InvestmentNews
The Leading Information Source for Financial Advisers

Maximize loss harvesting year-round

This tax-efficient strategy can improve returns, as long as it doesn't run afoul of the tax code

November 10, 2013 - 12:01 am EST

We advocate harvesting losses (once they are big enough) all year to get the most from this tax-efficient strategy, but most investors harvest losses only at the end of the year. I guess the reasons are either that they want to take losses only when they're sure they have gains or that they simply don't want to focus on it until November or December.

First Quadrant did a study that found that year-round loss harvesting could add 80 basis points annually in after-tax return to an S&P 500 portfolio. I would think an active strategy could produce even more. A long/short strategy might offer twice the opportunities.

So how do you take a loss without letting go of the stock and still not feel the wrath of the wash sale rule?

There are many "perfect end runs around the wash sale rule," as a prominent tax attorney wrote. Most involve the use of exchange-traded put and call options.

As an example, let's say you bought 1,000 shares that are now underwater. You'd love to take the loss for tax purposes but are afraid to be out of the stock for the requisite 31 days.

Most investors are aware of the possibility of "doubling up": buying another 1,000 shares and, after 31 days, selling the first 1,000 shares you bought at the higher cost basis to realize your loss.

The bad news is that you have to double your risk to accomplish the harvest. It seems clear in the tax law that no rules would stop you from hedging the risk of owning the second lot of 1,000 shares. Note: This doubling up must start before the end of November because the loss isn't realized until you get out. Doubling up so that you have 31 days of holding before selling for a loss in 2013 is required.

Another end run is utilizing call options. Tax law states that if you sell for a loss and then buy a call option on the same shares, you will have triggered a wash sale. Remember, if you have a wash sale, the loss is not worthless; it just isn't currently useable. A wash sale loss increases your cost basis in the shares/options that triggered the wash sale.

Let's say you bought XYZ at $50 and it is now trading at $30. If you sell and then purchase new shares, you trigger a wash sale and the $20 loss is "denied" and instead increases your cost basis in the new shares you bought at $30 up to $50.

ANY CALL OPTION

The same thing happens if you sell a stock for a loss and then buy a call option on the stock. This covers any call option, not just a call option that is “substantially identical” to the shares you sold for a loss.

So if you sell the stock for a $20 loss and then buy a call option for, let's say, $4, you wind up with a call option that is worth $4 but has a cost basis of $24. Once that option is sold or expires, you should realize the loss. Note: Once you've purchased the call option and taken the cost basis penalty, you should be able to buy the stock again.

The order of this is very important. It is: 1) sell stock, 2) buy call option, and 3) buy stock again. Although this can all be done on the same day, it will make the paperwork more obvious if you wait until the next day to buy the stock back.

For index exchange-traded funds and their options, it can be even simpler. Index options are marked to market for gain/loss purposes Dec. 31 each year. If you sold the S&P 500 ETF and then bought a call on the S&P 500, you have certainly triggered the wash sale rule. But because the call option's cost basis was increased, the end-of-year mark to market of gains/losses will force you to realize your loss.

Because the SPDR Gold ETF (GLD) has had a bad year, many investors want to harvest their loss but stay in gold. The wash sale rules apply only to securities. It is clear that the wash sale rules do not apply to physical gold. Theoretically, you could sell physical gold and soon repurchase it without the wash sale rules capturing the loss.

Is GLD a security or gold? The tax section of the GLD offering documents is confident that because GLD is a grantor trust, the trust is ignored for tax purposes when you have a gain. GLD is treated like physical gold, and long-term gains are taxed at the higher collectible gains rate of 28% instead of 20%. If the same holds true for losses, the wash sale rule does not apply. If you believe it is possible the government will try to take two opposing views on this, you should treat GLD as you would any other security.

These and other “perfect end runs” should be considered by all advisers. If you really didn't have to disturb your alpha, wouldn't you want to loss-harvest all year?

Robert N. Gordon (bob@twenty-first.com) is chief executive of Twenty-First Securities Corp. and an adjunct professor at New York University's Leonard N. Stern School of Business.