

A Vacation from Capital Gains Taxes? It Might be Shorter than You Think.

Summary¹

- After last year's losses, investors believe they are free from capital gains for a significant amount of time.
- In reality, losses are used quicker during periods of recovery and higher tax rates.
- It is important to know long will it take to exhaust the losses.
- Tax-loss harvesting can be especially helpful to manage the loss carry-forward period.

How Long Will It Take to Exhaust the Losses?

Although each investor's tax situation is unique, experience tells us that excess losses, even a large carry forward, will get used quickly. Given an eventual recovery and higher tax rates on the horizon, it makes sense to continue to manage investment related tax liabilities. Tax rates are poised to go up in 2011. If that occurs, investors will burn through their loss carry forwards and face the double shock of (1) having to pay capital gains tax again, and (2) having to pay at a much higher rate. Those who take a long-term strategic view to tax management will be able to avoid this tax shock.

Case Study

Consider the following example:

- A \$10 million dollar portfolio with a \$3 million dollar loss carry forward.
- An active portfolio with a turnover of 80%. (This is in line with the average manager in the Morningstar US equity mutual fund universe.)
- A 3% dividend yield and a 7% price appreciation.
- A 15% tax on dividends and a 35% tax on capital gains.

In this scenario, the loss carry forward is reduced by \$560,000 in the first year—from \$3,000,000 to \$2,440,000. The table below breaks out the "buy and hold" portion of the portfolio and the "turned over" portion of the portfolio and shows the effect of taxes on the portfolio. Capital gains can come from other sources as well (fixed income, real estate, etc.) but for simplicity we only address gains coming from the active equity portfolio.

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	Buy and Hold Portion	Turned Over Portion	Total
Initial Value	2,000,000	8,000,000	10,000,000
Dividend	60,000	240,000	300,000
Capital Gain	140,000	560,000	700,000
Dividend Tax	(9,000)	(36,000)	(45,000)
Capital Gain Tax	-	(196,000)	(196,000)
Ending Value	2,191,000	8,568,000	10,759,000

If we apply these assumptions over a few years, we see that one would have only four years of respite from capital gains taxes until the \$3 million loss carry forward is depleted and taxable gains become painful again.

	Total Return	Active Portfolio	Net Gain	Loss Carry Forward	Tax Liability
Year 0		10,000,000		(3,000,000)	
Year 1	10%	11,000,000	560,000	(2,440,000)	-
Year 2	10%	12,100,000	616,000	(1,824,000)	-
Year 3	10%	13,310,000	677,600	(1,146,400)	-
Year 4	10%	14,641,000	745,360	(401,040)	-
Year 5	10%	16,105,100	819,896	-	146,600
Year 6	10%	17,715,610	901,886	-	315,660
Year 7	10%	19,487,171	992,074	-	347,226
Year 8	10%	21,435,888	1,091,282	-	381,949
Year 9	10%	23,579,477	1,200,410	-	420,143
Year 10	10%	25,937,425	1,320,451	-	462,158

On the other hand, suppose the market recovers more dramatically than our 10% per year example. If we look to the market recovery we experienced from 2003 to 2007, we see a more dramatic rebound. The table below shows that the net effect is that the loss carry forward vacation ended after only four years.²

	Total Return	Active Portfolio	Active Gains	Core Portfolio	Core Gains	Net Gain	Loss Carry Forward
		7,000,000		3,000,000			(3,000,000)
2003	29%	9,011,800	1,441,440	3,862,200	(121,714)	1,319,726	(1,680,274)
2004	11%	9,991,383	567,383	4,282,021	(46,346)	521,037	(1,159,238)
2005	5%	10,481,960	152,668	4,492,268	(57,501)	95,167	(1,064,071)
2006	16%	12,139,157	1,074,191	5,202,496	(52,624)	1,021,567	(42,503)
2007	6%	12,806,811	242,783	5,488,633	(52,025)	190,758	-

The current market environment provides an opportunity for investors to take lemons and make lemonade by harvesting losses to shelter future gains. To extend this vacation from capital gains taxes, we recommend continued tax management vigilance.

Key points:

² Here we use S&P 500 returns and loss harvesting averages from our 2003 vintage composite for Tax-Managed Core accounts.

- *Manage Taxes Every Day.* Although the “year-end” approach to tax planning worked okay in 2008, it is better to loss harvest throughout the year.
- *Use Separate Accounts.* Investing through a separate account and owning individual securities provides the flexibility to loss harvest up markets as well as down markets. Additional benefits include portfolio customization and tax management techniques such as tax-efficient portfolio transitions and distributions.
- *Catch the Recovery.* A concentrated portfolio faces the real possibility of missing out during a recovery. It is difficult to predict when markets will turn around and which companies and industries will lead the way in a market recovery—instead of betting on a particular industry or set of stocks, own the market.
- *Control what you can.* Reduce the drains on your returns — management expenses, taxes, and transaction costs.

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