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Investing Essentials – Tax Harvesting

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(flicker)

har-vest

verb
gerund or present participle: **harvesting**

- **collect or obtain (a resource) for future use**
  "the research teams are leading the way in identifying new ways of harvesting the sun's energy"

(source; google dictionary)

As 2018 draws to a close, many of our Lakeview clients will be reviewing their portfolios with their advisors and positioning them for the future. In addition to rebalancing allocations, reviewing managers/mutual funds/ETFs or otherwise adjusting a portfolio, there is something else to consider before year's end. It's a tax strategy called tax-loss harvesting, and it could reduce your current tax bill.

"It takes as much energy to wish as it does to plan." – Eleanor Roosevelt

Annual tax planning should be a part of everyone's calendar. Due to climbing markets, tax planning hasn't involved as much tax loss harvesting in the last few years, but it is time to put it back on the agenda. Although none of us like the idea of losing money, most well-diversified portfolios will usually contain some investments that have indeed lost value, at least over the short term. But with tax loss harvesting, you can at least make a plan to get a tax benefit to help offset some of your losses. Tax harvesting involves selling an investment at a loss in order to generate capital losses that you can write off on your tax return. By realizing or "harvesting" the loss, investors can offset taxes on both gains from other investments and on a limited amount of income (typically up to $3,000/year).

The key to an effective harvesting strategy is to work with your adviser and/or financial planner to evaluate what you own and why you own it, identify investments that have a loss, and then consider the sale of some portion of those holdings to offset realized gains, expected future gains, or even income. Your adviser will be there to make sure that the portfolio doesn't stray from the target investment mix and diversification strategy. Also, because evaluating and managing the tax consequence of your investment decisions can be tricky, its always a good idea to have your tax professional involved in the discussions as well.

The Short and Long of it…

As most investors are aware, there are two types of capital gains/losses; short-term and long-term. Short-term capital gains and losses are those realized from the sale of investments you have owned for less than one year. Long-term capital gains and losses are realized after selling investments held longer than one year. The key difference between the short and long-term gains is the rate at which they are taxed.

Short-term capital gains are taxed at our client's marginal tax rate on ordinary income. After the Tax Cuts and Jobs Act of 2017 (public law code 115-97), the top marginal federal tax rate on ordinary income is 37% (down from 39.6%). For the tax year 2018, it applies to couples filing jointly with income above $600,000, and single taxpayers with income above $500,000. In addition, in 2013 (under IRS code Section 1411) a new levy on capital gains and income was created to help pay for the health care reforms that were enacted in 2010. This new levy is called the net investment income tax (NIIT). For those subject to the NIIT, which is 3.8%, the effective rate can be as high as 40.8%. Add in state and local income taxes and rates can be even higher.

2018 Adjusted Gross Income					
Income Tax Rate	Single	Married, Filing Jointly	Rate on Long-Term Capital Gains and Qualified Dividends	Single	Married, Filing Jointly
10.0%	$0-$9,525	$0-$19,050	0.0%	$0-$38,600	$0-$77,200
12.0%	$9,526-$38,700	$19,051-$77,400	15.0%	$38,601,425,800	$77,201-$479,000
22.0%	$38,701-$82,500	$77,401-$165,000	20.0%	$425,801 and above	$479,001 and above
24.0%	$82,501-$157,500	$165,001-$315,000			
32.0%	$157,501-$200,000	$315,001-$400,000			
35.0%	$200,001-$500,000	$400,001-$600,0000	Investment Surtax Rate		
37.0%	$500,001 and above	$600,001 and above	3.8%	$200,000	$250,000
www.skloff.com					

(Source: www.skloff.com)

Long-term capital gains are a little easier to calculate. The current rate for long-term capital gains is 20%, but if you add in the NIIT, that rate can climb up to 23.8%.

"Maximus" or maximize, whichever works

Since we are fans of the movie Gladiator – the analogy of "slashing your tax liability like Maximus" makes sense to us. For those who haven't seen the movie, then let's just stick to *maximizing your tax-efficiency.*

In an attempt to maximize your potential tax savings, your adviser and CPA are likely to recommend applying as much capital loss to your short-term gains as possible, because they are taxed at a higher marginal rate. So, when your looking for tax losses, focusing on short-term losses provides the greatest benefit because they are first used to offset short-term gains. According to the tax code, short and long-term losses must be used first to offset gains of the same type. But if your losses of one type exceed your gains of the same type, then you can apply the excess to the other type (for more information, contact your CPA).

If you own mutual funds at Lakeview or other firms, you are likely going to receive distributions from the mutual funds. Your Lakeview advisor will be able to tell you what type of distribution you are receiving (short-term or long-term). These gains may also be eligible to be offset by losses from the sale of other investments.

Since interest rates have moved higher in 2018, clients should speak to advisors about maximizing the mark-to-market (MTM) losses that clients may see in their bond portfolio. You may have a great opportunity to sell those positions and potentially purchase another bond (of similar credit quality) with a higher book yield. In 2016, the Financial Analysts Journal wrote a paper on the mathematical reasons' investors should harvest both taxable and tax-free (municipal bonds).

(Source: Schwab Center for Financial Research)

Lastly, when maximizing tax harvesting, it may mean that you realize a capital loss even if you didn't realize a capital gain for 2018. As the illustration (above) shows, thanks to the capital loss tax deduction (one of the few deductions not to be taken away from ordinary tax-payers) and carryover provisions, the tax code allows you to apply up to $3,000 a year in capital losses to reduce ordinary income. If you still have capital losses after applying them first to capital gains and then to ordinary income, you can carry them forward for use in future years.

Issues

As parents, Beth and I both understand that our older children think we have issues because we are no longer "cool" in their eyes (we beg to differ). But the one area none of us want issues is with the Internal Revenue Service (IRS).

We at Lakeview believe investors would be well suited to work with their Lakeview adviser and their CPA in order to avoid the improper use of tax-harvesting. Wash-sale rules and cost basis accounting can take a well-organized plan and turn it into a nightmare with your local IRS agent.

Like any strategy, tax harvesting is just that, a strategy. Whether and to what extent you use this tactic should be governed by your overall financial planning and investment goals. Selling holdings that fit your overall long-term investment plan to realize a short-term loss might not be the best move. That said, if you can work this strategy into your typical portfolio rebalancing, it can be an excellent way to manage your investments in a tax-efficient manner.