Tax-Loss Harvesting
Making Lemonade out of Lemons

As your investment office, our primary objective is to build customized investment portfolios that maximize your after-tax returns. One way to meet this goal is to proactively harvest tax losses. These losses can reduce your tax liability and help boost your after-tax investment returns while maintaining similar market exposure. However, in order to harvest tax losses you must comply with stringent IRS rules that can be quite complicated. In this paper, we will explain the mechanics of tax-loss harvesting and how we execute this strategy on your behalf.

How Does Tax-Loss Harvesting Work?

Tax-loss harvesting is the practice of selling stocks, mutual funds, exchange-traded funds and other publicly traded securities that are worth less than what investors initially paid for them (or their current cost basis). By realizing a loss on these investments, investors are able to offset taxes on both gains from other investments and from income.

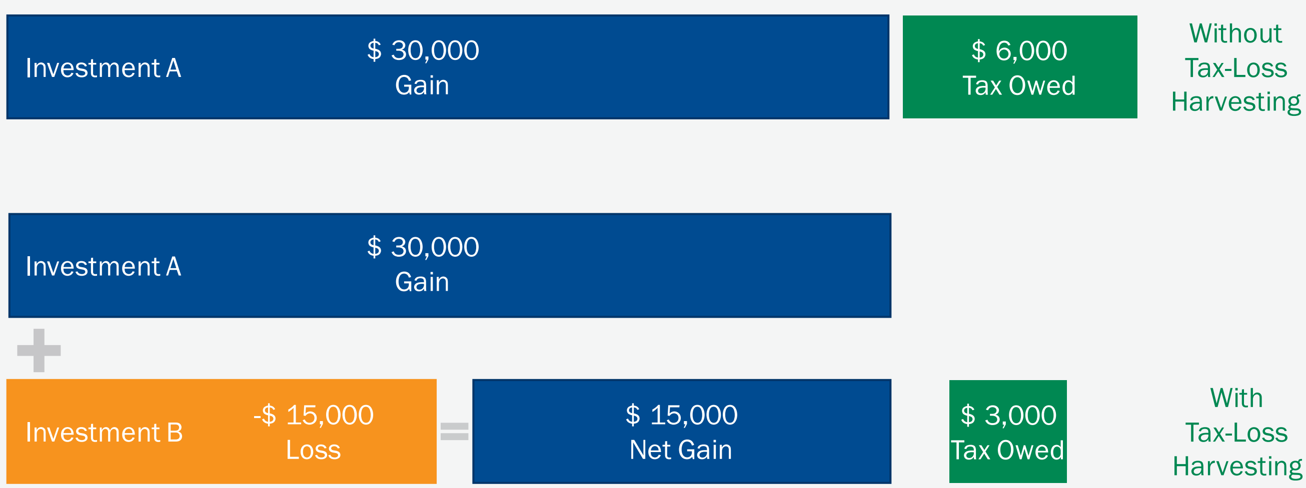
Tax-loss harvesting can be broken down into three distinct steps:

1. Sell an under-performing investment.
2. Use the loss to offset capital gains and/or up to $3,000 of other income. Any remaining losses can be carried forward into future years.
3. Reinvest sale proceeds in an asset that fits with your overall investment strategy.

Even if you do not currently have any gains, there are benefits to harvesting losses now, since they can be used to offset income or future gains.

ILLUSTRATIVE EXAMPLE

Investment A has produced $30,000 in long-term capital gains. To minimize the tax liability of those gains, you elect to sell Investment B which generates a $15,000 long-term loss. Because of tax loss harvesting, your gain and loss offset each other to generate a net long-term gain of $15,000. Assuming a long-term capital gains tax rate of 20%, your tax bill is reduced from $6,000 to $3,000.



Investors typically consider tax-loss harvesting strategies as they look to rebalance their portfolios. For example, if you own an investment that has appreciated beyond your asset allocation targets and you would like to trim your position, you can match the long-term capital gains with a similar long-term capital loss. Or, if an investment has decreased in value and you determine that it no longer fits with your overall investment objectives, you can use this loss to offset a gain somewhere else in your portfolio.

Key Issues to Consider

Tax-loss harvesting can be very complicated within a diversified portfolio. There are a range of factors that should be considered to effectively implement this strategy:

The Wash-sale Rule: The wash-sale rule prevents taxpayers from selling securities at a loss to claim tax benefits. The rule states that a loss on a sale will not be permitted if the same or a "substantially identical" security is purchased within 30 days **before** or **after** the sale. The best way to avoid the wash-sale rule is to make sure that you wait at least 31 days after the sale of the security to buy it back or to purchase a similar investment to the one that was sold. If you want to remain in the market, you can buy a different investment that is not considered "substantially identical."

For example, you could sell an energy stock and purchase shares in an energy ETF directly thereafter. The wash-sale rule applies to your accounts and your spouse's accounts.[1] You should thoroughly review your recent purchases to ensure that you did not buy the same security in any related accounts within 30 days before the sale.

Long-term Losses vs. Short-term Losses: The IRS mandates that short-term losses must be matched with short-term gains and long-term losses matched with long-term gains.[2] However, if you have more long-term losses than long-term gains, you can use the excess to offset short-term gains. The same rules apply if you have more short-term losses than short-term gains. Both forms of gains come with meaningfully different tax rates. Short-term federal tax rates range from 10% to 37% while long-term capital tax rates range from 0% to 20%. Capital gains are also subject to the 3.8% Net Investment Income Tax or Obamacare Tax as well as state and local income taxes.

Pay Attention to Your Cost Basis: It is important to pay attention to your cost basis when deciding which shares to sell as it will impact the magnitude of your gain or loss. A higher cost basis will create a larger loss or alternatively a smaller gain.

Reinvestment of Fund Distributions and/or Dividends: Before harvesting tax losses, it is important to determine if you have inadvertently purchased shares through automatic repurchase programs. Fund distributions and/or dividends that are automatically reinvested back into the fund or used to purchase additional shares of stock could cause you to unwittingly violate the wash-sale rule thus reducing and deferring the benefit by the amount purchased.

What Assets Are Best for Tax-Loss Harvesting?

Not all stocks, funds and investments are good candidates for tax-loss harvesting. You should target assets that meet any or all of the following criteria:

- Easily replaced with similar assets
- No longer fit with your investment strategy
- Poor prospects for future growth
- Short-term losses because they can be used to offset short-term gains which have the highest marginal tax rate

HC APPROACH

At Hirtle Callaghan, we incorporate tax-loss harvesting into our year-round tax planning and investment strategy process. We evaluate your portfolio holdings including individual purchase dates throughout the year, staying mindful of opportunities to reduce the impact of taxes on your investments. Investments can be volatile and a tax-loss harvesting opportunity that arises early in the year could disappear before year-end. By being continually vigilant, we aim to proactively position your investment portfolio for long-term success net of taxes.

[1] *It is important to review the trade activity in your spouse's and your other investment accounts (including IRA and Roth IRA accounts). The wash-sale rules are triggered if you sell an investment at a loss and your spouse and/or you buy in another account (including a retirement account), the same or "substantially identical" investment within the wash-sale time period.*

[4] *Short-term gains and losses are those realized from the sale of an asset that you have owned for one year or less. Long-term gains and losses are realized after selling an investment that you have owned for more than a year.*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