HARVESTING CAPITAL GAINS AND LOSSES

Margaret Hwang Smith and Gary Smith, Department of Economics, Pomona College, Claremont CA 91711. 909 607-7897, mhwang@pomona.edu, gsmith@pomona.edu

ABSTRACT

Various strategies have been proposed to take advantage of the facts that (a) capital gains and losses have no tax consequences until they are realized; and (b) short-term and long-term gains and losses are taxed at different rates. However, analyses of these strategies generally ignore the complexity of the tax code and the riskiness of the portfolios that result from tax-based trading. We use a Monte Carlo simulation model to evaluate several tax-based strategies. The most attractive strategy is to realize all losses, using the excess losses to offset realized gains that will rebalance the portfolio.

Deferring Gains and Harvesting Losses

One good reason for not realizing capital gains is to continue earning dividends and capital gains on the deferred taxes; one good reason for realizing capital losses is to invest funds provided by the IRS. More sophisticated strategies attempt to take advantage of opportunities to deduct capital losses from fully taxed ordinary income while paying lower tax rates on long-term capital gains. Unfortunately, these strategies have generally been analyzed with unrealistic assumptions; e.g., they ignore the offsetting of gains and losses for tax purposes and the $3,000 limit on capital losses that can be realized in any year. In addition, unbalanced portfolios are generally riskier than balanced ones, and an important difference between two strategies may be how well they facilitate such rebalancing. For example, a strategy of realizing gains allows the redeployment of funds invested in the stocks that have increased in value.

A Monte Carlo Simulation Model

We use a Monte Carlo simulation model to analyze these five strategies:

1. Buy and hold: never sell any stocks. This is the benchmark for the tax-based strategies.
2. Realize gains and losses: realize all capital gains and losses each year. This strategy allows the investor to rebalance the portfolio completely each year.
3. Realize gains in even-numbered years: realize losses every year and realize gains in alternate years in order to create opportunities to realize future losses.
4. Realize losses: realize all losses and defer all gains; excess losses are carried forward.
5. Realize losses and rebalancing gains: realize all capital losses each year and use excess losses to offset realized capital gains on those stocks that have become the largest part of the portfolio.

Strategy 5 increases the average return by deducting losses and also mitigates risk by allowing low-cost rebalancing. In comparison, buy and hold foregoes the deduction of losses and leads to very unbalanced portfolios. Strategy 4 takes advantage of the deductibility of losses, but does little to rebalance the portfolio. Strategy 2 permits complete rebalancing and thereby reduces the variability of wealth; however, the taxes paid on the excess capital gains outweigh this benefit. Strategy 3 is not much better.