvesting strategy takes advantage of U.S. federal income tax laws that allow capital losses to offset capital gains, and up to $3,000 of ordinary income. If a mutual fund or stock is throwing off capital gains in the form of dividends, then the losses that are ‘harvested’ when an underwater security is sold will neutralize them—saving taxes when they come due on the 1040.

Those rules mandate that the seller who ‘harvests’ the loss cannot immediately buy back the same investment. You have to wait 30 days before a repurchase; otherwise, the tax loss is invalidated. But in today’s marketplace, where there is a plethora of similar (but not substantially equal) investments to most mutual funds or ETFs, it is possible to stay invested during that waiting period at minimal risk of losing out on a significant market movement.

Some advisors will harvest gains throughout the year, opportunistically—a labor-intensive activity that can save even more on taxes in the current year. There’s a price to be paid down the road, however, since the selling and then re-buying will lower the cost basis of the investment where the losses were ‘harvested,’ leading to higher capital gains at some point in the future. But kicking the tax down the road means that the immediate tax savings can be reinvested, and those gains, over the years, can potentially offset or overwhelm the higher future tax obligation. And if those investments are held until death, then they can be passed on to heirs with what is known as a step up in basis, basically meaning that the capital gains taxes on any appreciation go away, and the loss harvesting strategy turned out to be all gain and no cost.

Sources:

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If you have any questions about this article or want to discuss your family finances, investment portfolio, or financial planning advice, please call on me anytime at my number (215) 325-1595 or you can click here to schedule a meeting.

Please feel free to forward this article and offer to anyone you know who might have financial questions or need some unbiased advice. Most financial advice is sales advice. In stark contrast, we are fee-only (non-commissioned) fiduciary advisors. We just provide truthful, unbiased advice to our clients.

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