Harvesting Season for Tax Savings

Global Financial Private Capital

- Using investment losses to offset taxes on gains – a strategy known as tax-loss harvesting – can be an effective way for investors to potentially reduce their tax liability. By minimizing their investment-related tax obligations, investors may be able to improve their after-tax returns.
- Tax management is an important part of long-term financial planning. As we approach the closing months of 2018, investors may want to consider exploring year-end portfolio adjustments that could potentially enhance the after-tax returns of investments held in taxable accounts.

Tax-loss harvesting: What is it?

Most investors are unhappy when their investments decrease in value, and I'm no exception. However, there is a silver lining. By harvesting investment losses, you can offset taxes on gains and income. Let's begin with some basic terms: A **capital gain** is a profit on an investment. There are two categories of capital gains: realized and unrealized. A capital gain is unrealized until you sell it, at which point it becomes realized. The same goes for a capital loss.

Tax-loss harvesting is the practice of selling investments that have fallen in value since they were purchased. The losses are subtracted from any gains realized on other investments that were sold, reducing long-term or short-term capital gains tax. Even if you don't currently have any gains, the harvested losses can be used to offset future gains. Furthermore, if losses exceed gains, the excess losses can be used to reduce ordinary taxable income by up to $3,000 a year.

In addition to reducing tax burden, tax-loss harvesting has the potential to improve returns without adding risk. The concept is not particularly complex, but the execution can be tricky. Thus, it's always recommended to consult a tax professional and financial advisor.

Let's take a brief look at how tax-loss harvesting works, where it is sensible to use it, and the potential benefits.

Not all capital gains are treated equally

For tax purposes, capital gains and losses are divided into short-term and long-term. The Internal Revenue Service (IRS) taxes different kinds of income at different rates. Capital gains, such as profits from the sale of an investment, are generally taxed at a more favorable rate than your salary or wages. However, not all capital gains are treated equally, and the tax rate can vary dramatically between short-term and long-term gains. Short-term capital gains (profits made from selling investments held less than a year) are taxed at a higher rate than long-term capital gains (profits from investments held longer than a year). Short-term capital gains are taxed at the same rate as ordinary income, whereas long-term capital gains are often taxed at a lower rate to encourage long-term investing.

In other words, tax-loss harvesting can have a bigger impact if you are invested in strategies that see higher turnover and thus more short-term gains.

Tax-loss harvesting: how does it work?

When your investments rise in value, you are subject to taxes on the money you make once you sell the investment. It doesn't matter whether the investment rises in value during your holding period. The key for tax purposes is when you sell the investment, which triggers the taxable event. During market declines, investors can check their taxable accounts for opportunities to harvest losses. It's important to note that tax-loss harvesting does not apply to IRAs or other tax-sheltered accounts.

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Let's look at an example: Jane is in the 20% tax bracket. At the beginning of the year, she bought $100,000 of Investment A and B, each in her taxable account. Further, let's imagine that as of today, Investment A is worth approximately $90,000, while Investment B is worth $110,000. To tax-loss harvest, Jane would sell Investment A, thereby recognizing a $10,000 capital loss, and use the $10,000 capital loss to offset the capital gains she realized on the sale of Investment B. Additionally, had Jane's capital losses exceeded her capital gains for the year, she could use up to $3,000 of her net capital loss to offset ordinary income, thereby reducing her income tax by $600 (i.e., $3,000 x 20%). If she has remaining capital losses after that, they can be carried forward to be used in future years (subject to the same limitation).

Important considerations

The IRS does have a rule in place to prevent people from gaming the system. Known as a "wash sale," the rule states that investors cannot buy and sell the same investment, or a substantially identical one, within the 30-day period before or after the trade simply to take advantage of the tax loss. Thus, the loss harvested from a wash sale can be disallowed for tax purposes. Finally, as capital gains tax rates move up and down in the future, the effectiveness of the strategy is primarily based on the benefit within each investor's tax bracket.

Conclusion

Tax-loss harvesting is often an underappreciated strategy. For investors with a diversified portfolio, capital gains and losses are triggered as various portfolio managers within each of their selected strategies buy or sell holdings that have appreciated or depreciated in value. Investors share the tax burden in the same calendar year that the net gains or losses were realized. Tax-loss harvesting requires identifying which portfolio holdings appear likely to distribute net capital gains before the end of the year while also finding holdings that are likely to sustain losses. Typically, near year-end, asset managers provide notices to shareholders to aid in year-end tax planning. Tax-loss harvesting and portfolio rebalancing often go hand in hand. In addition to keeping your portfolio aligned with your goals, periodic rebalancing provides an opportunity to re-examine lagging investments that could be candidates for tax-loss harvesting. Now is an opportune time for investors to review their financial plans with their advisors and explore how to maximize tax efficiency.

Of course, there's no guarantee that tax-loss harvesting will achieve any particular tax result, or that it will be in an investor's best interest over the long run. It's also important to note that tax considerations should not outweigh investment merits. An investment strategy should always be based on one's financial goals, risk tolerance, and a variety of other factors – not simply tax considerations. Before implementing any tax strategy, it's always best to check with your tax accountant and financial advisor.

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