ASTORIA
STRATEGIC WEALTH

Tax Loss Harvesting

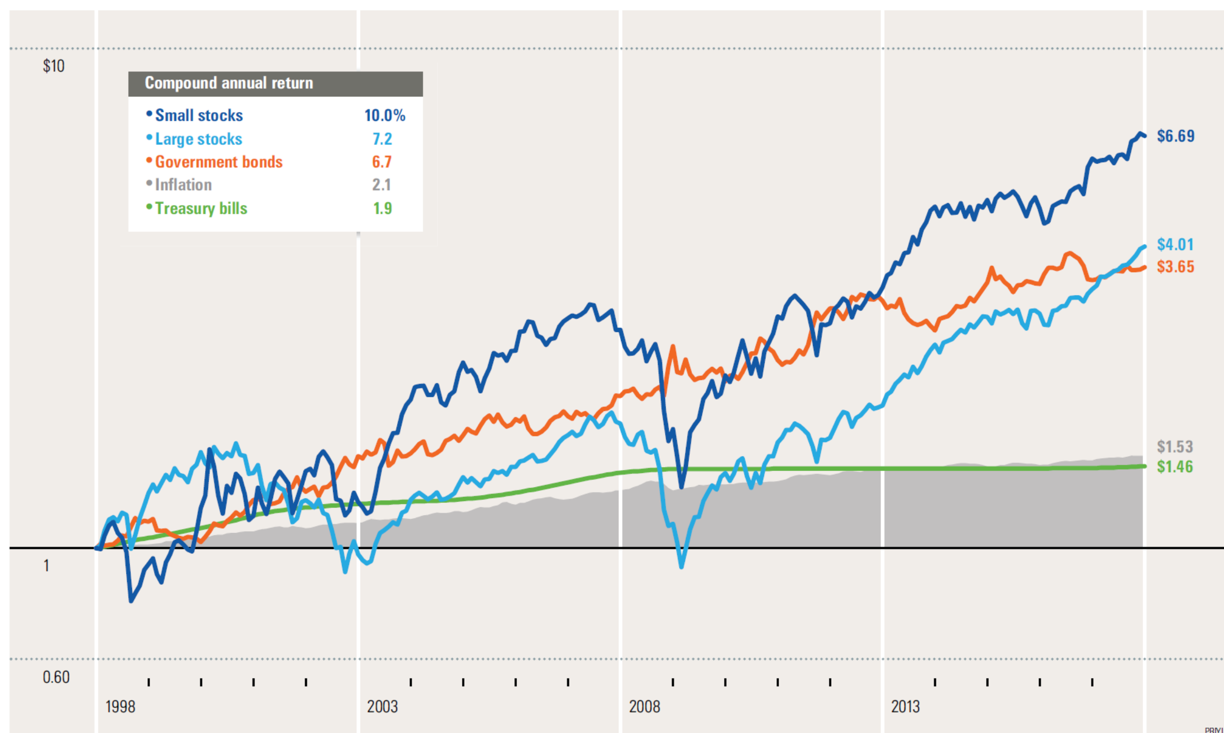
“Making Lemonade Out of Lemons”

The Strategy:

Markets go up and markets go down over the course of an economic cycle, but the long-term trend is “Up and to the Right” over time, making all downturns “temporary.”

Ibbotson® SBBI®

Stocks, Bonds, Bills, and Inflation 1998–2017



Past performance is no guarantee of future results. Hypothetical value of $1 invested at the beginning of 1997. Assumes reinvestment of income and no transaction costs or taxes. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. ©2018 Morningstar, Inc. All Rights Reserved.

Regardless, we believe you should benefit from either condition.

- When markets are temporarily down, TLH to
  - Offset realized Capital Gains for the current year
  - Reduce $3000 of Ordinary Income
  - Bank any remainder for use in future years. There is no limit to the amount which may be carried forward; and, they can be used through the year of your death (2nd to die for couples).
- When markets are up, Tax Gain Harvest (TGH) in the most tax-efficient manner:
  - In retirement accounts, to mitigate the need to recognize a Capital Gain in a taxable account.
  - In taxable accounts, to the extent the Capital Gains can be offset with “banked” Capital Losses.
  - To replenish Short- and Medium-Term Portfolios.
  - To rebalance the Long-Term Portfolio back to its target asset allocation.
  - To harvest as many gains as possible at the 0% Capital Gains Rate.
  - To “re-set” the cost basis of selected securities at the higher, current Market Value.

- To take gains at the 15% Capital Gains Rate if anticipated to be in the higher 20% Capital Gains Bracket (20%) in future years when proceeds will be needed.

When possible, it is better to take *Long*-Term(LT) Capital Losses, as they provide a tax-rate arbitrage as your Capital Gains Rate (0%, 15%, 20%) is typically lower than your Ordinary Income Rate (10% to 37%). You can use the lower LT Losses to offset the ST Capital Gains and Ordinary Income which are taxed at the higher, Ordinary Income Tax Rate. However, at the end of each calendar year, it is worth evaluating if taking additional Short-Term (ST) Capital Losses - presuming no additional LT Capital Losses are available - will reduce your overall tax bill by offsetting ST Gains, LT Gains, and the allowable $3000 of Ordinary Income. If so, we consider this rate tradeoff worthwhile.

The Tactics:

You invest $100,000 in the US Large Cap Stocks asset class by purchasing the Vanguard 500 Exchange Traded Fund (ticker symbol: VOO) which is an Exchange Traded Fund (ETF) tracking the S&P 500 index – an index of the 500 largest US stocks by market weight.

Over the course of time, the market drops 10% (as we expect that it will at some point) and your investment in VOO is now worth $90,000, giving you an *unrealized* loss of $10,000 on that holding – some refer to this as a "paper loss.".

At this point, what are our choices?

1) Hold the position and wait for the market to rise, riding the long-term trend of "up and to the right."
2) Sell, recognize the loss, and hold the cash proceeds from the sale. Now, we've harvested a loss which we can use, BUT we're no longer in a position to ride the inevitable up cycle when it occurs.
3) Sell, recognize the loss, and use the proceeds to purchase another ETF in the same asset class – US Large Cap Stocks, e.g. the iShares S&P 500 ETF (symbol: IVV).
    a. Before the trades, we held a $90,000 position in US Large Cap Stocks via VOO.
    b. After the trades, we held a $90,000 position in US Large Cap Stocks via IVV.
    c. The asset class position is the same before and after the trades – US Large Cap Stocks – with its long-term track record of "up and to the right."
    d. And, we've realized a $10,000 Capital Loss which can be used to offset:
        i. $10,000 of Long-Term Capital Gains (at a tax savings of $1,000 to $1,500).
        ii. Or, $10,000 of Short-Term Capital Gains and/or Ordinary Income (at a tax savings of $1,000 to $3960.)
        iii. Or, a combination of the above.
    e. Cost? Not more than $21 in trading fees.
    f. Would you trade $21 to pick up $1000 to $3960 of tax savings?

Some argue that when the market rises, you end up with a Capital Gain and pay the tax savings you made on the first trade, i.e. you're no better off for having executed the TLH. We disagree and see the benefits as…

1) Time value of money. The loss can be used immediately (rather than later); and, as we know, a dollar today is worth more than a dollar tomorrow.
2) Offset capital gains. You've banked an "asset" (the loss) that you can use when you harvest gains in *any* asset class which may be underfunded in your asset allocation, not just in the asset class of your original position. Since different asset classes do better (or worse) than others at different points of the economic cycle, you get more freedom for taking gains (and not paying taxes).
3) While we like gains, we don't like paying the tax on them. This was especially evident during the tech boom (which later busted). People lost a lot of money because they wouldn't take their gains as they didn't want to have to pay the capital gains tax. Instead, they ended up with an out of balance asset allocation and overdependence upon one asset class which they saw rise (and, then fall).
4) Reduce ordinary income taxes. If you have enough losses available, you can use up to $3,000 of losses to offset ordinary income (your W-2 income) each year.
5) The losses carryforward to subsequent tax years – it's not a "use it or lose it" proposition in the year you take the loss.

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