TAX

The risky side of tax-loss harvesting that advisors need to know

By Lynnley Browning July 19, 2022, 10:03 a.m. EDT 6 Min Read

Deliberately taking losses to offset gains can backfire for some investors. *Pixabay*

Wealth advisors like to cast market downturns as unhappy news with a silver lining.

Sell a losing stock or fund, buy another one, then use the loss to blunt taxes owed on profitable investments. No tax is due on the sale. Not enough gains to soak up the loss? You can use $3,000 of it to reduce taxes on ordinary income, like wages, and roll forward any leftover bit for future tax savings.

But while the strategy, known as tax-loss harvesting, is widely promoted by the retail investment industry as a boon to after-tax returns, it has a risky side. With the S&P 500 index in a brutal downturn following its record high in January, the detrimental aspect could hit unwitting investors this year.

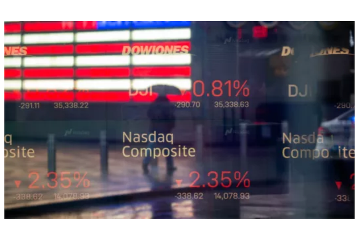
TAX

How wealthy investors can cut their tax bills like a hedge fund

It's counterintuitive, but basic short selling can boost the after-tax return on an entire retirement portfolio.

By Lynnley Browning

February 22



Call it the cloud in the silver lining. When repurchased stock or a replacement investment later appreciates and is sold, it faces tax bills that can outstrip the strategy's savings, sometimes considerably.

"Contrary to this no-lose framing, there are situations where tax-loss harvesting results only in a net neutral outcome for the investor, and can even leave the investor worse off than if they had done nothing to begin with!" wrote planner Ben Henry-Moreland in a July 13 post on Michael Kitces' Nerd's Eye View blog.

The hitch in the strategy comes from IRS rules that calculate capital gains taxes on investing profits based on a holding's original purchase price, or its cost basis. Using tax-loss harvesting to buy stock at a "reduced" price means that there's more room for taxable profit once the asset appreciates.

If an investor wants to buy the same or "substantially identical" stock — perhaps because she thinks it will bounce back quickly — they must sit tight for 30 days before purchasing. The pause is required under the IRS's wash-sale rule, which is designed to prevent investors from selling a security at a loss just so they can claim a tax benefit, only to turn around and immediately buy the same security.

Lemonade into lemons

Say an investor sells Facebook stock that has declined 50% (the stock is down that much this year). She originally paid $200,000 for her shares, which are now worth $100,000. Confident the stock will rebound, she waits 30 days to buy it back. She thus keeps her stake in Facebook and also generates a $100,000 loss to offset that same amount in profits from other investments that did better. With the long-term capital gains rate at 23.8%, including the 3.8% Affordable Care Act levy, she captures $23,800 of tax value ($100,000 x .238).

Now say two years later, Facebook bounces back, and another year in, it's up a further 10%. Our investor now owns shares worth $220,000 for which she paid only $100,000, a hefty gain. If she sells them, she owes $28,560 in capital gains tax on the $120,000 profit. Despite Facebook having rebounded substantially, she has lost $4,760 ($28,560 minus $23,800) via the technique.

"Tax-loss harvesting is a strategy with at best very small return benefits," Maneesh Shanbhag, the co-founder and Chief Investment Officer of Greenline Partners, wrote in a post on finance blog Alpha Architect. "Tax loss harvesting is widely promoted, but we think the benefits are generally misunderstood and often overstated."

Lemons into lemonade

Wealth advisors and brokerages have conveyed the opposite impression to Main Street investors.

Schwab says the strategy "can lower your tax bill and better position your portfolio going forward." Fidelity says it "may be able to help you reduce taxes now and in the future." "Even in the storm clouds of investment losses, there's a silver lining," says Vanguard, noting only in a footnote that the strategy can have "unintended tax implications."

As Wall Street flirts with a bear market, defined as a decline of at least 20% over at least two consecutive months, advisors are giving the strategy an even louder shout-out. Referring to the market's peak on Jan 3. following a roughly 27% gain last year, "There are a lot of portfolios out there with some pretty large built-up gains," said Emerson Ham, a co-founder of Sound View Wealth Advisors in Savannah, Georgia. "Tax-loss harvesting is going to be front burner this year."

A case in point: Some sectors and industries are down double digits, but energy stocks are up over 24% this year, after Russia's invasion of Ukraine rocked global markets and travelers returned to the road and air in droves. Occidental Petroleum is up roughly 90% so far this year. Amid that tale of two markets, "Ongoing tax loss harvesting can help transform market volatility into tax benefits for you," wrote J.P. Morgan Private Bank on June 22.

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The strategy produces the most bang for the buck when an investor has short-term capital gains — on investments held less than a year and taxed like ordinary income — and lives in a high-tax state like California or New York. "The biggest winners are those who can generate short-term losses," said Lance Sherry, a wealth advisor at Kovitz in Chicago.

Andy Rosenberger, a chartered financial analyst and the head of tax managed solutions at Orion Advisor Solutions and Brinker Capital Investments in Berwyn, Pennsylvania, used the strategy this month for a client who plowed more than $218,000 last October into a U.S. large-cap equity fund.

The client lives in California, where the top ordinary rate is 13.3%, the highest in the nation. His total state and federal rates are a combined 54.1%. When Rosenberger sold the fund earlier this month, the client generated tax savings of more than $188,000 to offset gains and income.

Robert Kuharic, the investment strategist for tax-managed solutions at Russell Investments, said that critics of the technique overlook a point: Swapping out investments can create a more valuable portfolio over time, thanks to the compounding of returns. "You're creating a larger portfolio that outweighs the tax cost," he said. What he called the "average advisor" typically uses the strategy once a year in December for clients, a missed opportunity for clients; "We do it once a week."

But Brett Bernstein, the CEO and co-founder of XML Financial Group, flagged a danger. He said that with Wall Street's recent swings, waiting 30 days to buy back the same security "could really hurt you. I would not do this in a volatile market." The reason: staying with the same shares can mean an investor misses "significant rebounds" in other industries.

'Tax alpha'

A secret sauce for generating what wonks call "tax alpha" — a boost in after-tax returns — first grabbed advisors' attention two decades ago, when a 2001 academic paper found that the strategy could boost portfolio returns by 27% over 25 years.

The finding stemmed from a time when trading commissions and bid-ask spreads — the difference between the highest price a buyer is willing to offer and the lowest a seller is willing to accept — were much higher. With both costs now lower, the technique boosted average returns by just 0.85% per year over 1926-2018, according to a 2020 revised paper from scholars at the Massachusetts Institute of Technology and Chapman University.

The strategy can be a labor-extensive process for advisors, who must pick out which losers to sell and what to replace them with. When ordinary investors take on the task, it can be akin to trying to time the market — a no-no. Trading fees for selling losers and buying fresh securities can eat up the tax savings if done in small quantities, making the strategy generally better for larger portfolios.

Robo advisors like Wealthfront that automate harvesting say the technique "can pay for your fees many times over." The SEC accused the online brokerage in 2018 of overstating the benefits.

Shanbhag estimated the boost from harvesting is at best 0.28%, not including trading costs. "Simply buying and holding positions for at least a year," he argued, "is the most impactful way to improve tax efficiency."

Lynnley Browning Wealth Editor, Financial Planning

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By Tobias Salinger

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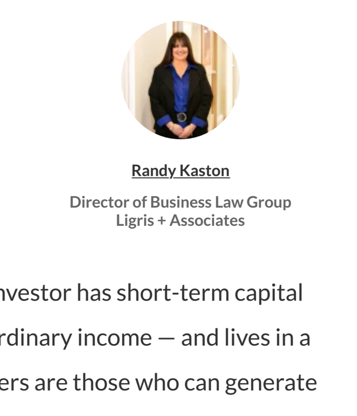

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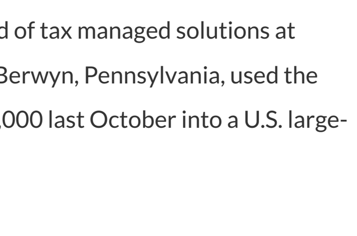

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