Key Questions

Why Bother with Tax-Loss Harvesting?

December 2, 2019

Justin Tantalo, Senior Lead Research Analyst

Tax-loss harvesting is a simple concept that has a proven track record. However, quantifying the exact impact on investment returns is a different story.

Benjamin Franklin, one of our country's Founding Fathers, wrote in 1789 that "in this world nothing can be said to be certain, except death and taxes." Taxes are still a certainty (unfortunately), but steps can be taken to defer or minimize them and improve financial outcomes along the way. One of the most commonly used strategies to defer taxes is loss harvesting, and there are increasingly efficient tools available to do so.

As a reminder, tax-loss harvesting involves selling an investment at a loss in order to offset capital gains realized elsewhere in an investor's portfolio. For example, consider Mary, an investor with a long-term cost basis of $50,000 in GE stock. She might sell this holding for $35,000 and use the realized loss to offset up to $15,000 of long-term capital gains generated on her sale of Amazon Inc. shares. The tax liability on the gain will be avoided so long as Mary abides by the wash-sale rule, which prohibits her from repurchasing GE shares for 30 days. If Mary has no realized capital gains, then her ordinary income can be offset up to a maximum of $1,500 if she's a single filer ($3,000 if she's filing jointly). Any remaining losses can be carried forward to offset capital gains in the future.

Tax-loss harvesting is a simple concept that has a proven track record. However, quantifying the exact impact on investment returns is a different story.

Consider that:

- The strategy requires realized capital gains somewhere in the portfolio. This is critical: Generating tax losses without gains to be offset creates tax-loss carryforwards that might not be immediately valuable.
- Taxes are deferred, not avoided. Recall Mary's sale of GE shares; Her cost basis in that case declined from $50,000 to$35,000, following reinvestment. This lower cost basis will result in commensurately higher capital gains for Mary in the future if she ultimately sells her new holdings for more than$35,000. It's really a tax deferral that was created, which is analogous to an interest-free loan.
- Mary is ultimately better off from her deferral because the tax savings can remain invested and grow. The return on this deferral is the true free lunch for Mary, much in the same way as her 401k benefits from the compounding of untaxed contributions.

  The exact after-tax benefit for Mary thus depends on:

  1. Market returns
  2. Potential changes in the capital gains tax rate
  3. Gifting and/or any other estate planning strategies that step up her cost basis

- We've estimated the after-tax benefit from systematic loss harvesting US equities over various 10-year vintages to have added 0.8%-1.2% in annualized return — a meaningful improvement.

While tax-loss harvesting is typically done late in a tax year (November/December), it can also be done systematically throughout the year to build a reserve of tax-losses. At Key Private Bank we have recently added capabilities to systematically harvest tax-loss opportunities without distorting exposure to US equity markets (S&P 500) or running afoul of the wash-sale rule. Implementation is handled through a separately managed account (SMA) that tracks the S&P 500 (tracking error of ~50 basis points) while maximizing tax-loss opportunities. This solution can be sized to fit an investor's typical capital gain run-rate or in a multi-year planning effort to offset future capital gains from the expected sale of a closely held business.

While it may not have been Benjamin Franklin who insisted that investors consult their own tax, legal, and accounting advisors before engaging in any transaction, we certainly think you should do so anyway.

For more information, please contact your Key Private Bank Advisor.

Key Private Bank

Publish Date: December 2, 2019

Any opinions, projections or recommendations contained herein are subject to change without notice and are not intended as individual investment advice.
Investment products are:

NOT FDIC INSURED • NOT BANK GUARANTEED • MAY LOSE VALUE • NOT A DEPOSIT • NOT INSURED BY ANY FEDERAL OR STATE GOVERNMENT AGENCY

© 2019 KeyCorp. **Member FDIC.** 190104-521319-1121269341