



“Versus Purchase” Method Delivers the Best Tax Trading Execution

As tax loss harvesting strategies have evolved over the last several years significant innovations have improved the ability of investment managers to benefit taxable investors. The concept of systematic, year round loss harvesting as opposed to simply taking losses at year-end is made possible by the adoption of the “Versus Purchase” (VP) trading methodology. Although First In, First Out (FIFO) or Min Tax have been the industry’s default for years the VP methodology offers the best after tax results for the taxable investor. The industry’s hesitancy to embrace VP has nothing to do with its value but everything to do with the fact that it takes more effort to set up the account and monitor each lot individually. With the potential for higher tax rates in the future and the demand for better absolute returns VP trading can no longer be overlooked.

When posting trades in taxable accounts all three trading methods attempt to determine which security is best to sell for the client. FIFO operates under the guideline that the first security bought is the first one that will be sold. Due to the fact that the first security bought has been held the longest, more times than not it has accrued the largest gain, and will potentially incur the largest tax bill. This trading methodology is ideal for the institutional client that has no tax concerns, however, most managers agree that FIFO is a poor system to use while posting trades in taxable accounts.

The Min Tax methodology is the current industry standard for taxable clients. When using the Min Tax methodology, sales priorities are categorized as follows: short-term losses are prioritized over long-term losses and long-term gains are prioritized over short-term gains. In other words, Min Tax will sell the stock that has the highest tax rate (35%) when harvesting losses, and will sell the stock with the lowest tax rate (15%) when posting a gain. This method, while more tax friendly than FIFO, does not take into consideration the actual tax implications of the sale and can miss opportunities to save money on taxes as will be demonstrated below.

The final, and most tax friendly trading method, is Versus Purchase (VP). When trading under the VP guidelines, the manager looks at each individual tax lot and applies the appropriate tax rate to each gain or loss to evaluate the actual tax implications of making a trade. When selling a stock at a loss, VP will sell the stock that provides the greatest reduction in taxes (by offsetting gains). When selling a stock at a gain the manager will sell the stock that will simply generate the smallest tax bill. Unlike Min Tax, VP does not prioritize by tax rate but looks at the actual tax result of the trade.



LOSS									
	# Shares	Basis		Term	Price	Current Value	Gain/Loss	Tax Rate	Taxes
Lot 1	100	25	2,500	ST	20	2,000	-500	0.35	-175
Lot 2	100	50	5,000	LT	20	2,000	-3,000	0.15	-450

- > Min Tax would sell lot 1, prioritizing a Short Term loss over a Long Term loss.
- > Versus Purchase trading would sell lot 2 due to the higher expected dollar reduction of tax.

GAIN									
	# Shares	Basis	Tot Cost	Term	Price	Current Value	Gain/Loss	Tax Rate	Taxes
Lot 3	100	40	4,000	ST	45	4,500	500	0.35	175
Lot 4	100	10	1,000	LT	45	4,500	3,500	0.15	525

- > Min Tax would sell Lot 4, prioritizing a LT gain over a ST gain.
- > Versus Purchase trading would sell Lot 3 due to the lower actual tax implication.

Versus Purchase offers investors the best opportunity to reduce capital gains taxes when trading in a taxable account. However, since trading using the VP methodology requires the manager to manage down to the individual tax lot basis most managers choose to default to the Min Tax methodology if they are even attempting to manage for taxes. When evaluating tax managers, be sure to ask two pertinent questions:

1. Do they have the ability to harvest year round?
2. Can they execute using Versus Purchase method?

M3 has the ability to execute tax loss harvesting year round using the VP trading methodology.

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