



TAX-LOSS HARVESTING: A TIMELY STRATEGY IN ALL MARKETS



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Many aesthetic physicians, as well as non-physician investors, wrongly assume that they should examine ways to reduce taxes on their investments only at the end of the year, when they have an idea of how their portfolios have performed. Similarly, many operate under the assumption that the opportunity to reduce taxes only exists when asset values are up, when they may be incurring gains from any assets they sell. As we approach the end of 2023, with many investors experiencing mixed returns on their investment assets for the year, many may want to consider the strategy of tax-loss harvesting.

TAX LOSS HARVESTING FUNDAMENTALS

Tax-loss harvesting occurs when an investor sells an investment at a loss to offset current or potential future gains on other investment positions. The result is that you only pay tax on the net amount of those gains/losses from positions sold, thereby lowering, or even eliminating, your taxable gain for the year. Often, the proceeds from either the assets sold for a loss, or those sold for a gain, are then re-invested in a similar fund or asset class, to keep the overall portfolio in its proper overall allocations.

The benefit here is reducing taxes—and the higher an aesthetic physician's

personal income tax bracket, the greater the opportunity is for tax-loss harvesting. A quick recap of current ordinary income tax rates and the corresponding capital gains rates explains this concept: Those earning less than \$40,000 as single filers, or \$80,000 as joint filers, pay a 0% long-term capital gains tax. Individuals in the top tax bracket, however, pay a 20% long-term capital gains tax, and some investors are subject to an additional 3.8% net investment income tax.

TAX BACKGROUND

From the IRS's standpoint, these trades are allowable as long as you avoid the wash-sale rule. According to the SEC, a wash sale occurs when you sell or trade securities at a loss and within 30 days before or after the sale you:

- Buy substantially identical securities,
- Acquire substantially identical securities in a fully taxable trade, or
- Acquire a contract or option to buy substantially identical securities.

To properly execute loss harvesting and re-investment properly, and not run afoul of the IRS rules, it is crucial that one works with a professional advisor experienced in this strategy.

OPPORTUNITY IN DOWN MARKET

Before the pandemic hit in March 2020, many investors, or even professional advisors, may have thought that loss and gain harvesting should be executed at year-end when one understands which elements of the portfolio are up or down, and the

overall tax picture for the calendar year is clearer. For many investors and advisors alike, this approach is short-sighted, and we can use 2020 to highlight its potential shortcomings.

In 2020, if an investor waited until the fourth quarter to harvest gains and losses, they would have missed a tremendous opportunity to enjoy large tax losses since most broad-based equity investments increased significantly by year end. The opportunity to enjoy this “win-win” had come and gone by mid-2020. At one point in late March of that year, the S&P 500 was down over 34% year-to-date. By the end of the calendar year, however, the S&P 500 rested well above a positive 10% return. If you waited until year end to realize losses, then you missed out on a valuable opportunity to deploy this strategy.

An added benefit of a portfolio that is properly diversified across various asset classes is that the securities don’t always move in tandem. This divergence of returns among asset classes not only reduces portfolio volatility, but also creates a tax-planning opportunity.

These concepts also apply today when assets classes are mixed and there may be components of a portfolio that are up significantly, or close to all-time highs, while other assets are in the red. Loss harvesting can then be combined with gain harvesting (ie, selling some investments for losses and others for gains) to achieve allocation goals or rebalancing without incurring taxes.

A CLIENT CASE STUDY

The following case study provides a real-world illustration of tax-loss harvesting in action:

In mid-to-late March 2020, Advisor Firm Alpha made trades in almost all of its clients’ taxable accounts, realizing substantial losses. Alpha had an emphasis on the firm’s international equity and emerging market equity actively managed mutual funds, and targeted replacement funds in those asset classes that would avoid any wash-sale issues.

Focusing on one physician’s portfolio, the Alpha team:

- Sold all holdings in an Emerging Markets Equity Fund, valued at \$619,000, but initially purchased for this client in late 2014. This transaction realized a total loss of \$94,000.
- On the next trading day, the Alpha team purchased \$619,000 of a different actively managed Emerging Market Equity fund.
- As of December 31, 2021, that position was up 64% and was valued at \$1,014,000.

In this way, the investor was in an ideal position – up significantly in that segment of their portfolio yet sitting on an almost six-figure loss for tax purposes. Further, if the investor didn’t utilize all the losses in 2020, the net amount would be carried forward for future tax years.

One of the key success factors for this strategy to work as it did in this case study is for the investment manager to have targeted and researched replacement funds in the target sector before the opportunity to make the trades arose. Disciplined unbiased investment research cannot happen the day of a trade – it needs to be done over time in advance of trading days. Ideally, an investor or his/her advisor has taken the time to continually identify a list of potential attractive replacement funds and has them at the ready so that when the targeted fund is sold to harvest the loss, they are confident of where the sale proceeds can be invested. This was the case for the Alpha team in 2020.

CONCLUSION

Tax-loss harvesting should be part of every astute investor’s game plan. Of course, one needs to understand the rules to implement these tactics properly, and a professional advisor can add significant value in this area. As 2020 so aptly demonstrated, tax-loss harvesting is ideally a year-round process that can be applied in down markets, allowing the investor to

take advantage of opportunities as they arise. ■

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Disclosure: David Mandell, JD, MBA, and Adam Braunscheidel, CFP, are employees of OJM Group, LLC.

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