Tax-Loss Harvesting

- By Brandon Rozanski

Losses are an unfortunate part of investing. Unless an investor can time the market perfectly, a well-diversified portfolio will have losses at some point due to the fluctuation of the market. Fortunately, negative returns can have a silver lining: tax-loss harvesting can allow an investor to take market downturns and give them a positive outcome.

Tax-loss harvesting involves the realization of investment losses and uses them to offset capital gains in a portfolio. In the event realized losses are greater than realized gains in a tax year, the IRS allows taxpayers to apply up to $3,000 of losses against ordinary income. Any additional losses are carried forward to the next tax year to offset future ordinary income and/or gains. Tax-loss harvesting can only occur in taxable accounts; tax-deferred and tax-exempt accounts, such as Roth or Traditional IRA's and 401(k)s, are not subject to the capital gains tax and cannot be used to harvest losses to offset gains.

One specific area investors need to pay attention to is the wash-sale rule. The IRS does not want investors buying and selling an asset for the sole purpose of paying less taxes. The wash-sale rule states that a loss will be disallowed if the "same or substantially identical" asset is purchased within 30 days of realizing a loss. A violation of the rule will negate the tax benefits of tax-loss harvesting.

Ultimately, the tax planning strategy should not override the investment strategy for the portfolio. Optimal portfolio allocation should take precedence when considering the idea of tax-loss harvesting. If there is not an appropriate substitute for an investment, it is our view that investment should be held instead of risking performance if the market rewards that investment during the wash-sale period.

It is important to be proactive when implementing a tax-loss harvesting strategy. Market conditions play a major role. A brief sell-off during a bull market can be an opportunity to harvest losses and should be utilized, assuming the investment strategy is not being compromised. Volatility can provide an investor with a chance to recognize lagging investments as loss harvesting candidates and rebalance the portfolio on an ongoing basis. When this tax strategy is executed properly, loss harvesting can help to mitigate taxes without deviating from the investment strategy.

Please feel free to contact us with any questions you may have regarding your particular financial situation and planning needs.

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DISCLOSURES:

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