



## WHITE PAPER

October 2010

Tax Strategies, Tax Loss Harvesting, and DFA Funds  
By Sheryl L. Rowling, CPA/PFS<sup>1</sup>

### Introduction

Clients have two paramount aversions: losing money and paying taxes. While advisors can't control periodic market declines, they can mitigate them through diversification and rebalancing. And, although advisors can't ensure that clients will never pay taxes, they can minimize taxes through location optimization, tax lot identification and tax loss harvesting. This paper will discuss tax management strategies that can save your clients money and add significant value to the advisor-client relationship. Through education and quantification clients can learn to get excited about how much money their advisor is saving for them!

### Tax-Aware Portfolio Management

Strategies for tax-aware portfolio management include:

**Location Optimization:** Current taxes may be reduced by shifting ordinary income producing bonds from taxable accounts to IRAs. Future taxes may be reduced by shifting appreciating securities to taxable accounts (where gains can be taxed at capital gains rates) from IRAs (where gains would be taxed at ordinary rates). Future taxes may be avoided permanently by holding highly appreciating securities in Roth IRAs.

**Tax Lot Identification:** Capital gains may be minimized during the rebalancing process by choosing high cost lots. Although clients with capital loss carryforwards might not notice the savings in the current year, tax lot identification can help to preserve the loss carryforwards for use when rebalancing gains are unavoidable.

**Tax Loss Harvesting:** Tax loss harvesting seeks to recognize losses by selling loss positions solely for tax purposes. Tax loss harvesting produces capital losses that can be carried forward indefinitely until used up, thereby offsetting future gains realized from rebalancing (both short-term and long-term) or distributions.

---

<sup>1</sup> The author wishes to acknowledge, with gratitude, the assistance and input of Glenn Freed and Jeff Cornell, of Dimensional Fund Advisors.

Location optimization and tax lot identification are tax-saving strategies that don't require movements in and out of funds. However, by definition, tax loss harvesting requires such transactions.

To carry out tax loss harvesting, loss positions are sold. Since wash sale rules disallow loss recognition if the same or substantially identical securities are purchased within 30 days of the sale, the investor must either stay out of that position for 30 days or purchase a similar position (that is not substantially identical). In the event of market growth within the 30 days, this "replacement" security should be appropriate for long-term holding.

A potential indirect consequence of mass tax loss harvesting activities is the creation of unstable cash flows into/out of mutual funds. This can harm fund shareholders who desire relatively stable cash flows in order to minimize the impact of frictions from excessive trading. For this reason we have sought input from Dimensional Fund Advisors (DFA) as to the optimal tax loss harvesting activities that will not hurt fund shareholders.

There are two primary issues to be considered when approaching tax loss harvesting with DFA funds: timing and dollar amounts. To avoid extreme cash flow movements within DFA funds, advisors should pursue opportunistic tax loss harvesting on a periodic basis rather than solely at year end. Additionally, DFA prefers to be forewarned any time \$1 million or more will move in or out of any particular fund. Please notify your DFA Regional Director of such trades.

### Tax Loss Harvesting Strategy

It is the position of the author that DFA advisors should hold to the following tax loss harvesting strategies:

- Take advantage of tax loss harvesting on an opportunistic basis, not solely at the end of the year.
- Choose an appropriate alternate DFA fund as the replacement security when harvesting tax losses.
- Harvest losses only when the benefits are material.
- Notify DFA in advance of fund movements of \$1 million or more.

The benefits to the first strategy are twofold: DFA funds will not get hit all at once with transactions at the end of the year; and clients will reap greater tax savings by periodic tax loss harvesting.

With periodic tax loss harvesting, it is possible to recognize losses even during up markets. Tax losses should be recognized when:

1. **The loss is material.** The materiality of the loss can only be based on client preferences and advisor's judgment. Typically, materiality is expressed as a fixed dollar amount or a percentage of the client's portfolio. Because even short-term losses will likely eventually offset long-term gains, the tax benefit should be calculated based on the long-term capital gain rate, currently 15 percent.
2. **The percentage loss is material.** The percentage loss is significant to ensure that daily price fluctuation doesn't turn a planned loss transaction into a gain. Typically, a 10 percent loss minimum should be required for tax loss harvesting.
3. **An appropriate replacement fund exists.** As previously noted, since the replacement fund might appreciate, it is important that such fund be appropriate for long-term holding. A plan to simply sell the replacement fund after 30 days may negate the harvesting transaction if the market has increased in the interim.
4. **The value of the tax savings is significant compared to transaction costs.** Finally, the tax savings should be significant compared to the costs of the transaction. A good rule-of-thumb (based on DFA's tax-managed strategies) is that the savings must be at least eight times the cost.

#### Example

Let's say client Bill holds the following positions in his portfolio for a total value of \$2,280,000:

Fund A, current value \$100 per share:

1,000 shares bought at \$105

1,000 shares bought at \$120

Fund B, current value \$200 per share:

4,000 shares bought at \$150

2,000 shares bought at \$210

2,000 shares bought at \$250

Fund C, current value \$80 per share:

3,000 shares bought at \$70

3,000 shares bought at \$100

Each of these lots has the following loss characteristics:

Fund A: 1,000 shares – loss of \$5 per share (5%), total loss \$5,000

1,000 shares – loss of \$20 per share (20%), total loss \$20,000

Fund B: 2,000 shares – loss of \$10 per share (5%), total loss \$20,000

2,000 shares – loss of \$50 per share (25%), total loss \$100,000

Fund C: 3,000 shares – loss of \$20 per share (25%), total loss \$60,000

For purposes of this example, we will assume that a suitable replacement fund exists, transaction costs are 0.25%, and the advisor's minimum loss requirement is the greater of \$10,000 or 2% of the portfolio. Applying the strategy rules above would result in the following:

Fund A shares would not be sold because the first lot's loss is less than 10% and the second lot's loss is less than 2% of the portfolio.

The first lot of Fund B would not be sold because its loss is less than 10%. The second lot's loss is greater than 10% and also greater than 2% of the portfolio. Transaction costs on the sale of \$400,000 would be \$1,000. The tax savings generated would be \$15,000. Since this is greater than 8 times the cost, this lot would be sold for tax lot harvesting. Fund C's loss is in excess of 10% and is also greater than 2% of the portfolio. Transaction costs on the sale of \$240,000 would be \$600. The tax savings generated would be \$9,000. Since this is greater than 8 times the cost, this lot would be sold for tax lot harvesting.

Thus, Bill will recognize harvested losses of \$160,000 at a total cost of \$1,600 and will realize tax savings of \$24,000.

#### DFA Replacement Funds

To effectively harvest tax losses, the DFA advisor will need to identify appropriate DFA replacement funds. There are essentially two options for this:

- Replace a core fund with another core fund and replace component funds with other component funds
- Replace a core fund with component funds or vice versa

Although either option may be used by an advisor, the author recommends the first option. By replacing a core fund with a core fund and component funds with component funds, the advisor can more cleanly execute trades and will be able to maintain a more consistent strategy.

In the opinion of the author, the following DFA Tax Loss Harvesting Substitution Table<sup>2</sup> represents potential replacement funds for tax loss harvesting purposes. For example, US Core Equity 2 or US Sustainability Core 1 may be substituted for US Core Equity 1. Additionally, Tax Managed US Small Cap may be substituted for US Small Cap.

---

<sup>2</sup> It is the opinion of the author that these funds, although similar, are not "substantially identical" and, thus, will not trigger wash sale treatment. This interpretation is based upon current tax and case law as well as interpretations of the tax laws. The strategies discussed may not apply to a particular investor's situation. The author strongly suggests speaking with a tax advisor prior to making any specific trading decisions.

DFA Tax Loss Harvesting Substitution Table

Core/Component Funds	Similar Tax Managed Funds	Other Similar Funds
US Core Equity 1	Tax Managed US Equity	US Sustainability Core 1
US Core Equity 2	TA Core Equity 2	US Social Core Equity 2
US Targeted Value	Tax Mgd US Targeted Value	US Vector Equity
US Small Cap	Tax Mgd US Small Cap	
US Large Value	Tax Mgd Marketwide Value	
International Core Equity		Intl Sustainability Core 1
Intl Small Cap Value		Intl Vector Equity
International Value	Tax Mgd International Value	
Emerg Mkts Core Equity		Emerg Mkts Social Core

The table attached at the end of this paper, DFA Funds by Asset Class, includes a comprehensive list of the DFA funds categorized by asset class and may be helpful for identifying appropriate replacement funds. If you have any questions about the characteristics of a fund on the list, please contact your DFA Regional Director. In addition, the Allocation Evaluator on DFA’s website may be helpful for estimating the overall tilt of your portfolio before and after tax loss harvesting transactions.

Communicating Benefits to Clients

Advisors can demonstrate significant value to clients by making them aware of money saved from tax management strategies. To get “credit” for future tax savings, advisors will need to educate their clients. To get “credit” for current tax savings, advisors will need to give them numbers. For example, let’s say that an advisor used a program like TRX, accomplishing the following for a \$1,000,000 account during 2009:

1. Tax Loss Harvesting: Recognized \$200,000 of losses
2. Location Optimization: Moved \$100,000 from municipal bonds paying 4% in the taxable account to corporate bonds paying 7% in the IRA.
3. Tax Lot Identification: Reduced gains recognized by \$50,000 from selecting high cost lots over average cost.

In the annual performance report, the client’s pre-tax return will be increased by 0.3%  $((\$100,000 \times (7\% - 4\%))/\$1,000,000)$ . In a supplemental report, the advisor can point out that, assuming a 15% capital gains rate, \$37,500 of taxes were deferred  $((\$200,000 + \$50,000) \times 15\%)$ , or 3.75% of the portfolio.

Finally, in quarterly report letters or client seminars, the advisor can explain the value of tax savings strategies, including the significant benefit of utilizing capital gains rates (or possibly basis step-up at death) by shifting growth assets to the taxable account (rather than the IRA).

Advisors who are not providing state-of-the-art portfolio management are depriving their clients of significant tax benefits. Through automation, advisors can more easily fulfill their fiduciary responsibility and differentiate themselves from the competition. Showing clients continued added-value will give advisors the edge they need to retain happy clients and attract new business!

###

About the author:

Sheryl L. Rowling, CPA/PFS, co-creator and CEO of Total Rebalance Expert<sup>®</sup> portfolio management software, is also a Partner of Moss Adams Wealth Advisors. She has been providing fee-only tax and financial planning advice since 1979. Sheryl has been named one of the nation's top 250 financial advisors by Worth magazine and one of the country's most influential CPAs by CPA Magazine. She has also received recognition as one of Accounting Today's 100 Most Influential People and as a 5-Star Wealth Manager by San Diego Magazine. She is a member of the American Institute of Certified Public Accountants, the California Society of Certified Public Accountants, the Association of CPA Financial Planners and the All-Star Financial Group. Sheryl holds an M.B.A. in Finance and a B.S. in Accounting from San Diego State University.

Sheryl can be reached at [sheryl@trxpert.com](mailto:sheryl@trxpert.com).

DFA Funds Categorized by Asset Class

Fund	Symbol	Asset Class					Notes
		Small Cap	Small Value	Marketwide	Large Cap	Large Value	
<b>US Equities</b>							
US Large Company	DFLUSX					X	
Enhanced US Large Company	DFELX					X	may have large income distributions
Tax-Mgd US Equity	DTMEX				X		modest tilt to small and value
US Core Equity 1	DFECX				X		modest tilt to small and value with sustainability screens
US Sustainability Core 1	DFSCX				X		larger tilt to small and value than Core 1
US Core Equity 2	DFCTX				X		similar to Core 2 with tax advantaged investing
TA (Tax-Advantaged) US Core Equity 2	DFTEC				X		similar to Core 2 with social screens
US Social Core Equity 2	DFLUC				X		excludes largest growth stocks and significant tilt to small and value
US Vector Equity	DFVEX			X			Soft Close - only existing shareholders can purchase
US Small Cap Value	DFSVX		X				
US Targeted Value	DFTVX		X				
Tax-Mgd US Targeted Value	DTMVTX		X				
US Mikro Cap	DFSCX		X				Soft Close - only existing shareholders can purchase
US Small Cap	DFSTX		X				
Tax-Mgd US Small Cap	DFTSX		X				
US Large Value	DFLVX					X	
Tax-Mgd Mktwd Value	DTMNVX					X	
<b>International Equities</b>							
Fund	Symbol	Small Cap	Small Value	Marketwide	Large Cap	Large Value	Value
International Large Cap	DFALX				X		
International Core Equity	DFICX			X			tilt to small and value similar in magnitude to US Core 2
International Sustainability Core 1	DFISX			X			modest tilt to small and value with sustainability screens
International Small Company	DFISX	X					
International Small Cap Value	DFISX		X				
International Vector Equity	DFVQX		X				excludes largest growth stocks and significant tilt to small and value
International Value	DFIVX					X	
Tax-Mgd International Value	DTMIX					X	
<b>Emerging Markets Equities</b>							
Fund	Symbol	Small Cap	Small Value	Marketwide	Large Cap	Large Value	Value
Emerging Markets (large cap)	DFEMX				X		
Emerging Markets Core Equity	DFECX			X			modest tilt to small and value
Emerging Markets Social Core	DFESX			X			similar to emerging core with social screens
Emerging Markets Small Cap	DFMSX	X					
Emerging Markets Value	DFEVX						X
<b>Global ex US Equities</b>							
Fund	Symbol	Small Cap	Small Value	Marketwide	Large Cap	Large Value	Value
TA (Tax-Advantaged) World ex US Core Equity	DFTWX			X			International developed and emerging markets approximate mix = 85:15 (Int:Emg)



For further information, please contact us at

[info@trxpert.com](mailto:info@trxpert.com)

Total Rebalance Expert®  
8889 Rio San Diego Drive, Suite 202  
San Diego, CA 92108

(619) 294-4TRX

[www.trxpert.com](http://www.trxpert.com)