IS IT TIME TO HARVEST?

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In a rising tax rate environment, many investment and tax professionals will tell you that you should "harvest" as much in gains as possible. If you conduct a Google search for "capital gain harvesting," you will find almost 60,000 search results on the topic. So, with approximately two weeks left in the year, have you decided to recognize all you can? What is an investor to do? It depends on the investment.

With the year-end deadline looming, Washington continues to debate the upcoming automatic tax rate changes. If the Bush era tax rates do sunset, a frequently discussed rate change for taxable investors is the long term capital gains rate. The current tax rate is 15%, and, in 2013, it could increase to as high as 23.8% - assuming the end of the Bush era rates plus the 3.8% surtax on net investment income imposed by The Patient Protection and Affordable Care Act.

UNREALIZED GAINS WITHIN A SEPARATELY MANAGED ACCOUNT (SMA)

Say you have a brokerage or custody account that is managed by an investment advisor and he/she consistently buys and sells securities resulting in an annual turnover of 20%. As a result, the advisor will likely sell all the current holdings over the next five years. In this situation, the numbers are straightforward - you can sell now at 15% or sell later at 23.8%. If you have a long term holding worth $20,000 with a $10,000 cost basis, by selling that security now, you will incur tax of $1,500. Selling that same security during the next five years, you will incur tax of $2,380, an $880 increase. Selling now, or harvesting gains, enhances the after-tax return on that security by 4.4% from the tax savings of $880, divided by sale proceeds of $20,000. This enhanced after-tax return does not consider the net present value of future tax savings.

POTENTIAL PITFALLS

Assuming your advisor continues to like the stock and repurchases it, the pitfall lies in converting a long term holding to a short term holding. If your advisor decides to liquidate the position within the next year, any appreciation would be taxed as a short term capital gain and taxed at ordinary income rates, which could be as high as 43.4%. (Assuming no agreement is made to extend the current 35% top ordinary income tax rate and the top rate increases to 39.6% plus the 3.8% surtax). Should the security you gain harvested in 2012 increase to $30,000, here is an example of how you could end up with fewer after tax proceeds:

	Sold in 2013	Gain Harvested in 2012 and Sold at Short Term Gain in 2013
Sale Proceeds	$30,000	$30,000
Cost Basis	10,000	10,000
Realized Gain	20,000	20,000
Tax Rate	23.8%	29.2%
Tax Liability	-4,760	-5,840
After Tax Proceeds	$25,240	$24,160
Reduction in After Tax Proceeds		-$1,080

Mutual funds and Exchange Traded Funds (ETF)

A similar analysis can be applied to mutual funds, except that the turnover is determined by you, the investor. It is your decision to sell at some future time when tax rates are higher. If you are invested passively in index funds or ETFs, depending on how often you reallocate your portfolio, you may or may not sell any of the investments while tax rates are higher. If you have no intention of reallocating, foregoing gain harvesting may make more sense.

For actively traded mutual funds and ETFs, the same analysis applies, except the likelihood of changing the fund or ETF is higher. If the manager's performance deteriorates, you would not want to hold that investment because of the additional tax cost on liquidation. If you have a tendency to frequently replace managers, gain harvesting is a good idea.

Concentrated Holdings

Concentrated holdings make gain harvesting decisions complicated. If you have held a stock for decades, you may have an emotional connection to the stock. Note that your emotional tie can lessen your objectivity in the "should I harvest now" decision making process. A second complicating factor often accompanying concentrated holdings is their hefty dividends. These dividends are often lifestyle supporting and may make you less likely to sell and harvest gains. A third factor to consider is your time horizon. If you plan on holding a specific stock until your passing and expect to receive a step up in value so your heirs can liquidate without paying income tax on the unrealized gain, gain harvesting today may not make sense.

Perhaps you are an investor with concentrated holdings and wish to diversify. If you have been selling or gifting shares to reduce your concentrated holdings down to a "reasonable" percentage of your portfolio, this year may be the year to be more aggressive. Say you own 10,000 shares of a $100 per share position worth $1 million with a very small cost basis. The cost to liquidate in 2012 is $150,000 while that same cost next year could be $238,000, or $88,000 more expensive. Time to harvest? While this savings is significant, you may be concerned about foregoing upside in the stock value. The increased tax rate mitigates some of that upside. Selling $1 million of a $100 stock in 2012 would net you $850,000 after tax. Selling the same number of shares next year would require you to sell at a price greater than $111 to net the same $850,000 after tax. Hence, the first 11% of additional appreciation is absorbed by income taxes.

The majority of investments fall into one of these three types. While some analysis and long term goals must be considered, gain harvesting in 2012 makes financial sense in an increasing tax rate environment.

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