’TIS THE SEASON FOR TAX LOSS HARVESTING

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With the fourth quarter in full swing, not only are the holidays approaching, tax season is coming up as well. This is the time of year when many financial advisors talk taxes with their clients, especially if those clients have capital gains and if there is the potential for tax loss harvesting. Tax loss harvesting is the act of selling a losing position to offset capital gains created by income or the sale of profitable investments.

Tax Loss Harvesting

So, how exactly is this achieved without altering the long-term investment goals of the client? The security sold to create the tax loss opportunity is simultaneously replaced by a similar investment to maintain proper asset allocation within the client’s portfolio. For example, an advisor can sell a market cap-weighted European exchange-traded fund (ETF) for a client at a loss and replace that ETF with a dividend-weighted or currency-hedged fund that’s focused on European equities.

When identifying tax loss harvesting opportunities, advisors must be aware of the Internal Revenue Service’s (IRS) wash-sale rule. The IRS rule states that when you sell a security at a loss, you cannot purchase one that is substantially identical to replace it within 30 days before the sale and 30 days after the sale is complete. If an advisor has done so and attempts to include the loss on the client’s tax filing, the IRS will disallow the tax benefit. The IRS does not offer an explicit definition of what a “substantially identical security” is, so this rule is vague. ETFs offer an advantage when it comes to tax loss harvesting because the IRS also does not consider them “substantially identical” to mutual funds. Furthermore, it is fairly easy to examine if the ETF you are selling and the ETF you are considering buying track the same index. This will give you an indication if the securities may be too similar.

Strategies for Tax Loss Harvesting

There are a number of potential ways for investors to implement a tax loss harvesting strategy. If an advisor sells a single stock to offset gains by another security, he or she can buy an ETF with exposure to the sector or industry of that stock. After the 30 days have passed, he or she can either keep holding the ETF long term or reinvest back into the sold security. The same can be done for mutual funds or ETFs if they are not considered substantially identical. What is key to note is that when a strategy is implemented, it is paramount for the advisor to let his or her broker know of their intention. There are potentially large execution savings, as this can be considered a “switch trade”. A switch trade is when an investor moves out of one position and into another simultaneously. If there is overlap in the underlying securities, there will most likely be execution improvement.

Risk and Benefits

For many clients, tax loss harvesting is a practical strategy worth considering, but there are always potential risks, as with any financial investment. The first risk is that the investment sold for tax loss purposes must be replaced if the advisor is looking to maintain the allocation. There most likely will be differences between the two securities. Additionally, a

client's cost basis and expected holding period must be considered because as these components change, higher taxes could be waiting down the road. The entire picture, both long and short term, must be considered.

The Bottom Line

Tax loss harvesting can be an effective way to mitigate gains taxes. It can be a valuable tool, but it is important to make sure that it is the correct tool. There are many situations where tax loss harvesting can add sizeable value for a client, but there are also situations where tax loss harvesting is a wash. ETFs are an extremely useful vehicle to achieve tax loss harvesting when the opportunity presents itself. WisdomTree can help you discover and align the asset allocation needs of your portfolio.

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Dividend weighted : Constituent securities represented within the Index in proportion to their contribution to the dividend stream of the Index.

Currency hedging : Strategies designed to mitigate the impact of currency performance on investment returns.

Wash-Sale Rule : An Internal Revenue Service rule that prohibits a taxpayer from claiming a loss on the sale or trade of a security in a wash sale. The rule defines a wash sale as one that occurs when an individual sells or trades a security at a loss, and within 30 days before or after this sale, buys a “substantially identical” stock or security, or acquires a contract or option to do so.