

Rebalancing and Tax-Loss Harvesting in Schwab Intelligent Portfolios[®]

Key points

- A disciplined process of rebalancing as asset class weightings move beyond pre-set thresholds helps keep the level of risk in your portfolio consistent with your current risk profile
- Schwab Intelligent Portfolios applies a sophisticated algorithm for rebalancing that may also provide current federal income tax benefits through tax-loss harvesting¹
- The algorithm considers both rebalancing and tax-loss harvesting as part of a unified process to coordinate the impact of trades

Background

Over time, taxes can eat into a significant amount of one's investment gains in a taxable account. Schwab Intelligent Portfolios is designed with the goal of improving the after-tax, risk-adjusted rate of return for the account holder who chooses to enroll in tax-loss harvesting by deferring current tax liabilities, leaving money that can be reinvested and potentially grow over time. To do that, it uses an algorithm that simultaneously incorporates tax-loss harvesting and rebalancing strategies designed to keep the level of risk in the portfolio commensurate with the goals, risk tolerance and risk capacity of the target asset allocation..

This white paper explains tax-loss harvesting and rebalancing, and how they work in combination.

The Benefits of Tax-Loss Harvesting

Under current U.S. tax law, losses incurred in the sale of securities and other assets provide potential tax benefits for investors. A systematic and automatic process for tax-loss harvesting provides an investor with a convenient way that may improve total net-of-taxes returns over time.

How Tax-Loss Harvesting Works

Gains and losses from investment (i.e., capital assets resulting in capital gains or losses) are subject to specific tax rules under the Internal Revenue Code of 1986, as amended (the "IRC").¹

The taxation of capital gains depends on whether such gains are "long-term," meaning gains or losses from investments held for more than one year (i.e., 12 months and one day, or longer), or "short-term," meaning gains and losses from investments held for one year or less². The difference in tax treatment is significant because long-term capital gains generally receive preferential statutory tax treatment, while short-term gains are generally taxed at the higher

ordinary income tax rate. For example, in 2018, the federal ordinary income and capital gain tax rates are as follows:

2018 federal income tax brackets

Single

Tax rate on ordinary income	<i>over</i>	<i>to</i>	Tax rate on qualified dividends and long-term capital gains
10%	\$0	\$9,525	0%
12%	\$9,526	\$38,700	0%
22%	\$38,701	\$82,500	15%
24%	\$82,501	\$157,500	15%
32%	\$157,501	\$200,000	15%
35%	\$200,001	\$500,000	15%
37%	\$500,000		20%

Married filing jointly / Qualifying widow or widower

Tax rate on ordinary income	<i>over</i>	<i>to</i>	Tax rate on qualified dividends and long-term capital gains
10%	\$0	\$19,050	0%
12%	\$19,051	\$77,400	0%
22%	\$77,401	\$165,000	15%
24%	\$165,001	\$315,000	15%
32%	\$315,001	\$400,000	15%
35%	\$400,001	\$600,000	15%
37%	\$600,000		20%

Source: IRS.

As indicated, under current law, the tax savings between long-term and short-term capital gains tax treatment could be almost 20 percentage points, in some cases. An additional 3.8% surtax applies to net investment income for taxpayers with adjusted gross income (AGI) over \$200,000 (for single filers) or \$250,000 (for married persons filing jointly).³ So, to the extent that proactive loss harvesting can be used to shield short-term capital gains from immediate tax, as much as 20.8 percentage points in tax might be saved.

Please note the income tax discussion herein is based on currently applicable provisions of the IRC, the regulations thereunder, and judicial and administrative interpretations thereof, all of which are subject to change or modification by subsequent legislation, regulatory, administrative, or judicial decisions, potentially with retroactive effect. Any such changes could have a material effect on the discussion herein. Also please note that the discussion herein is limited to the potential federal income tax effect of tax loss harvesting and rebalancing as presented herein. Other issues may exist that could materially impact the utility of tax loss harvesting for any particular investor. Each investor is strongly encouraged to consult their own tax advisor in order to determine the utility of the tax loss harvesting program in light of their particular circumstances.

Capital Gains and Losses—in general

To determine your total net gain or loss, combine your net short-term capital gain or loss with your net long-term capital gain or loss. Long-term capital gains and losses generally are calculated separately from short-term capital gains and losses for federal income tax purposes. Capital gains and losses are classified as long-term or short-term. If you have held the asset for more than one year before you dispose of it, your capital gain or loss is generally long-term. If you have held it one year or less, your capital gain or loss is generally short-term. To determine how long you held the asset, count from the day after the day you acquired the asset up to and including the day you disposed of the asset.

If you have a net capital gain as calculated above, a lower tax rate may apply to the gain than the tax rate that applies to your ordinary income. The term "net capital gain" means the amount by which your net long-term capital gain for the year is more than your net short-term capital loss for the year.

Net Capital Gain = Net Long-Term Capital Gain – Net Short-Term Capital Loss

In the above equation, the term "net long-term capital gain" means long-term capital gains reduced by long-term capital losses including any unused long-term capital loss carried over from previous years.

Net Long-Term Capital Gain = Long-Term Capital Gains – Long-Term Capital Losses – Long-Term Capital Loss Carry Over

The maximum tax rate on most net capital gain is generally no higher than 15%. Some or all net capital gain may be taxed at 0% if you are in the 10% or 12% ordinary income tax brackets. However, a 20% rate on net capital gain applies to the extent that a taxpayer's taxable income exceeds the thresholds set for the 37% ordinary tax rate—\$500,000 for taxpayers filing singly, and \$600,000 for married taxpayers filing jointly.

Tax-Loss Harvesting and Rebalancing Algorithm

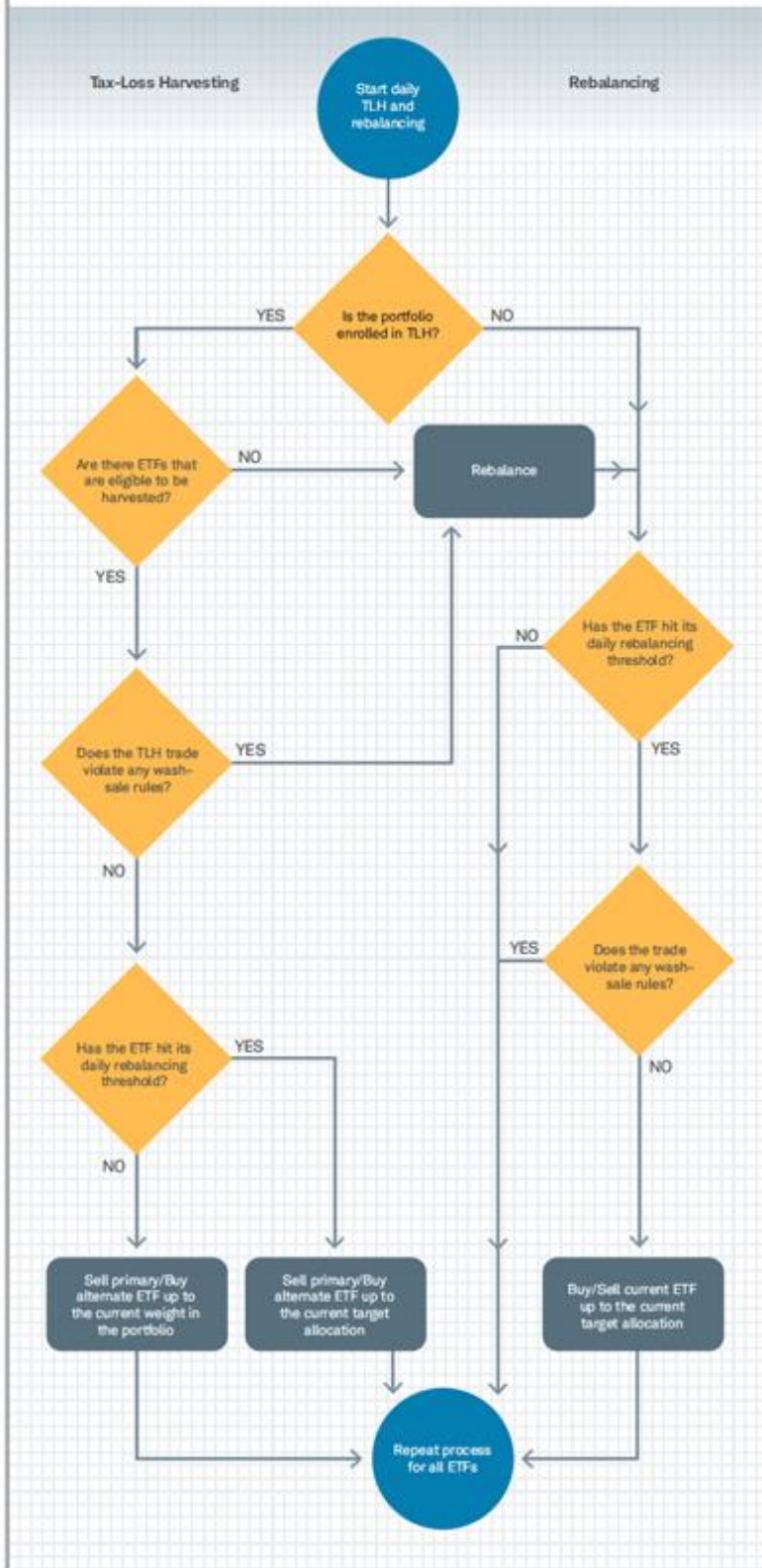
The goal of the Schwab Intelligent Portfolios algorithm is to maintain a portfolio that closely tracks the investor's strategic asset allocation and that captures tax-deductible losses while

generally preventing wash sales in the Schwab Intelligent Portfolios account. The algorithm is broken down into six sections: the initial portfolio buy, tax-loss harvesting, rebalancing, combining tax-loss harvesting and rebalancing, selling and buying.

Tax-Loss Harvesting

Tax-loss harvesting is the process of selling a security at a loss, and using the proceeds to purchase a similar but not substantially identical security. The tax-loss harvesting process allows investors to retain a similar market exposure while generating tax deductions for federal income tax purposes that can be used to offset recognized capital gains and up to \$3,000 of ordinary income a year. Additional captured losses can be carried forward into future years if not used in the year in which they occurred.

Trading Process for Taxable Accounts



Flowchart: This schematic diagram shows key elements of the tax-loss harvesting and rebalancing process for Schwab Intelligent Portfolios accounts. The computer algorithm conducts daily checks of each Schwab Intelligent Portfolios account and its ETF holdings for certain thresholds and requirements to help determine trades for tax and/or asset allocation purposes.

Schwab Intelligent Portfolios seeks to reduce an investor's current net federal income tax burden within the program by capturing tax-deductible capital losses, while monitoring linked Schwab Intelligent Portfolios accounts (but not other Schwab accounts or accounts held outside Schwab) in order to avoid triggering a wash sale). Capital losses may be used to offset capital gains from any source. To the extent capital losses exceed capital gains in any tax year, they generally may be used to offset up to \$3,000 of ordinary income. If such losses are not fully utilized in the year they occur, the excess may be carried forward without expiration during your lifetime for use in future tax years.⁴

The utilization of realized losses may be limited by a number of special rules in the IRC, in particular by the "wash sale" rules. Wash sales occur when you sell a security at a loss and when you, your spouse, or one of your IRAs buys the same or a "substantially identical" security within 30 calendar days before or after the sale.

When a wash sale occurs, the loss is typically disallowed or deferred for federal income tax purposes.⁵ The wash sale rule is designed to prevent taxpayers from claiming deductible losses on securities if they acquire a "substantially identical" position in that security within 30 days before or after the sale.⁶

A wash sale will trigger several consequences. First, if a taxpayer violates the wash sale rule, the loss resulting from the initial sale cannot be deducted currently (the wash sale rule only applies to losses). Instead, that loss is added to the cost basis of the replacement security purchased. The holding period for the replacement security includes the holding period of the original security previously sold.

To prevent wash sales, Schwab Intelligent Portfolios utilizes two similar ETFs for each asset class (a "Primary ETF" and an "Alternate ETF").⁷ Therefore when the price movement of one ETF is large enough to warrant a sale to capture a loss⁸, the other ETF in the asset class is purchased to maintain the asset class market exposure.

Combining Daily Tax-Loss Harvesting and Rebalancing

Rebalancing is the process of buying or selling securities within an asset class to bring the asset class back to its target allocation. This helps control the portfolio risk by not allowing asset classes to drift too far from their target allocations.

On a daily basis, the algorithm checks to determine if asset class weights remain within a drift tolerance.

1. If an asset class has drifted above its target allocation by a sufficient amount, the asset class is sold to bring it back to its target allocation. The cash received from the sale is allocated to the asset classes that are underweight.
2. If an asset class has drifted below its target allocation by a sufficient amount, additional shares of the asset class are bought to bring it up to its target allocation. To make this purchase, overweight asset classes are sold down until there is enough cash to make the purchase.

Since tax-loss harvesting and rebalancing conditions are checked on a daily basis, the algorithm follows a set of rules to net out both trade types. When evaluating each situation, the algorithm looks at the shares held in both the Primary ETF and Alternate ETF.

Examples

To show generally how the algorithm works, this section describes some scenarios. For ease of exposition, we've focused on a single asset class. Under real-world conditions, an account holder would own many ETFs across several asset classes and the results may differ.

Scenario 1: Tax-Loss Harvesting / No Rebalancing Trade

In this scenario the algorithm will sell the amount specified by the tax-loss harvesting function and buy an equal amount of the other ETF (i.e., the Alternate) in the asset class. The price movement of the primary ETF hasn't been large enough to trigger a rebalancing trade.

Example: On April 1, sell the Primary because it meets the tax-loss harvesting parameters.

Date	Primary				Alternate			
	Action	Shares	Price	\$ Amount	Action	Shares	Price	\$ Amount
January 1, 2014	Buy	100	\$100	\$10,000				
February 1, 2014	Buy	100	\$109	\$10,900				
March 1, 2014	Buy	50	\$120	\$6,000				
April 1, 2014 (Tax-Loss Harvesting)	Sell	50	\$110	\$5,500	Buy	110	\$50	\$5,500

1. On April 1, sell 50 shares of the Primary for \$5,500
2. Buy \$5,500 of the Alternate using the proceeds from selling the Primary.

Scenario 2: Tax-Loss Harvesting / Rebalancing Buy

This scenario is the same as scenario 1 (i.e., the assumption is that the Primary ETF is the one being harvested for tax purposes and the algorithm is selling the appropriate amount of the Primary to capture the losses). The proceeds are being used to buy the Alternate. However, the

weighting of this asset class also has dropped enough relative to other asset classes that a rebalancing event has been triggered. Therefore, additional shares of the Alternate are purchased until the Rebalancing Buy amount is met.

Example 2: On April 1, sell the Primary because it meets the tax-loss harvesting requirements. Buy an extra \$500 of this asset class due to rebalancing.

Date	Primary				Alternate			
	Action	Shares	Price	\$ Amount	Action	Shares	Price	\$ Amount
January 1, 2014	Buy	100	\$100	\$10,000				
February 1, 2014	Buy	100	\$109	\$10,900				
March 1, 2014	Buy	50	\$120	\$6,000				
April 1, 2014 (Tax-Loss Harvesting)	Sell	50	\$110	\$5,500	Buy	120	\$50	\$6,000

1. On April 1, sell 50 shares of the Primary for \$5,500
2. Buy \$5,500 of the Alternate using the proceeds from selling the Primary, plus an additional \$500 (for instance, derived from the sale overweight asset classes or otherwise) to meet the rebalancing requirements.

Scenario 3: No Tax-Loss Harvesting Trade / Rebalancing Sell

In this scenario, there has been enough movement in the portfolio to cause an asset class to be too far overweight, requiring it to be sold down to its target allocation. If only one ETF in the asset class is owned, then sell the appropriate amount of that ETF. But if both the Primary and Alternate ETFs in an asset class are owned, then the algorithm will sell the Alternate ETF. Proceeds would be reinvested in the most underweight asset classes, starting with the most underweight.

References

[IRS Publication 550, Investment Income and Expenses](#)
[IRS Topic 409 - Capital Gains and Losses](#)

1. Tax-loss harvesting is available for clients with invested assets of \$50,000 or more in their Schwab Intelligent Portfolios account. Clients must enroll to receive this service.
2. IRC §§1221-1223.
3. IRC §1411.

4. State income tax laws do not always conform to federal law and differences may be material. Consult your tax professional regarding your particular state's rules.

5. IRC §1091 and Treasury Regulation 1.1091-1. See also, [IRS Publication 550](#) pp. 58-59

6. Note that even though brokerage firms can only report on an account level, the wash sale rule applies at the taxpayer level. Therefore, individual taxpayers must coordinate sales and purchases among their various accounts. Married taxpayers are generally considered one economic unit for purposes of the wash sale rule. Furthermore, tax-deferred retirement accounts are included for purposes of determining whether a substantially identical security has been purchased within 30 days. See [IRS Rev. Rul. 2008-5](#), 2008-1 C.B. 271. For purpose of the tax loss harvesting and rebalancing process, unless Schwab Intelligent Portfolio accounts are linked together, the process will be undertaken on an account by account basis and no single account election is assumed to be made under the cost basis rules or otherwise with respect to multiple accounts.

7. There is very little authority governing whether an ETF is "substantially identical" to another ETF for purposes of the wash sale rules. As a result, no assurances can be provided that an ETF chosen to be similar but not substantially identical to a disposed of ETF will be treated as such by the IRS or a court. Each investor is strongly encouraged to consult their own tax advisor in preparing their own tax returns light of their particular circumstances.

8. This assumes the client will be able to utilize such a loss against his or her capital gains after the annual \$3,000 ordinary income allowance is used.

[Disclosures](#)

Schwab Intelligent Portfolios is designed to monitor a client's portfolio on a daily basis and will also automatically rebalance as needed to keep the portfolio consistent with the client's selected risk profile unless such rebalancing may not be in the best interest of the client. Trading may not take place daily.

The tax-loss harvesting feature that will be available with Schwab Intelligent Portfolios is subject to significant limitations which are described on the Schwab Intelligent Portfolios website and mobile application (collectively, the "Website") as well as in the Charles Schwab & Co., Inc., Schwab Intelligent Portfolios® disclosure brochures (the "Brochure"), and the IRS website at www.irs.gov You should consider whether or not to enroll in tax-loss harvesting based on your particular circumstances and the potential impact tax-loss harvesting may have on your ultimate federal income tax liability.

You should read the tax-loss harvesting disclosures on the Website and in the Brochure before choosing the tax-loss harvesting feature if you decide to enroll in Schwab Intelligent Portfolios. Neither the tax-loss harvesting strategy for the Schwab Intelligent Portfolios program, nor any discussion herein is intended as tax advice, and neither Charles Schwab & Co. Inc. or its affiliates, including but not limited to Charles Schwab Investment Advisory, Inc. represents that any particular federal income tax consequences will be obtained.

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