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It’s harvest time – for tax losses

By Robert N. Gordon

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As November approaches, and 2007 comes to a close, investors are taking stock of their realized and unrealized gains and losses for the year. Many investors who find themselves with net realized gains are looking to harvest some unrealized losses to offset those gains.

Tax loss harvesting, done properly, can increase returns. But first, the basics.

Only realized gains or losses are immediately taxable (except for futures and broad-index options that are marked to market at yearend). To determine their tax liability, taxpayers must first net short-term gains against short-term losses, then net long-term gains and losses. Finally, the investor nets the short-term result against the long-term result, dollar for dollar, creating a tax liability or loss carry-forward after the first $3,000.

This can produce unanticipated consequences. For instance, a short-term loss used to offset a long-term gain saves the investor only 15 on the dollar, which is the tax that would have been paid on the long-term gain. Alternatively, when long-term losses are used to offset short-term gains that would have been taxed at 35%, the tax savings are much greater.

When taking losses, you must be aware of the wash sale rule. If an investor disposes of an asset for a capital loss and repurchases the asset within 31 days, the loss is deferred (that is, not currently deductible). Investors do not usually want to dispose of a stock for 31 days, because during that time, they fear that the stock's value will rise, and they will have missed the appreciation.

But satisfying the wash sale rule carries risks: The rule also prevents selling stock for a loss and then buying a call option. Nor can you sell for a loss and then sell a put on the stock that has a high likelihood of being exercised (such as an in-the-money put).

One way of working within the confines of the wash sale rule is to double up. Here's an example:

Suppose an investor has 1,000 shares that are underwater. They can buy another 1,000 shares and hold the 2,000 shares for 31 days. After that, they sell 1,000 shares, identifying those shares as the ones purchased previously, now with a loss. This too is not optimal, because they are distorting alpha by owning twice as many shares as desired for the month. A better idea might be to double up yet remove the risk of owning the second lot of 1,000 shares.

To do that, the investor could sell a call option and buy a put option, which can negate the risk of owning the second lot of shares, without violating the wash sale rule.

Advisers should be informing clients that loss harvesting need not be thought of as a post-Thanksgiving activity. In fact, there are probably many opportunities to harvest losses throughout the year. Let's assume that an investor bought a stock at $10 in January. By August, it has declined to $7. Fast forward to December, and the stock has recovered to $10. The result: neither an unrealized gain nor a loss. That's not bad, but a harvested loss of $3 in August could be used to offset gains realized in the year.

A study done by First Quadrant LP, an investment management firm in Pasadena, Calif., found that those who harvested losses when the loss was 15% of their cost basis added significantly to after-tax returns, or about 0.8 percentage points per year. This was over a 25-year period, with higher returns in the early years. The extra return seems available in both bull and bear markets.

Note also that the wash sale rule is a one-way rule. If the investor sells for a gain and repurchases in 31 days, the government still wants the tax on capital gains. This characteristic of the wash sale rule can be used to an investor's benefit if they possess taxable bonds with unrealized long-term gains. The idea is to sell and realize their long-term gains and immediately repurchase the same bond, thereby resetting the investor's cost basis at a higher point.

There are other ways to work within the wash sale rule, but under all circumstances, taxable investors owe it to themselves to investigate the possible benefits from harvesting unrealized losses.

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