Tax Loss Harvesting

Tax loss harvesting is an active portfolio management tool that Virtue Asset Management utilizes to potentially lower current and future taxes. The tax code allows you to sell securities at a loss and you can use these losses to offset capital gains and reduce taxable ordinary income up to $3,000 a year. Another advantage of tax loss harvesting is that you can buy back the exact security you sold in 31 days.

The goal of tax loss harvesting is to sell securities at a loss to capture the losses for income tax purposes. If you sell a stock after holding it over a year, the highest capital gains rate you can pay is 23.8% if you are subject to the net investment income tax. The net investment income tax is a Medicare surtax of 3.8% on investment income. If you purchased a stock two years ago for $20,000 and sell it in a taxable account for $25,000 you will create a capital gain of $5,000. That $5,000 is then taxed at the capital gains rate and at the maximum rate of 23.8% the tax owed is $1,190. However, if you had another stock in your portfolio at a loss of $5,000 you could sell it in a taxable account and create $5,000 in capital losses. The $5,000 in losses offsets the $5,000 in gains and eliminates the tax of $1,190.

When you sell a security you have held for less than a year, you are taxed at your federal income tax rate. The highest federal income tax rate is 43.4% if you are subject to the net investment income tax. The short term rate is much higher than the previously discussed long term rate of 23.8%. This large difference in taxes creates a dilemma for investors when a recently purchased stock appreciates quickly. The question becomes: is it worth the risk to hold the stock for a year to only pay 23.8% in capital gains versus 43.4%. If the portfolio had created $5,000 in capital loss harvesting from a prior sale those losses could be used to offset $5,000 in short term gains and a cash savings of $2,170 ($5,000 multiplied by the maximum rate of 43.4%).

If you don't have any capital gains for the year you can still take advantage of tax loss harvesting. The tax code allows you to take up to $3,000 a year in carryover losses to reduce your ordinary income. If you have more than $3,000 in losses, the losses rollover to future years or can be used to offset future capital gains from sales of stocks.

Tax loss harvesting is a valuable tool in a market pull back. Here at Virtue Asset Management we understand the concept and have the time and expertise to execute it correctly. For this scenario, consider a $1 million portfolio and the market drops 10%. In scenario 1 outlined below, the portfolio manager can sell the securities at a loss and purchase similar but not identical securities. After a 10% drop the portfolio manager realizes losses of $100,000. By purchasing similar but not identical securities the portfolio should appreciate at a similar rate if the securities weren't sold. If the market then appreciates by 20% the portfolio is up to $1,080,000. The portfolio has $80,000 in gains which could be sold, if needed, and the $100,000 in losses would offset the gains. Therefore, the client would have zero capital gain taxes and $20,000 in carryover losses. In scenario 2 outlined below, the manager doesn't make any sales. The portfolio has $80,000 in gains with no capital gain losses. If the client needed $80,000 they could pay as much as $19,040 in capital gain taxes (23.8%).

	Scenario 1 (Tax Loss Harvesting)	Scenario 2 (Static Portfolio)
Starting Value	$1,000,000	$1,000,000
Value after 10% drop	$900,000	$900,000
Tax Losses Harvested	$100,000	$0
Value after 20% increase	$1,080,000	$1,080,000
Taxes on $80,000 in sales	$0	$19,040

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