Tax-Loss Harvesting: The Rebalancing Act

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Advisors seeking to add value to their client portfolios during turbulent times are well served to review the details of the rules of tax-loss harvesting. In particular, advisors using mutual funds as part of a disciplined investment approach that calls for rebalancing, systematic investments, and/or reinvestment of capital gains and dividend distributions may want to focus on the fine points of the wash sale rules.

Tax-loss harvesting can be an effective strategy for reducing tax liability as investors are able to net realized losses against capital gains earned during the year. Additional losses of up to $3,000 can also be deducted against ordinary income with any remaining losses carried forward indefinitely. Tax-loss harvesting seems straightforward, but the intricacies must be understood and carefully managed in order to not disrupt a disciplined investment strategy.

IRS Wash Sale Rule-IRC Section 1091

The wash sale rule adds greater complexity to tax-loss harvesting. It prohibits an investor from claiming a loss if he or she sells a security and buys a substantially identical security 30 days before or after the sale (also applies to transactions in a spouse's account).

For example, an investor runs afoul of the wash sale rule if he or she owns XYZ security at $50, sells the security at $40, and immediately purchases XYZ back at $40. The transactions are a "wash" because the investor ends up in the same economic position. Rather than claiming the loss, the amount of the loss is added to the cost basis of the new XYZ purchase (basis in the new position is $50 despite paying $40). In other words, the $10 loss is recovered upon eventual sale of the new position in XYZ.

Again, tax-loss harvesting seems straightforward. Complexity enters the equation when attempting to define what constitutes a "substantially identical security" and when attempting to steer clear of the recent IRS Revenue Ruling 2008-5 (discussed below).

Substantially Identical Securities

If investment advisors sell a security strictly for tax benefits, they generally attempt to replace it with a security that has similar risk/reward characteristics. Are securities that have similar risk/reward characteristics considered substantially identical securities? Unfortunately, the IRS has provided a less-than-thorough answer to that question.

The IRS Publication 550 states, "Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation." Despite the apparent logic with the statement, the ambiguous nature of the term "ordinarily" has been a source of angst within the investment community.

IRS regulations and case law will certainly be reviewed for guidance in recent mergers and acquisitions (e.g., Bear Stearns shares for JP Morgan shares, Merrill Lynch shares for Bank of America shares).

Regarding mutual funds, Publication 564 states, "Ordinarily, shares issued by one mutual fund are not considered to be substantially identical to shares issued by another mutual fund. For more information on wash sales, get Publication 550." Reading Publication 564 and being directed to Publication 550 might lead an investor to believe that selling a mutual fund for a loss and replacing it with a mutual fund (or ETF) that owns substantially identical securities (i.e., Vanguard S&P 500 Fund for the Fidelity Spartan 500 Fund) is an acceptable transaction under Section 1091, and that may be contrary to the views of many advisors and investors.

Although a search of IRS materials (including revenue rulings and private letter rulings) and tax case law (including U.S. Supreme Court and U.S. Tax Court) has not yielded a clear definition of "substantially identical security" as it relates to mutual funds, guidance from the IRS has provided clarity with respect to other securities and the wash sale rule.

For example, in Revenue Ruling 76-346, the IRS stated that transactions in Treasury obligations do not trigger a wash sale if the interest rates and maturities differ. Guidance has been provided by Revenue Ruling 56-406 with respect to selling warrants in a stock and buying the underlying stock. The IRS stated that a loss on the sale of warrants could be disallowed if the underlying stock was purchased within the 61-day wash sale period. The Revenue Rulings do not offer much help to the mutual fund advisor and investor.

The lack of clear direction from the IRS regarding mutual funds and the wash sale rule has led many investment advisors to develop a working list of transactions that are generally considered to be acceptable under the wash sale rule contained in Section 1091. For example, a tax-loss swap from one S&P 500 Index fund to another S&P 500 Index fund managed by a different fund company (as described above) may raise a red flag at the IRS. However, if the new fund tracks another large capitalization index, such as the Russell 1000, the tax loss should be allowed.

The following is a list of mutual fund transactions that are generally considered to be acceptable under the wash sale rules contained in Section 1091 despite the lack of a concrete definition of "substantially identical security":

1. Sell one index fund and buy another index fund, if the indexes of the two funds are not the same index (e.g., S&P 500 for the Russell 1000).
2. Sell one actively managed fund and buy a fund at another company with different portfolio managers.
3. Sell an index fund and buy an actively managed fund regardless of the fund company.
4. Sell an actively managed fund and buy an index fund regardless of the fund company.

IRS Revenue Ruling 2008-5

IRS Revenue Ruling 2008-5, effective December 2007, goes beyond the traditional wash sale rules and expands the

interpretation to disallow a tax loss sale by an individual in a taxable account and associated purchase in the individual's IRA. In addition, the Revenue Ruling disallows an increase in the security's basis in the IRA or Roth IRA (i.e., you have a permanent loss that will not be recovered in the future).

A Rebalancing Act

The latest ruling, forcing investors to scrutinize transactions in their IRAs and Roth IRAs when a tax-loss sale occurs in a taxable account, coupled with the vague definition of substantially identical securities, can affect investors' carefully laid out investment strategies. Many advisors and investors use various investment strategies including asset allocation, rebalancing, systematic investing and/or capital gains and dividend reinvestment that can each be affected by the wash sale rule if not properly managed.

Asset Allocation-Advisors and investors adhering to an asset allocation strategy where investment style and asset class is a focus must balance the desire to sell the security for tax losses and the desire to hold the security for asset allocation purposes. Can the security be replaced with a security that offers similar risk/reward characteristics, investment style and diversification benefits without being ensnared by the wash sale rule?

Portfolio Rebalancing-A rebalancing program realigns the portfolio with the investor's objectives and investment policy. If the rebalancing plan entails selling outperforming investments and buying underperforming investments, then a wash sale may be more likely. The program may trigger the wash sale rule if an underperforming investment is sold for a loss in the taxable account and bought in the IRA as part of the rebalancing discipline. The timing of the tax-loss sale and the rebalancing program must be monitored to assure both the tax consequences and the investment strategies are considered.

Systematic Investing-The investment of IRA contributions must be appropriately managed if an investor would like to take advantage of tax-loss harvesting. If the investor owns a substantially identical security in the IRA that was sold for a loss in a taxable account, consideration must be given to how and when the contribution is invested.

Capital Gains & Dividend Reinvestment-If an investor owns a substantially identical security (in the form of a mutual fund) in an IRA that was sold for a loss in the taxable account, he/she must be mindful of the timing of the sale and capital gains and dividend distributions and reinvestment. The investor will lose the tax advantage of the tax loss to the extent of the capital gain and/or dividend reinvestment if it occurs within the 61-day wash sale period.

Tax-loss harvesting is a useful strategy, but can easily be negated if the investment is not considered as part of the strategy. As investment advisors, a tax-loss harvesting strategy should be viewed in the context of an overall investment plan. In a disciplined investment strategy, losses are not taken for the sake of taking losses, but are used to increase after-tax returns of a well-diversified portfolio.

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