

Harvesting Capital Losses

As year end quickly approaches, it is time once again to actively plan to reduce your income taxes. Too many people take a reactive approach to income taxes. However, it is those that take a proactive approach that often pay far less.

One simple year end income tax planning technique is to “harvest capital losses”. It is called harvesting because the objective is to realize a capital loss for the sole purpose of the income tax benefit. Little concern is given to the economic appropriateness of the investment decision. So long as you do not purchase the same security within thirty days of the sale of the security, the loss will be realized and enter into the computation of your capital transactions.

I will focus on securities, although the capital loss rules apply to all capital assets held for business or investment purposes. The capital gain rules, but not the capital loss rules, also apply to personal use capital assets. Therefore, if you fix up an old car and sell it for a gain, the gain is taxable, but if you sell it for a loss, it is not deductible.

Another reason why this article will focus on only securities is to limit the rates of taxation that can apply. A net short-term capital gain on securities is taxed at a taxpayer’s ordinary income tax rates and a long-term capital gain on securities is taxed at a maximum of either 5% or 15%. Conversely, long-term capital gains on collectibles are taxed at up to 28%, and gains on sales of previously-depreciated property can be taxed at a myriad of different rates depending on the type of property sold, the holding period, and the depreciation method used. These situations require personal attention.

As additional background, it is important to understand that there are no tax implications of unrealized gains and losses, only of realized gains and losses. An unrealized loss is the excess of the basis in a security over the current fair market value of the security. A realized loss is the excess of the basis in a security over the sales price of a security.

Tax Benefits of Harvesting Losses

Deducting capital losses can have a reasonably substantial tax benefit. Suppose that a Mr. Turner has long-term unrealized capital losses on particular securities in his portfolio in the amount of \$5,000, although his portfolio as a whole has an unrealized gain of \$25,000. Mr. Turner also knows that he will have short-term capital gain distributions from his mutual funds of approximately \$1,500.

To date, Mr. Turner has not sold any securities. If he does nothing, he will incur income tax on the \$1,500 of short-term capital gains at his marginal income tax rate, which could cost him over \$500. Conversely, if he realized all \$5,000 of his unrealized capital losses, after he nets his gains and losses, he will end up with a \$3,500 loss. He can deduct a \$3,000 net capital loss in the current year. Thus, if Mr. Turner sells, he saves \$1,500. Moreover, next year, he can use the \$500 capital loss carryover to offset additional gains.

In this case, I have been careful to use the capital losses against income that would otherwise be taxed at ordinary income tax rates, earned income, portfolio income, passive income and short-term capital gains. Capital losses can without limitation be used to offset capital gains. Thus, if Mr. Turner had a \$12,000 gain on the car he fixed up, he could realize all of his securities losses of \$5,000 and decrease his net capital gain to \$7,000. When capital losses are used to offset long-term capital gains, the tax savings is diminished because the long-term capital gain would otherwise be taxed at a favorable rate, either 15% or 5%, but it is still a savings.

Investment Concerns

As indicated above, harvesting capital losses focuses on only the tax benefit and does not consider the appropriateness of the investment decision. As also indicated above, you can purchase the same security back thirty one days later. However, from an investment perspective, thirty one days can be quite a meaningful period of time.

Suppose for example you have an unrealized capital loss on 500 shares of Merck stock as a result of the recent decline of its stock price, but you feel very confident that drug stocks will do extremely well in the near term. You have two alternatives. First, you could purchase a second lot of 500 shares of Merck, wait thirty one days and then sell the first lot realizing a capital loss. So long as you specifically identified the lot to be sold and your broker sells that lot, you are permitted to deduct the capital loss on that lot even though you own an identical lot of the same company. However, this solution can only work in November for this year though because, if the calendar reads December, you will not have enough time to wait the thirty days and sell the original lot in 2004.

The second alternative is to sell the Merck shares and buy a different drug stock, such as Pfizer. The Merck holding could be sold and the Pfizer one purchased on December 31st and you would still be permitted to deduct the capital loss on the Merck. (Capital transactions are said to occur on the trade date, not the settlement date.) Thus, although I indicated above that harvesting losses is a tax-driven technique, I do not advocate allowing the tax tail to wag the dog. If there are strong, sound investment reasons for wanting to hold a security and neither of the two alternatives above is viable, do not sell the stock just for the tax benefit. Any such benefit may be outweighed by lost opportunity.

Whether to harvest capital losses, and specifically what losses to harvest, are decisions best addressed with the help of investment and tax counsel.

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