



Faculty Advisor E-News

ACCUMULATE WEALTH AND REDUCE TAXES

<http://www.faculty-advisor.com>

December 2003

Tax Loss Harvesting

by James Lange, JD, CPA

Pittsburgh, Pennsylvania

Appropriate tax planning can't restore your losses, but it can reduce or eliminate the tax on your winners. Using losses to reduce taxable gains by means of tax-savvy realization of losses to match gains is referred to as *loss harvesting* or *tax-loss selling*. For many readers, *tax loss harvesting* is the single most important area for reducing taxes now and in the future. Financial planners and advisors who understand and apply these principles really do offer "value added service." Proper tax loss harvesting strategies can save you taxes and help you diversify your portfolio in ways you may not have considered. Now is the time to start thinking about harvesting losses to offset unrealized capital gains.

Example:

Assume you have a winner; you bought it for \$50, it is now worth \$100 and there is no adjustment to the basis.

Also, please assume, you have a loser; you bought it for \$100 and now it is worth \$50. What are your options?

Lets assume you are in the 25% tax rate table for federal purposes and both transactions qualify as a long-term sale.

Idea 1: Buy and Hold

Do nothing, buy and hold. No taxes on any transaction. Next year, if you sell the winner, perhaps in a rebalancing or diversification attempt, and hold on to the loser, you will have to pay \$7.50 in capital gains tax ($\$50 \times 15\% \text{ tax} = \7.50 tax).

Idea 2: Dump the Loser

Sell the loser and deduct \$50 in losses. This means you will pay \$12.50 less in taxes than you would have if you had done nothing (Idea 1). Knowing that you will pay \$12.50 less in taxes (the 25% of your losses that you can deduct), you can afford to reinvest \$62.50 (the \$50 sale price of the investment plus the \$12.50 tax savings; subject to limitations), which is 25% more than your losing investment was worth (\$62.50 is 25% more than \$50). So, you get an immediate \$12.50 benefit. When you add state capital gains taxes, the savings are greater.

If you later sell the winner for \$100 and have to pay capital gains tax of \$7.50 ($\$50 \times 15\%$), at least you enjoyed the time value of your \$12.50 while you held the stock. If you can use other

losses to offset the winner, you would be \$12.50 ahead plus the growth on the \$12.50 over time.

Idea 3: Dump the Loser and Repurchase

Let's assume you like the loser or it is a "core holding" of your portfolio or you think the loser will come back. Sell the loser and then, subject to the wash rules, buy it, or something similar to it, back. Assume you made the correct decision to sell and repurchase. After repurchasing the loser for \$50, its value climbs back to \$100. Except for transactions fees, you would have the benefit of the \$12.50 savings you made by deducting the loss, and you have the growth. Furthermore, you have maintained the integrity of your portfolio.

Idea 4: Use Your Losses to Diversify Your Portfolio

Let's assume you have a heavy position in a particular stock or mutual fund in a particular sector (like a large cap fund) that has a low basis. You have avoided selling it for years because you are too cheap to pay the capital gains tax. (Let's be honest here.) Then, either your advisor nags you or the fear of an Enron scenario makes you want to diversify.

Let's assume that the basis is \$10,000, and the value is \$100,000. You never sold it because you didn't want to pay the \$18,000 in taxes (\$100,000 proceeds less \$10,000 basis = \$90,000 gain x 15% = \$13,500).

Let's also assume you have a loser or losers with a combined loss of \$90,000. You sell both, winner and loser, offset the gains and the losses and pay no capital gains. Lo and behold, you just opened up your window to diversification and getting out of that heavy concentration in one stock or sector problem. You repurchase the winner and the loser or whatever you like, and your basis will be your purchase price.

The best losses are short-term capital losses. This is because the IRS forces you to match short-term gains against short-term losses and long-term gains against long-term losses first. Then the net short-term results are netted against the net long-term results. If the result is a gain, it will be taxable as short-term, long-term, or a combination thereof. If the losses incurred were short-term rather than long-term, there will be a better chance that your gain will be long-term instead of short-term and taxed at lower rates. The short-term gains tax rate can be almost twice the long-term gains tax rate. Therefore, if you own losing investments that you have owned for less than a year, they are a better choice for tax-loss selling than long-term investments.

The following example is somewhat complicated but it demonstrates why it is critical to think ahead and map out a strategy to capitalize on gains and losses.

Imagine you hold an investment that qualifies for a short-term capital loss (i.e., a losing investment held for less than a year) with an unrecognized loss of \$20,000. You also have a long-term winner with an unrecognized gain of \$20,000. You decide not to sell either prior to year-end. After all you haven't really lost any money on paper. (Hint: This may be bad logic.)

The following year you decide it's time to sell the long-term winner and recognize a \$20,000 long-term gain at a long-term tax rate of 15%. In this same year, you also incur a short-term

capital gain of \$10,000 from the sale of another stock. You now have \$30,000 in taxable income to recognize.

In the meantime, the loser is still down \$20,000. Fine you think, let's sell the \$20,000 loser, offset it against the \$20,000 gain, and pay tax on the \$10,000 gain. (By the time you decide to sell the loser, it is no longer a short-term transaction because you have held it for over a year.) When you prepare your 2003 Schedule D, you report a long-term gain and long-term loss that net to \$0. You also report a short-term gain of \$10,000 taxed at your ordinary rate of 28% that costs you \$2,800 of federal income taxes.

What you *could* have done in year one was to sell the loser. In year one, you would then realize a short-term capital loss, and deduct a \$3,000 loss at your ordinary tax rate of 28%, or \$840 ($\$3000 \times 28\% = \840) and recognize a \$17,000 short-term loss carryover. In the following year, using the netting rules, the \$10,000 short-term gain would be offset by the \$17,000 short-term loss carryover. The excess short-term loss of \$7,000 would then offset the long-term gain of \$20,000 leaving you with a long-term taxable gain of \$13,000. This gain would result in tax of \$1,950 ($\$13,000 \times 15\%$). The net tax over these two years is only \$1,110.

In summary, recognizing the short-term loss when you had the chance would have saved you \$1,690 or 60% in tax savings.

If your net capital losses exceed your net capital gains, you can deduct up to \$3,000 of the losses (short or long-term) against ordinary income. That adds up to an \$840 tax savings for an individual who is in a 28% tax bracket. *Be careful to avoid a wash sale*, i.e., buying the same security back within 30 days before or after you sell the shares. Tax rules will disallow the loss. Keep in mind, however, that with all the stock and mutual fund choices, there is probably a similar investment available for you to park your money in for 30 days. This may be a better strategy than keeping funds in cash for 30 days waiting to repurchase the same stock since the market or the sector may move up significantly in 30 days.

Another idea is double up in your position. Lets say you bought a stock for \$50 per share that is currently trading for \$20 per share. You still think it is a good long-term investment. You are currently showing an unrealized loss of \$30 per share. If you sell now, you would recognize a loss of \$30 per share but would have to wait 30 days to buy it back. A rise in the stock price over the next 30 days would be lost money. You could buy a second block of the same stock at \$20 per share. Then after 30 days, sell the original block and recognize the tax loss. You still own the same amount of shares as before except you now have a lower tax basis in the new shares- \$20 per share. If the stock did go up during the 30-day period, you didn't miss out on the appreciation.

Selling investments to realize net losses in excess of \$3,000 is a good idea too. The losses will carry over to future years when future gains can be reduced. Plus, up to another \$3,000 per year can be deducted from ordinary income. Even if investments you currently hold recover in value, you would have been much better off by selling them at a loss and reinvesting the proceeds in similar investments. Using this strategy, you will hold investments of the same value, but with a lower cost basis and have additional tax savings each year. To the extent that the \$3,000 net loss is deducted against ordinary income every year, you save money at ordinary tax rates. The loss carryover can also eliminate future short-term and

long-term capital gains and will free you from subsequently sticking with investments only because of the holding period. If the remaining investments are subsequently sold at a gain, it will be taxed at lower long-term gain rates, and the overall result will be less tax than holding the original investment. If the investment with a lower basis remains to become part of your final estate, the heirs will get a step-up in basis and avoid the tax altogether.

Harvesting your investment losses can reduce your capital gain income to zero and give you a bonus of a \$3,000 ordinary income reduction each year. It's a great way to increase the after-tax rate of return on your portfolio without the risks of active trading. In combination with a good asset allocation and reallocation strategy, you can add value to your investment portfolio without increasing your investment risk.

Finally, now is your last chance to review your portfolio to see if you have any net 2003 long-term capital gains that consist of pre-May 6, 2003 stock sales. The current law is still going to tax these gains at the old long-term rate of 20%. If you are still holding stock with both unrealized long-term gains and losses, you should consider selling and recognizing the long-term loss stock to offset the pre-May 6th gains. This will save 5% in current year taxes. If you sell the stock with the unrealized gains in 2004, they will be taxed at a maximum of 15%.

If you find all of this too overwhelming, and yet you see the inherent value of the advice, perhaps you would be well advised to consult with your financial advisor and your tax advisor.

P.S. On a different note, we received glowing praise for our teleseminars given in November. The seminar answered the most important questions readers have about TIAA-CREF and retirement plans. We will be making tapes, CDs and transcripts available after year end. If you are interested in this material at the lowest possible price, please send a blank e-mail to admin@faculty-advisor.com and write "best price" in the subject line. This doesn't commit you to anything, but will insure you will get a substantial discount if you later decide to purchase.

Faculty Advisor E-mail Newsletter

<http://www.faculty-advisor.com>
James Lange & Associates
2200 Murray Avenue
Pittsburgh, PA 15217
412 521-2732 - 800-387-1129
412-521-2285 FAX
admin@faculty-advisor.com