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Artemis Brief

Tax-Loss Harvesting: Is It Worth It?

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During market downturns, investment managers will often engage in tax-loss harvesting as a way to create a little tax 'alpha' (a.k.a. positive return) in an otherwise negative return environment. In this Brief, I explain what tax-loss harvesting is and summarize when it can be beneficial and when it is not.

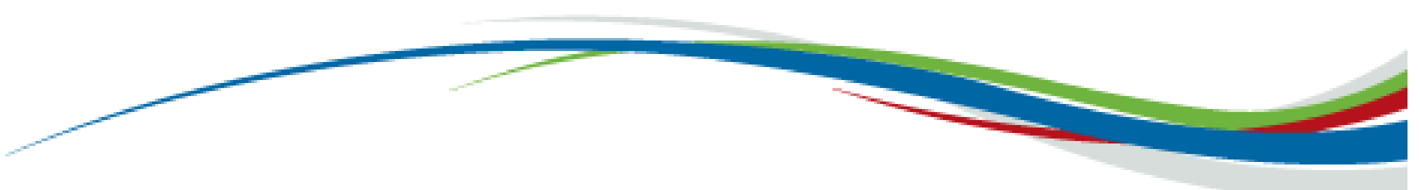
What is Tax-loss Harvesting?

Tax-loss harvesting is a strategy to lower current taxes paid to the U.S. federal government by deliberately selling an investment at a loss in order to use that loss to offset taxes owed on an investment sold at a profit, or even taxes owed on personal income. The proceeds are typically reinvested in a similar (but not identical) security or fund. Any harvested losses that do not offset gains in a given tax year can be carried over indefinitely to offset future income and capital gains.

The reality though is that the investor is not actually saving on their taxes over the long run. The reason is that while any harvested losses generate current tax savings, the act of harvesting a loss also reduces the cost basis of the replacement investment. To see how this works, assume you bought a security (or a mutual fund) for $20,000 but that the security is now trading at $10,000. You sell the security for $10,000 to harvest the loss and replace it with a similar security or fund with the proceeds. The cost basis in the new security is $10,000 and when the investment recovers to $20,000 and is sold, taxes will be due on the $10,000 gain. The investor is really only deferring the tax bill by tax-loss harvesting, not eliminating the bill all together. Yet harvesting is still valuable because any taxes that are deferred can be invested and earn a return.

One does need to carefully follow the rules. To prevent investors from harvesting losses by selling a security and immediately buying the same security back, the government imposes what's called the "wash sale rule", which says that one cannot repurchase the original security for 30 days. The rationale is that an investor should only benefit from deducting a loss if he/she truly disposes of the security, although not holding the original security for 30 days typically does not impose a great deal of risk.

Truth be told, the wash sale rule is a bit antiquated in a world where investors increasingly utilize pooled vehicles (e.g., mutual funds and ETFs – either actively or passively managed). The reason is that as long as the replacement fund does not hold the exact same securities in the same proportion as the original fund, the wash sale rule is not violated and the investor does not have to sit in cash for 30 days. Today, with so many funds to choose from, it is fairly easy to find one that behaves similarly to the one being sold, thus virtually eliminating the loss that might happen if the



market moves up while the investor is sitting in cash.

When It's Worth It

Tax-loss harvesting is generally valuable for investors with taxable accounts who have a long time horizon and who are in a reasonably high tax bracket. The longer you can invest and earn a return on money that is eventually going to go to the government, the more valuable the technique. There is also a greater chance that the investor will gain from the strategy if they are able to realize a deduction from a capital loss at a higher tax rate than the recovery gain of the replacement security when it is eventually sold. For example, realizing a loss at the maximum capital gains rate of 23.8%, and realizing the subsequent gain at a 15% or even 0% tax bracket.

Finally, tax-loss harvesting is especially valuable if the replacement investment with the now lower tax basis is never liquidated or is donated to charity. This is because when someone inherits a security (unless the security resides in an irrevocable trust), that security's new cost basis becomes the price that the security was trading for on the date of death of the donor so the tax owed is never paid. Similarly, if the security is donated to a charity, neither the donor or the recipient pay capital gains taxes. This is why it is typically more beneficial to donate appreciated securities.

When It Is Not Worth It

If one is only going to hold the replacement security for a short period of time, there simply isn't much time to earn a return on the deferred taxes before the tax bill becomes due. Second, one doesn't gain anything if the harvested losses end up offsetting gains that would otherwise be taxed at 0%. This can happen, for example, when one has a very low income year (e.g., took time off from their job).

Bottom Line

What this all means is that the value of tax-loss harvesting is not the same for everyone since not all investors have the same time horizon or the same starting and ending tax brackets. Tax-loss harvesting is a very good deal for those who have a long investment horizon in front of them, are likely to die with assets to bequeath and who are charitably inclined. In these cases, harvesting results in true tax savings.

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