

Taking Advantage of Tax-Loss Harvesting

There can be tax benefits to selling securities that have underperformed – if you're thoughtful about it.

If you want to minimize next year's tax obligations, optimizing your finances *this* year is a good place to start. But there's more to year-end tax planning than complex approaches to estate planning or charitable giving – portfolio maintenance strategies like tax-loss harvesting could help you realize significant benefits come next year's Tax Day. To understand how tax-loss harvesting can work for you, it's helpful to understand how sales of investments are taxed.

INVESTMENTS AND CAPITAL GAINS

Building wealth through investing is primarily a question of appreciation: You purchase a stock, bond or mutual fund for a certain amount (known as its *cost basis*), with the hope that it will appreciate over time before it's sold. The tax implications from that sale will depend largely on two criteria:

• *Did the sale result in a profit or a loss?*

If you were to sell that investment for more than its cost basis, you would

have a *capital gain*, while if you were to sell it for less than its cost basis, you would have a *capital loss*.

• *How long did you own the investment?*

If you held that investment for one year or less before selling, it's a *short-term* capital gain (or loss), while if you held it for longer than one year, it's a *long-term* capital gain (or loss).

The length of time you held an investment is important due to the difference in tax rates: Short-term capital gains are taxed at your ordinary tax rate, while long-term capital gains are typically taxed at a 15% tax rate (20% for higher income-earners, 0% for very low-income taxpayers). Typically, long-term capital gains are taxed at a lesser rate than ordinary income.

THE BENEFITS OF TAX-LOSS HARVESTING

Unfortunately, not every investment will appreciate, and whether it's due to a broad market decline or the financial troubles of an underlying company, you might have to decide whether to stay the course with that

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poor performer or sell it. Should you decide to sell, though, you can use tax-loss harvesting to lower your tax liability:

- By selling your portfolio's underperformers, you can use your capital losses to offset your capital gains and reduce your overall tax liability.
- If an overall net capital loss still exists, you can then deduct up to \$3,000 against your ordinary income.
- If you still have unused capital losses after applying that \$3,000 to ordinary income, you can carry forward the remainder to use in future years.

(Note that tax-loss harvesting is best used as a strategy to take advantage of investments that happened to not be profitable. Any decision to sell a security should be primarily based on its investment merits, with its tax considerations being a secondary concern.)

TAX-LOSS HARVESTING IN ACTION

Let's say you're a single tax filer with \$100,000 of wage income and you own two stocks: Your Acme Corp. stock is worth \$10,000 more than you paid, while your Boffo Inc. stock is worth \$10,000 less than you paid. At this level of income, if you sold Acme, you would realize a long-term gain that would create a \$1,500 tax bill. However, if you sold Boffo as well, you could take advantage of that harvested tax-loss to offset the Acme gain and reduce the net tax liability to \$0.

But now let's say the long-term capital loss on Boffo was even higher, at \$13,000. In this case, not only could you offset the entire long-term capital gain from Acme, but you could use up to \$3,000 of the remaining loss to offset other income. For someone with \$100,000 of wage income, this results in a tax savings of approximately \$720.

The holding period is critical to keep in mind: Under current tax law, 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. Once you've come to a net short-term and net long-term position, only then can a net loss in one category be used to offset a net gain in the other. If you're thinking about selling profitable securities that result in a long-term capital gain but have already realized short-term losses from previous sales, you might

be better served holding off on the long-term gain and using up to \$3,000 of that short-term loss instead to offset ordinary income. That ordinary income is taxed at a higher rate than long-term gains, meaning the tax savings will be greater. Any unused capital losses after applying \$3,000 to ordinary income can be carried forward to future years.

This strategy can benefit any investor who has sizable capital gains in a given year, as well as anyone who has avoided rebalancing their portfolio for fear of triggering taxable gains. In particular, investors whose modified adjusted gross income exceeds \$200,000 (\$250,000 for a married couple filing jointly) might use tax-loss harvesting to reduce their exposure to the net investment income tax, a 3.8% tax on most types of investment income, including capital gains.

BEWARE THE WASH SALE RULE

One final caveat: Wash sale rules prevent you from deducting a capital loss if you replace what you sold with the same or a "substantially identical" investment within 30 days before or after the sale. Instead, the loss would be added to your cost basis in the newly acquired asset and would provide a tax benefit when that replacement position is eventually sold. This is to prevent people from harvesting a depreciated stock for a tax deduction while remaining in the same investment position they were before the sale. The wash sale rule can be avoided by buying a comparable, but not identical, security that you anticipate having similar performance. This way, you can benefit from the realized loss while still allowing your investment portfolio to experience similar growth.

As you can see, the rules surrounding tax-loss harvesting can get tricky, so be thoughtful before executing this kind of strategy. Your Baird Financial Advisor regularly works with clients' attorneys and tax professionals to ensure all aspects of wealth management are addressed and would be happy to help determine if this strategy is right for you.

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