TRANSITIONS

HOW TO USE TAX LOSS HARVESTING

Tax avoidance is an important part of investing. If your personal portfolio is actively traded to earn a return, all the short term gains are treated as ordinary income, and are taxed at the federal level as high as 37%. When adding State taxes, nearly half these gains are being shared with your government. This type of portfolio has a substantially lower after-tax return than most realize. It is more tax efficient to incur long-term capital gains, which are taxed at federal rates between 0% and 23.8%.

Whenever we see a prospective client's portfolio being actively traded, we know they can earn a much higher return. Our approach is quite straightforward. We invest with a longer time horizon, and simply stop the short-term trading activity.

Tax loss harvesting comes into play in the fourth quarter of each year. If a portfolio has a capital gain, and there is a holding that has declined in value, then we sell the holding, harvesting this tax loss. The tax loss offsets part or all of the realized gains, which reduces the tax liability. If this holding is a stock that we want to hold in the portfolio over time, one approach we use is to buy back the same stock after the 30 day IRS waiting period.

When interest rates move higher, we use tax loss harvesting in a different way. Higher interest rates create paper losses in the market value of bonds. We take advantage of this situation by selling a bond to create the tax loss. Then, we immediately buy another quality bond that is sufficiently different to avoid wash sale tax rules, yet similar enough to protect the portfolio income stream.

From a portfolio management perspective, since losses can be carried forward to future years, tax losses do not need to be used up in the current tax year. The real benefit to this is in future years. When a

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profitable stock position has grown in size where we want to prune, or reduce the holding, then the tax loss carry forward offsets part or all of the gains from pruning the position. For example, this year, several stocks in our customer portfolios experienced substantial appreciation. Having tax loss carry forwards made it possible to prune back some of these holdings without incurring tax payments for these clients.

Different tax loss harvesting techniques are an important portfolio management tool to meet the goal of investing in a tax efficient manner. With the politicians clamoring to raise taxes, it makes sense to invest in a manner that keeps the returns with your portfolio, instead of following a canned formula that triggers taxes each year.

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