First Ascent Asset Management

HOW YOU BENEFIT FROM TAX LOSS HARVESTING

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What is Tax Loss Harvesting?

Tax loss harvesting involves intentionally taking a loss by selling a security that has declined in value, in order to receive a tax benefit.

How Does Tax Loss Harvesting Work?

We'd all be happy if every position we bought went straight up in value after we purchased it. Unfortunately, that is not how long-term investing works.

Markets rise and fall over time, whether we want them to or not. In the process, our portfolio holdings rise and fall in value too.

If one of our portfolio holdings declines to a value that is lower than the price at which it was purchased, we can sell it and realize the loss. That loss can be used to reduce your taxes.

Often, when a position is sold in order to "harvest" a loss in this manner, it is replaced by another position. The replacement position is usually selected so the portfolio will maintain the same objectives and risk/ return characteristics it had before the loss harvesting transaction.

What Are the Rules for Taking Tax Losses?

An investment loss can be used to offset other investment gains. There are two types of investment gains and losses—short-term and long-term.

Short-term gains and losses are those realized from the sale of an investment held for one year or less. Long-term gains and losses are those realized from the sale of an investment held for more than one year.

The key difference between short-term and long-term gains is the rate at which they are taxed. Short-term gains are taxed at a higher rate than long-term gains. The rates at which they are taxed will depend on your individual tax situation and the tax laws in effect at the time.

Short-term losses must first be used to offset short-term gains and long-term losses must first be used to offset long-term gains. But if your losses of one type exceed your gains of that same type, you can use those excess losses to offset gains of the other type.

If your investment losses exceed your investment gains in a given year, you can use the excess losses to offset up to $3,000 of ordinary income on a joint tax return in a single year.

Unused investment losses can be carried forward indefinitely.

Issues to Keep in Mind

Deferral, Not Avoidance. Instead of thinking about tax loss harvesting as a way to avoid taxes altogether, you should think of it as a way to defer taxes. Here's why.

Let's say you purchased one of the positions in your portfolio for $50,000. Shortly thereafter, the market declines and that position is worth only $45,000. You sell the entire position in order to harvest the $5,000 loss.

Using the proceeds from the sale--$45,000--you purchase a replacement position. A while later the market has recovered and risen steadily. Both your original position and your replacement position are now worth $60,000.

You decide to liquidate the entire portfolio to purchase a vacation home. When you sell the replacement position, you will realize a gain of $15,000. ($60,000 - $45,000 = $15,000.) If you'd held onto the original position rather than harvesting the $5,000 loss, you would have realized a gain of only $10,000 ($60,000 - $50,000 = $10,000.)

So, by harvesting the $5,000 loss, you saved on taxes in the earlier time period, but paid more in taxes later.

Wash Sales. If you sell a position to harvest a loss and then buy a replacement position, watch out for the so-called "wash-sale rule."

Under US tax law, if you sell a security to generate a loss and then buy the same or a "substantially identical" security within 30 days of the loss sale, your tax loss will be disallowed. It's easy to avoid buying back the same security within 30 days, but there is little guidance on what constitutes a "substantially identical" security, so be careful.

Stay Focused on Your Investment Goals. Everyone likes to reduce their taxes, but be careful not to do so at the expense of your long-term investment goals.

If you buy a replacement position, make sure, to the extent you can, that it is of equal or better quality than the position you sold to generate the loss. Also, make sure it does not change the return or risk characteristics of your portfolio, unless you mean to do so.

Take transaction costs into consideration when weighing the merits of a tax loss harvesting transaction.

Taxable Accounts Only. Tax loss harvesting only works in taxable accounts. Losses generated in tax-deferred accounts, like 401(k) plans or IRAs, cannot be deducted.

Can You Give Me an Example of How It All Works?

Here's an example of how tax loss harvesting can work in a portfolio.

You use $300,000 in cash that you had saved to start a diversified portfolio of exchange traded funds (ETFs). Within six months, one of those ETFs—we'll call it Position A—has gained $10,000 in value. Another ETF—Position B—has lost $15,000 in value.

You decide to sell Position A to lock in your $10,000 gain. You also decide to sell Position B in order to harvest the $15,000 loss.

The gain on Position A and the loss on Position B are both considered short-term because those positions were held for less than one year.

The entire $10,000 gain on the sale of Position A can be offset by $10,000 of loss from the sale of Position B. That still leaves $5,000 of loss generated from the sale of Position B.

The remaining $5,000 loss can be first used to offset any other short-term gains you might have. If you have none, it can be used to offset any long-term gains you might have.

Let's assume you have no other investment gains. Now you and your spouse can use up to $3,000 of the remaining $5,000 loss to offset ordinary income, like your salary, on your joint tax return. The remaining $2,000 of loss can be carried forward and used in another year.

What Are the Benefits of Tax Loss Harvesting?

Although it should be viewed as a way to defer taxes rather than a way to avoid them altogether, tax loss harvesting can have a number of advantages.

First, by deferring taxes you may avoid paying taxes at a higher rate. For example, if you avoid paying taxes during your peak earnings years and then pay them during retirement when your marginal tax rate is lower, you could gain an advantage.

Second, you may generate short-term losses when you tax loss harvest, but ultimately pay taxes later at the lower long-term capital gains rates if you hold your replacement position for more than one year before you sell it.

Third, you may take the tax savings you generate from tax loss harvesting and invest that money so that it grows over time. This allows your tax savings to compound until you must ultimately pay taxes on the gains in your portfolio.

Disclosures

This information is provided for educational purpose. It should not be considered an individualized recommendation or personalized investment or tax advice. You should consult your financial advisor and/or qualified tax advisor in any matters regarding your personal investment or tax situation. Tax laws are subject to change and the impact of strategies like tax loss harvesting on your taxes will be determined by your personal tax situation. All expressions of opinion contained in this document are subject to change based on changes in tax law, investment conditions, and new information.

Investing involves risk, including the risk of loss.