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Last chance to double up on losses

Harvest both long- and short-term declines while sticking to your investment strategy

By Robert N. Gordon

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A core principle of managing portfolios for tax efficiency is disciplined loss harvesting. And one of the most popular loss-harvesting techniques is doubling up, which allows investors to harvest losses effectively while sticking to a particular investment strategy.

In doubling up, an investor who has a loss buys as many shares as he or she already owns. After 31 days have passed, the investor sells half his or her shares using the specific lot identification method to deliver the original lot of high-cost-basis shares. In doubling up, the loss comes only on sale of the high-basis shares, which means that for this technique to be used in 2011, trades must be executed by Nov. 23 so that the requisite 31-day limit is satisfied.

There are multiple ways to double up. Some advisers suggest buying call options on the shares to double up, rather than buying another lot of shares. This might reduce the amount of money needed to double up but also could change the economics substantially unless the call options are deep in the money.

We've been advised that clients can hedge the second lot of shares completely. Here, the investor simultaneously buys the second lot of shares while both selling a call and buying a put with the same strike price and expiration (at least 31 days). This kind of a three-legged transaction is called a “forward conversion” and is considered a riskless position. Therefore, an investor can double up without increasing his or her risk in the stock.

This technique, of course, prompts the question of which losses to take. Shares with the highest cost basis will create the largest loss, but investors also should weigh which holdings have been held long-term versus short-term. There can be great value in balancing realized short-term capital gains/losses and long-term capital gains/losses. The rules direct that taxpayers first net realized short-term gains against realized short-term losses. The investor then is instructed to offset realized long-term gains against long-term losses. The taxpayer then offsets short term versus long term, dollar for dollar.

Short-term losses utilized against short-term gains save 35 cents in tax. Short-term losses netted against long-term gains shelter only 15 cents in tax. If an investor realizes both short-term gains and long-term gains, a short-term loss is worth more than double the value of a long-term loss.

Care should be taken during the year to take losses when they are still short-term. Loss harvesting optimally should be done all year, not just at year-end.

If the investor has only unrealized long-term losses, there is a way to capture those losses as short-term versus long-term. First, sell the position to realize a long-term loss. Next, buy a call option on the stock, triggering the wash sale rule. The deferred loss on the stock now adjusts the cost basis in the option, creating a large unrealized long-term loss on the option. Third, exercise the call option, thereby repurchasing the stock and starting a new holding period. Finally, sell the stock and realize a short-term loss instead of what would have been a long-term loss.

It is important that each of these steps is completed to reach the desired goal. If the investor sells the call option instead of exercising the call, the loss continues to be long-term. It is the exercise of the call that resets the holding period.

Whether or not these moves make sense for your clients, you should be calculating realized gains and losses in order to optimize the benefits of loss harvesting.

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