Generating Alpha Through Tax-Loss Harvesting

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One of the best ways to consistently and tangibly add value to client portfolios—especially in volatile markets—is through a tax-optimized investment approach.

Known as tax alpha, this can be obtained in three ways:

- Selecting products that are inherently tax efficient or managed in a tax-aware fashion
- Practicing asset location or holding inefficient assets—such as high-turnover equity funds or taxable fixed income assets—in tax-deferred accounts
- Tax-loss harvesting, a tactic that famed economist and author Burton Malkiel called "the only sure alpha that I know of"

Buy-and-hold strategies are fundamentally tax efficient because they produce limited, if any, capital gains until products are liquidated. But tax-loss harvesting takes this a step further by systematically selling off assets with unrealized losses. These losses can be used to offset gains in other parts of the portfolio, as well as a portion of ordinary income.

A Simple Practice That Can Provide Big Returns

Simply put, tax-loss harvesting is the practice of selling positions at a loss. While you should never set out to buy high and sell low, most diversified portfolios will inevitably have positions with unrealized losses. At a minimum, taking advantage of these losses will allow a client to delay paying taxes and attain more tax-deferred growth. Using these methods strategically can take it a step further, reducing the overall tax burden a client faces.

Most advisors approach this strategy at year-end by reviewing capital gains produced over the year and looking for losses that can offset them. Although this can be effective, working it into your process throughout the year can yield greater results. Market drawdowns often create the best harvesting opportunities, and they can happen at any time. By developing and maintaining a repeatable process in your playbook, you can address it when the opportunity arises.

In fact, according to a 2019 Envestnet | PMC study, effective tax management can add 1 percent to a portfolio annually, and potentially more in highly volatile years.

OFFSETTING CAPITAL LOSSES

Losses on investments must first be used to offset gains of the same type. So, by following the correct order, you would:

1. Deduct short-term losses against short-term gains
2. Deduct long-term losses against long-term gains
3. Net the two totals to determine if there is an overall gain or loss

You can deduct up to $3,000 of net capital loss against other kinds of income. Any excess capital loss can be carried over to offset gains in subsequent years.

Better yet, adding this strategy can extract a positive result from a downturn, demonstrating value to clients who are seeing losses mount in difficult market environments.

What Is the Best Approach?

Without being able to predict a market downturn, some advisors look for tax-loss harvesting opportunities on a periodic basis, such as quarterly, semiannually, or annually. No matter how often you decide to conduct reviews, there are two ways to go about it:

1. Identify a list of nonqualified accounts you would like to review individually. This could be a list of the largest households or accounts that deserve special attention on a position-by-position basis.
2. Look at the holdings across your business. What are the largest overall positions, and how have they performed recently? In aggregate, what are the unrealized gains or losses on a particular position?

Once positions have been identified as candidates for harvesting, confirm no purchases of the security have been made in any accounts in the past 30 days, including retirement accounts. (Losses from a dividend reinvestment will be disallowed, but it may be a small amount that won't derail the overall strategy.) Then, decide whether you want to keep the proceeds in cash or invest them in a replacement security for the next 30 days. We generally advise using a replacement security to maintain market exposure and avoid the potential pitfalls of market timing and missing out on a rebound over the next month; however, you'll need to be aware of wash sales.

The Impact of Wash Sales

According to the IRS, a wash sale occurs when you sell or trade securities at a loss and, within 30 days before or after the sale, do one of the following:

- Buy substantially identical securities
- Acquire substantially identical securities in a fully taxable trade
- Acquire a contract or option to buy substantially identical securities

The IRS created this rule to keep investors from reaping tax savings without materially changing their economic position. The concept is quite simple, but the implementation is far from it.

Because wash sales effectively disallow the losses generated through tax-loss harvesting, you need to be careful if you choose to use replacement securities.

The IRS is vague, leaving it up to investors to "consider all the facts and circumstances in your particular case" (IRS Publication 550) to determine if a position is substantially identical. Although everyone must ultimately interpret this based on their circumstances, there are some best practices you can follow when selecting a replacement security as a placeholder.

For example, if you sell an ETF or index fund, you can replace it with a product that tracks a different index. Replacing one S&P 500 fund with another is generally considered running afoul of the intent of the IRS. Swapping one security for a different one that holds the same 500 companies in nearly identical weighting does not put you in a different economic position, so you should seek another option. Most investors consider actively managed funds to be unique enough to be in safe territory, despite commonly overlapping positions. Identifying a security that gives the client exposure to a similar area of the market keeps the portfolio in line with its objective and can reduce opportunity costs.

Other Strategies to Consider

Tax-loss harvesting can be a good strategy during market turmoil, but similar approaches can provide benefits as well:

- **Tax arbitrage:** Because the IRS taxes different types of income at different rates, clients can utilize tax arbitrage to access lower tax rates. For example, long-term capital losses are typically used to offset long-term capital gains, allowing the investor to avoid paying long-term rates (up to 23.8 percent) on those capital gains. If you can delay realizing those gains, you can let long-term capital losses offset short-term capital gains and ordinary income (up to 40.8 percent). This strategy can add significant tax alpha because any leftover long-term capital losses can be deducted against ordinary income (up to $3,000 per year). When possible, pairing losses with short-term gains and ordinary income maximizes the value of those losses.
- **Harvesting gains:** It's important to note that harvesting gains can be timely as well. Clients in the 10 percent and 12 percent ordinary income tax brackets are subject to a 0 percent capital gains rate. Should they find themselves in these brackets in a given year, banking the gains will effectively increase their cost basis. Unlike tax-loss harvesting, wash sale considerations do not apply to gains, and securities can be repurchased immediately.

A Unique Ability to Turn Losses into Gains

Although tax-loss harvesting can be a challenging process to scale at times, the ability to take advantage of down markets is unique. Defining your process in advance of downturns can set you up for swift and successful implementation, especially as volatile markets often drive more client outreach and longer workweeks. The process can include periodic reviews, researching replacement securities for your top holdings in advance, and identifying key relationships that could benefit from this value-added service. The mastery of tax-loss harvesting can be another tool you can use to deliver alpha throughout all market cycles.

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