

Harvesting Losses

Making lemonade out of lemons

The Schwab Center for Investment Research

The Schwab Center for Investment, Research a division of Charles Schwab & Co., Inc., provides individual investors with professional-quality research and decision-making tools.

Overview

Even in the best of times, not every investment will be a winner and some losses are inevitable. Fortunately, since the 2000-2002 bear market bottomed in October of 2002 the ensuing rebound has been widespread. In contrast to the late 1990s when only a relative handful of stocks accounted for much of the Standard & Poor's 500® Index gains, 458 of the 500 stocks were up and only 41 were down (1 was unchanged) in 2003 as the Index appreciated 26.4% for the year (28.7% total return, including dividends).

Despite most stocks' solid performance in 2003, some investors may still yet be on the post-bear market road to recovery to one extent or another as the major indexes are yet to reach their previous all-time highs. Faced with old losses, investors could either continue to sit passively by and hope to eventually break even on their losing investments, or they could claim control over their situation and view such losses as a potential opportunity to undertake a portfolio makeover, better position the portfolio going forward AND receive what might be a significant income tax benefit in the process. For example, a period of out-performance in mid- and small-cap growth stocks (such as we saw in 2003) might present a good opportunity to utilize any old unrealized losses to offset gains as you get back to a more style-balanced, long-term asset allocation.

Key Findings

- Provided it makes sense from an investment standpoint, investors could utilize capital losses to offset any or all of their capital gains plus up to \$3,000 in ordinary income per year, with any currently unusable losses available in future years without expiration.
- Investors could proactively harvest their losses to rebalance and potentially upgrade their portfolios in a tax-efficient way and avoid the "wash sale rule" problem by identifying suitable, but not "substantially identical," replacement securities for their loss positions.

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Author

Rande Spiegelman, CPA, CFP®
Vice President, Financial Planning

Rande specializes in personal financial planning. Prior to joining Schwab, Rande was a Senior Manager of Personal Financial Planning with a major accounting firm. He has been widely quoted in the national media on a broad range of financial planning topics.

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Action Steps

- Periodically review your portfolio on an ongoing basis (don't wait until the last day of the year) to identify potential loss-harvesting candidates, as you seek to rebalance and/or upgrade your portfolio.
- Identify suitable replacements for your loss positions prior to taking the loss – for stocks and mutual funds, seek out professional

recommendations (such as Schwab Equity Ratings and the Schwab Mutual Fund OneSource Select List®); utilize available stock and mutual fund screening tools (such as those available on Schwab.com); consult with your investment adviser.

- Always consult your tax professional before entering into any transaction that may have significant tax consequences.

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Take losses for the right reasons

Professional portfolio managers may have myriad “sell disciplines,” or hard and fast rules for deciding when to sell a particular security. Individuals may have their own particular sets of criteria for deciding when to sell an investment. Even long-term investors who practice a prudent buy-and-hold approach with a focus on overall portfolio asset allocation and diversification should be aware that buy-and-hold does not necessarily mean buy-and-forget. It's important for investors to monitor the investment performance of individual securities and mutual funds. Realizing there may be all sorts of individual reasons to sell or not sell a particular investment, the motivation to sell might just boil down to three logical reasons. They are:

1. ***You need the cash*** – Selling to raise cash is typically not an appropriate motivation if you are in the earlier stages of capital accumulation and have long-term time horizons. However, if you already have achieved your goals (e.g., retirement, college, etc.), selling investments to raise cash for spending purposes can be considered perfectly acceptable. After all, the portfolio doesn't exist as an end unto itself – it's a tool that is eventually meant to fund your various goals.

2. ***You've identified a more appropriate investment*** – If you don't have an immediate need for cash, the logical conclusion is that you will reinvest the proceeds of your sale elsewhere. Presumably, selling and reinvesting elsewhere isn't the result of taking action for action's sake (e.g., reacting to some “hot tip” or selling based on emotion or to satisfy an itch, etc.), but is the result of your disciplined efforts to identify a more suitable place for your investment capital.

Number two, admittedly, is a catch-all. It could include everything from selling and putting the money into a different asset class for the purpose of asset allocation rebalancing (the target allocation is “a more appropriate investment”) to replacing specific securities, which either have failed to meet expectations or have reached pre-defined price targets. Whatever your particular motivation, when funds are marked for reinvestment it helps to stay focused on the fundamental fact that such a sale involves identifying a suitable replacement.

There is yet one more reason investors might consider a sale: harvesting capital losses for income tax purposes.

3. ***Harvesting capital losses*** – Selling for the purpose of taking an income tax loss can be a legitimate motivation, whether the same position is eventually

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maintained or a suitable alternative takes its place. In fact, harvesting losses can be a prudent way to let Uncle Sam share in your pain. Why not? He also takes a share of your realized profits. While you're at it, when applicable, you also can let your state and local tax authorities help ease the pain of losses.

Take Advantage of capital loss rules

Provided it makes sense from an investment standpoint, harvesting capital losses to offset capital gains in your taxable accounts can be one of the smartest strategies for taking control of your tax bill. Keeping the investment decision first, combining loss harvesting with routine rebalancing and portfolio pruning can potentially boost your after-tax returns. While investors should always consult their tax professionals on income tax matters, it helps to understand the federal rules surrounding capital gains and losses (state income tax rules surrounding capital gains and losses may vary).

What are the rules ?

A capital gain occurs when you sell an investment for more than it cost. A capital loss occurs when you sell an investment for less than it cost. Gains and losses are either short term (held one year or less) or long term (held over one year). Each year, investors must combine capital gains and losses they have realized during the course of the year in their taxable accounts, and recognize the net gain or loss on their income tax returns. Gains and losses are first offset by type, short and long-term, and then against each other, following ordering rules set forth by the Internal Revenue Code. Capital losses may be used to offset capital gains up to any amount. Ideally, it is more beneficial to offset short-term gains (which are taxed at the ordinary marginal income tax rate) with long-term losses than to offset long-term gains (which are taxed at the preferential long-term capital gain rate) with short-term losses, since you get the most bang for your tax buck that way. This

holds true even with the new lower long-term capital gain and ordinary tax rates that came into law in 2003. Prior to 2003, the difference between the top ordinary rate of 38.6% and the long-term capital gain rate of 20% was about 19%. That difference hasn't changed much since the top ordinary rate is now 35% and long-term capital gains are taxed at 15% (difference of 20%). So it still makes sense to efficiently match gains and losses when possible.

For example, let's say you're in the 35% ordinary income tax bracket and in the current year you have already recognized \$10,000 of short-term capital gains and \$10,000 of long-term capital gains. You also own two positions with \$10,000 in unrealized losses each, one that you've held short term and the other long term. According to the netting rules, if you take the long-term loss, the loss will offset your long-term gain, which would otherwise be taxed at 15%. But if you take the short-term loss it will offset your short-term capital gain, which is taxed at the same rate as your ordinary income. By taking the short-term loss, you offset \$3,500 in tax ($.35 \times \$10,000$), while taking the long-term loss would only offset \$1,500 ($.15 \times \$10,000$). That's a savings of \$2,000. (Even if you're ordinary bracket was 25%, it would still be a savings of \$1,000.)

You may not always be able to match gains and losses so efficiently. The primary goal should be to use losses to offset gains as efficiently as possible, within the context of your investment goals. But don't get hung up if the matching of gains and losses is less than ideal. In the example above, for instance, if all you had was the long-term loss, it might still make sense to harvest it – after all, a tax savings is still a tax savings.

To the extent capital losses exceed capital gains in any year, up to \$3,000 could be used to offset ordinary income (up to \$1,500 each for married filing separately).

If net losses total more than \$3,000 in any given year, they don't expire. This means any currently unusable losses can be used to offset gains in future years. Even if there isn't much in the way of current capital gains to offset, investors could still offset up to \$3,000 of ordinary income and put the rest of any net capital losses incurred in the "virtual" bank for future use.

Maintaining your position – Don't forget about the wash sale rule

As long as the loss sale occurs in a taxable account, the loss is generally recognized for income tax purposes. Don't lose sight of the "wash sale rule" exception, however, in which case the loss would not be allowed for income tax purposes under certain circumstances (the disallowed loss is added to the cost basis of the reacquired position). Specifically, a wash sale applies if you sell a security at a loss and acquire the "substantially identical" security within 30 days of the sale (before or after). There may be a number of reasons why you want to maintain the same position, hopefully because the investment still fits into your overall investment plan and the specific reasons you originally purchased the security still exist.

So what's "substantially identical" mean?

Unfortunately, there is not one clear, uniform definition of "substantially identical," so investors must consider all the facts and circumstances in each particular case (and should always consult their professional tax advisors for guidance). For practical purposes, substantially identical means the same security or an option to buy the same security. That means if you want to maintain the same position and still be able to recognize the loss for income tax purposes, you are faced with choices. You could sell XYZ stock and recognize the loss as long as you wait 31 days before buying XYZ back. Alternatively, you could purchase additional XYZ stock, and then wait 31 days to sell an equal amount of your original loss position. Obviously, there are risks with either approach. If you sell and decide to wait 31 days before repurchasing, you might miss out on some gains if the stock takes off during that time period. Conversely, if you decide to increase your position and wait 31 days to sell the original loss position,

you are increasing your exposure to the potential for further declines during the waiting period. In addition to the potential price movement of the security, investors should also take the size and nature of the loss, as well as transaction costs, into consideration.

A viable alternative – Find a suitable replacement

Those who don't want to be out of the market for an entire month or increase their exposure for the same period can identify a suitable, but not substantially identical investment to take the place of the old loss position for the required 31-day wash sale period. In other words, an investor could sell XYZ stock at a loss, simultaneously buy ABC stock, and still recognize the loss on XYZ for income tax purposes. The idea applies to bonds as well. Investors could "swap" a bond from one issuer for a bond from another issuer that has a similar yield, credit quality and maturity (or from the same issuer, as long as the maturity or coupon – preferably both – is substantially different). The same holds true for different mutual funds or ETFs (exchange-traded funds), even if they have a similar investment objective. After the wash-sale rule waiting period is over, you can decide whether you want to get back in to your original position or not (of course, you will probably have a gain or loss to deal with when you sell the replacement security).

Many investors hold on to their losses, hoping the investment will rebound. If you have good reasons for maintaining a particular position, that's fine. But losses are a part of every portfolio and selling at a loss now doesn't mean you've failed as an investor or that you should throw in the towel.

There are some caveats:

1. **“Fund XYZ class A” to “Fund XYZ class B”** – While swapping from one actively managed large-cap growth fund to a suitable large-cap growth fund in a different fund family would avoid the wash sale rule restrictions, switching from one class of mutual fund to another class of the same fund in the same fund family would likely be viewed as a wash sale transaction by the IRS. Besides, the idea is to reduce expenses with no-load, low-cost funds in the process, not pay more commissions by switching from one loaded fund to another.
2. **Indexed investments** – Similarly, switching from one mutual fund family or ETF to the identical index in another fund family or another ETF could trigger the wash sale rule. There are ways around this problem. For example, investors holding the Schwab S&P 500 Index Fund at a loss might consider switching into the more diversified Schwab Total Stock Market Index Fund. As to ETFs, investors holding NASDAQ 100 tracking shares (QQQ) at a loss, for example, might

consider selling the old position and simultaneous purchasing the relatively more diversified S&P Technology “Spiders” (XLK). These examples are not meant as specific recommendations, but as illustrations of how you might creatively approach the challenge of finding suitable replacements for indexed investments.

3. **Replacement risk** – Even with extensive research, there is always the potential that the replacement security could underperform the old security going forward. However, with some thought and care, you may be able to find an appropriate replacement with reasonable potential for as good or better performance, particularly if, in the case of mutual funds, future expenses are lowered and tax-efficiency is increased as part of the process. Remember, while the future performance of the replacement security relative to the old loss security may be an unknown, the tax savings resulting from the loss harvesting exercise is real and permanent.

Hypothetical Example

Joan originally purchased XYZ, a stock that had dropped to an SER D-rating, for \$12,000, but it's currently worth only \$9,000. The position is part of her overall asset allocation, which she wishes to maintain going forward. Joan is reluctant to sell and recognize the loss, especially if it means upsetting her investment plan or involves trying to time the market. What can she do? Joan could do some research to find a suitable replacement security. For example, she may find that security ABC, a B-rated stock in the same sector, style and asset class is as good or even better than XYZ given her overall goals and objectives. She could simultaneously sell XYZ and purchase ABC, avoiding the wash sale rule while maintaining her investment plan.

Value of position XYZ before transaction – \$9,000

Value of position ABC after transaction – \$9,000 (less commissions, if any)

As far as her portfolio is concerned, Joan is in the same financial position after the sale as she was before (less commissions, if any). BUT, if Joan has a combined federal/state marginal income tax bracket of 35% she could also receive an income tax benefit of up to \$1,050. Her overall loss would be reduced, in effect, from one of 25% to 16.25%. While there's no guarantee ABC will do any better than XYZ going forward, Joan's tax savings is “in the bank.”

How to find a replacement security

When it comes to finding a suitable replacement, there are more tools and information available to individual investors than ever before, but investors should always be on guard for potential conflicts of interest when evaluating available information. Charles Schwab, for example, utilizes a comprehensive quantitative approach in developing its Schwab Equity Ratings™ of over 3,000 stocks. If you're looking for a suitable replacement, you might consider focusing your research on stocks with a Schwab Equity Rating of A or B. Stocks with D or F ratings could be candidates for sale based on Schwab's 12-month performance outlook. Using such ratings, investors could objectively and systematically replace stocks showing a current loss with stocks in the same sector or industry which have equal or, preferably, higher ratings. Mutual fund investors looking for objective guidance might consider the Schwab Mutual Fund OneSource Select List,™ a list of funds in virtually every category.

Avoid the “But it’s not really a loss until I sell” syndrome

Unfortunately, buy and sell decisions are not always based on objective criteria and common sense. Investors may be reluctant to sell at a loss for apparently irrational, emotional reasons. Many investors hold on to their losses, for no other reason than the hope that the investment will rebound. If you have good reasons for maintaining a particular position, that's fine. But losses are a part of every portfolio and selling at a loss now doesn't mean you've failed as an investor or that you should throw in the towel, as the hypothetical example above illustrates.

Harvesting losses as part of your long-term planning

Harvesting losses regularly and proactively—when you rebalance your portfolio for instance—can save you money over the long run, effectively boosting your after-tax return.

For example, imagine a \$100,000 portfolio of 10 stocks returns 8% for the year as a result of six stocks gaining 20% on average (\$12,000 in gains), and four stocks losing 10% on average (\$4,000 in losses).

Assuming you can find better prospects elsewhere (the investment decision should always come first), replacing the four losers makes \$4,040 (\$4,000 plus \$40 in hypothetical trade commissions) of realized losses available to offset realized short-term gains. Alternatively, you could use the realized loss to offset a combination of short-term gains plus ordinary income up to \$3,000, and carry over any unused losses for use in future years.

Assuming you could use the entire \$4,040, a combined federal/state margin tax bracket of 40% would result in a net savings of \$1,576 (\$1,616 tax savings, less \$40 commissions paid)—not to mention a potentially better-positioned portfolio going forward.

Even in a combined marginal bracket of 30%, just taking advantage of the annual \$3,000 capital loss limit against ordinary income means an extra \$900 per year in your pocket (less commissions, if any). Assuming an average annual return of 8%, reinvesting \$900 each year would amount to an extra \$41,185 after 20 years.

Next step: Take control

Combining tax-loss harvesting with portfolio-rebalancing efforts can help investors to take even greater control over their performance by implementing a more tax-efficient and cost-effective plan for moving ahead. That could mean positioning more tax-efficient investments in taxable accounts and less tax-efficient investments in deferred accounts, while still focusing on the overall asset allocation, investment performance, and keeping costs as low as possible. Importantly, harvesting losses as part of your ongoing portfolio-maintenance program doesn't need to be reserved for year-end when there is potentially less time to make a reasoned decision, but should be viewed as a periodic year-round exercise.

Finally, don't become overly obsessed with income taxes. Keep your eye on the investment ball. Ultimately, it's not necessarily about paying the least amount of income tax, but about maximizing your after-tax per-

formance at your chosen risk level. With all this in mind, now may be an excellent time for you to get back to basics, take control of your situation by putting your investment house in order, and receive a tax break from Uncle Sam in the process.

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