TIME TO TALK TAX LOSS HARVESTING

WisdomTree ETFs
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With the fourth quarter here and tax season fast approaching, now is an ideal time for advisors to initiate conversations with their clients about tax loss harvesting. Tax loss harvesting is the act of selling a losing position to offset capital gains created by income or the sale of profitable investments.

The security sold to create the tax loss opportunity is subsequently replaced by a similar investment to maintain proper asset allocation within the client's portfolio. For example, an advisor can sell a standard, diversified European exchange-traded fund (ETF) for a client at a loss and replace that ETF with a small-cap dividend or currency-hedged fund focusing on European equities.

When searching for tax loss harvesting opportunities, advisors must remain aware of the Internal Revenue Service's (IRS) wash-sale rules. IRS rules state that the wash sale comes into play when a security is sold and any of the following scenarios occur within 30 days:[1]

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

When using ETFs, a good rule of thumb for avoiding the wash-sale rule is to avoid funds with similar underlying indexes to the product sold to create the tax loss opportunity. Clearly, selling one S&P 500 Index-based ETF only to buy another two weeks later could expose client portfolios to wash-sale ramifications. Conversely, selling a sagging small-cap growth fund to move into a mid-cap dividend ETF could help advisors steer clear of wash-sale issues.

Risks with Tax Loss Harvesting

For many clients, tax loss harvesting is a practical strategy worth considering, but it is not a free lunch. There are risks associated with this strategy, and those risks extend beyond the wash sale.

Obviously, the investment sold for tax loss purposes must be replaced if advisors are looking to keep client portfolios allocated comparably to where they were prior to the tax loss sale. Differences in value between the sold and the purchased investments can potentially negate some of the benefits of tax loss harvesting.

Additionally, investors' cost basis and expected holding periods must be considered, because as those factors change, higher taxes could await down the road. In other words, searching for a tax break today can result in higher taxes in the future.[2]

Another scenario to consider is the investor harvesting more losses plus, say, $3,000 in ordinary income than he or she has in offsetting gains. This scenario might seem shrewd to save on taxes today but could result in a higher tax tab in the future.

Tax Loss Harvesting Still Has Advantages

While there are risks associated with tax loss harvesting, as is the case with nearly any financial strategy, there are benefits too. For starters, creating tax loss opportunities does not require material alterations to a portfolio's allocations. In the hypothetical example mentioned earlier, the advisor maintains European exposure for her client by selling out of a lagging European fund to move into an alternative avenue for European equities. Thus, exposure to Europe is maintained.

Another potential benefit is that if losses remain after short-term losses are used to

offset short-term gains or long-term losses are used to offset long-term gains, investors can use remaining losses from one category to offset gains in another.[3]

[1]Abraham Bailin, “Tax-Loss Harvesting: A Tactical Strategy to Add Incremental Value,” Morningstar, 11/2/11.

[2]Jason Zweig, “Look Before You Reap: Tax-Loss Harvesting Can Backfire, The Wall Street Journal, 12/11/10.

[3]“How Tax-Loss Harvesting Benefits You,” JPS Financial, 12/10/15.

Important Risks Related to this Article

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DEFINITIONS

Tax Loss Harvesting : Selling securities at a loss to offset a capital gains tax liability. Tax gain/loss harvesting is typically used to limit the recognition of short-term capital gains, which are normally taxed at higher federal income tax rates than long-term capital gains.

Dividend : A portion of corporate profits paid out to shareholders.

Currency hedging : Strategies designed to mitigate the impact of currency performance on investment returns.

Wash-Sale Rule : An Internal Revenue Service rule that prohibits a taxpayer from claiming a loss on the sale or trade of a security in a wash sale. The rule defines a wash sale as one that occurs when an individual sells or trades a security at a loss, and within 30 days before or after this sale, buys a “substantially identical” stock or security, or acquires a contract or option to do so.

IRA : Individual retirement account.

Roth IRA : An individual retirement plan (a type of qualified retirement plan) that bears many similarities to the traditional IRA. The biggest distinction between the two is how they’re taxed. Since traditional IRAs contributions are made with pretax dollars, you pay income tax when you withdraw money from the account during retirement. Conversely, Roth IRAs are funded with after-tax dollars; the contributions are not tax, depending on your income and life situation. But when you start withdrawing funds, these qualified distributions are tax free.

S&P 500 Value Index : A market capitalization-weighted benchmark designed to measure the value segment of the S&P 500 Index.