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Tax-Loss Harvesting in Inclement Markets
Michael J. Evans, Founder, The Cogent Advisor

In some alternate universe, there may be markets where nobody ever experiences any loss and every investment just keeps growing. In our world, we know better. While markets are expected to climb over time, periodic downturns happen. When they do, they can leave you feeling left out in the cold. That's why it pays to look for opportunities to leverage inclement markets through year-round tax-loss harvesting.

Tax-Loss Harvesting: An Overview

The concept of tax-loss harvesting is relatively simple. I'll go into more detail in a moment, but the general goal is two-fold:

1. **Realize a loss for tax purposes.** When appropriate, sell assets at a loss and use the losses to offset taxable gains on other investments.
2. **Keep assets in the market according to your investment plan.** Buy a similar holding (one that's not "substantially identical") until you can reinvest those assets as originally intended without running afoul of the IRS' "wash sale rule."

In other words, tax-loss harvesting is *not* about abandoning your carefully crafted asset allocation by panic-selling a losing holding. It's about achieving an available tax break while sticking to your disciplined investment strategy throughout.

What Is the Wash Sale Rule?

There are often several mutual funds and ETFs that make good substitutes for one another from a practical perspective. But when tax-loss harvesting, you cannot claim a deductible loss on a sale if you (or your spouse, for joint filers) sell a security at a loss and then buy the same security or a "substantially identical" one within 30 calendar days before or after the transaction. If you violate either of these conditions, the IRS' wash sale rule will typically disallow the loss for current income tax purposes. Thus, it's important to use caution in choosing "similar" funds.

A Tax-Loss Harvesting Illustration

It might help to see an illustration. Assume you purchase a fund for $10,000. Two months later, it's trading at $7,000. You decide to harvest the short-term, $3,000 loss (short-term because the fund was held less than a year). With a 35 percent ordinary federal income tax rate, this can result in a $1,050 tax savings.

At the same time, you take the $7,000 from the sale and invest it in a similar holding. After 31 days, you can reinvest it back where it came from. As long as the market eventually recovers and

the fund returns to the level at which you originally bought it, you've effectively lost nothing while gaining a $1,050 tax break.

There Is No "Tax-Loss Harvesting Season"

Maybe it's because tax-loss harvesting is associated with tax planning, but many investors (and even some advisors) treat it as a strictly year-end task.

This is a mistake. Losses can occur any time of the year, and vanish by year-end. On the one hand that's good, because it means your investments are no worse for the wear (*if* you remained invested). But if you skip the opportunity to also tax-loss harvest when the (hopefully) temporary losses occur, you miss the chance to lower your tax bill while you're at it.

How It Works (and How It Doesn't)

Now that you understand the basics, let's cover some of the finer points. In a December 2015 MarketWatch article, Robert Powell shares BAM ALLIANCE Director of Investment Strategy Kevin Grogan's advice: "Most investors should do tax-loss harvesting as long as the loss is large enough."

But what is "large enough"? As I'll explain in a moment, tax-loss harvesting opportunities are best considered on a case-by-case basis, but in the aforementioned article, Grogan offers some general starting points: For stocks, start with at least a $5,000 or 5 percent loss and for bonds start with at least a $5,000 or 2 percent loss.

There are additional factors to help you decide when a loss seems ripe for harvesting.

Transaction costs: Clearly, it won't make sense to harvest a tax loss if the trading costs are going to erase the benefits. For example, say your tax break would be $100. You're better off staying put if it's going to cost you $80 to complete the trades involved (selling the holding, reinvesting in a similar one, and then ultimately repurchasing the initial investment).

Asset location: You cannot harvest losses from holdings that are in tax-sheltered accounts (such as IRAs or retirement plans). Because realized gains in these accounts are not taxable to begin with, they cannot be offset with any losses.

Market uncertainty: There can be times when the market is so extraordinarily volatile that you are better off just remaining seated. Remember, your goal for tax-loss harvesting is to sell at a loss AND invest in a temporary replacement holding that is similar (but not "substantially identical"). You then typically want to swap back to your original holding after 31 days. This ensures your portfolio remains true to your greater wealth plans.

When it's time to complete a swap, it works best when the price of your replacement holding is the same or lower than the price you paid for it. Why is that so? Taxes. When you sell the replacement holding, if it's gone up in value, you'll incur short-term taxable gains, which could cost you more than the loss harvesting will save you.

Because highly volatile assets often incur large gains or losses over very short periods, tax-loss harvesting should be carefully executed if the market is highly unstable. For example, some advisors employed tax-loss harvesting where appropriate following the passage of the June 2016 Brexit referendum. Depending on your individual holdings and your ability to focus on careful execution, it might or might not have made sense for you to do the same.

Why Are Short-Term Losses More Valuable?

In our earlier illustration, we mentioned harvesting a short-term loss. Why would that matter? Again: taxes. Short-term losses are first deducted against short-term gains that are otherwise taxed at higher ordinary income tax rates. Long-term losses are first deducted against long-term gains that are otherwise taxed at lower capital gains rates. Thus, short-term losses are considered more valuable to your tax management efforts, especially if you are in a higher tax bracket.

The Takeaway

Given that periodic market losses are inevitable and inherent to investing, I'd recommend making the most of them when they occur. So consider employing year-round tax-loss harvesting as part of your overall wealth strategy – while also ensuring that the tax-loss harvesting "tail" doesn't inappropriately wag the portfolio management "dog."

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Michael J. Evans is founder of The Cogent Advisor, an independent member of the BAM ALLIANCE.

Prior to founding The Cogent Advisor, Michael was a veteran commodities trader on the Chicago Mercantile Exchange for more than 20 years. He remains a proud member of the exchange.

Michael currently serves on the DePaul University College of Commerce Finance Advisory Board as well as the Lane Tech Alumni Association and The Irish Fellowship Club of Chicago. He holds a bachelor's degree from the DePaul University College of Commerce and completed the graduate certificate program in Financial Planning at DePaul.

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