Ruminations on Tax Loss Harvesting

Tax loss harvesting is the sale of securities in a taxable account that have declined in value since their purchase in order to recognize the loss for tax purposes. Most people (including professional financial advisors) do this at the end of the year determining whether the transaction is worthwhile by comparing the immediate tax savings to the transaction cost. This is wrong on both counts.

First, positions should be evaluated throughout the year for opportunities to save on taxes; there is no reason to wait until the end of the year. Because investments tend to go up more than down and there is little serial correlation in the market, taking losses when they are big enough to be worthwhile is prudent.

Second, the calculation of tax savings and costs is more complicated than it first appears. Consider first the standard analysis:

- Assume you invested $10,000.
- The investment has declined in value to $9,000.
- You are in the 15% tax bracket (assuming this will offset other long term capital gains).
- You can make an alternative investment that is equally attractive as keeping this one.
- The transaction costs are $20 for each trade ($40 total – one sell and one buy). Note that transaction costs should include not only the explicit commissions but also bid/ask spread costs and market impact costs.

This appears to be a "no brainer"; spend $40 to save $150 (a $1,000 loss times 15% tax savings).

In fact, given the information above, you have no idea whether this is a prudent strategy. You are missing three key pieces of information:

- How long do I expect to keep the "old" investment in my portfolio if I don't do this transaction?
- What will my tax bracket be at that time for that transaction?
- What is my hurdle rate for the return on this strategy?

Let's assume if you don't do the tax sale you will sell the investment in 5 years anyway for some reason (perhaps we estimate this by simply knowing you have about a 20% portfolio turnover rate). Further, assume your tax bracket at that time will continue to be 15%. The future transaction costs aren't relevant since you are going to sell something at that point anyway – it doesn't matter which investment it actually is.

At this point, it is simply a time value of money problem. If you do the tax loss harvesting, you save $150 now less the $40 for transaction costs for a net of $110. However, in 5 years your cost basis is $1,000 lower than it would have been had you kept the old investment. Thus, your tax bill at that time is $150 *higher* than it would have been. Essentially you made $110 now by paying $150 more in five years.

Since the rate of return that will grow $110 to $150 in 5 years is 6.40%, you should only do this if you can invest the current tax savings to earn more than 6.40%. Alternatively, you could look at it as an opportunity to borrow at 6.40% for 5 years. That might or might not be attractive depending on the situation.

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To recap, tax loss harvesting is more attractive to the extent:

- The loss to be harvested is large.
- The transaction costs are low.
- The alternative investment is attractive.
- Future tax rates will be low.
- You expect to keep the investment for a long time.

Conversely, tax loss harvesting is unattractive if:

- The loss to be harvested is small.
- The transaction costs are high.
- The alternative investment is unappealing (such as keeping cash for 30 days to avoid the wash sale rules and then repurchasing the original investment).
- Future tax rates will be high.
- You expect to sell the investment shortly anyway.

Tax loss harvesting is an opportunity to improve after-tax returns, but it should be done throughout the year and should use a multi-period analysis to determine if it is worthwhile.

Notes:

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