

Tax Loss Harvesting

One upside to the decline in the markets is the opportunity to utilize tax-loss harvesting strategies

Investment Solutions & Financial Planning
Baird Private Wealth Management

WHAT IS TAX LOSS HARVESTING

Tax-loss harvesting is the selling of securities at a loss with the intention of using these losses to offset current and future capital gains. Before diving into this strategy further, it is important to review the basics of taxation on selling securities. When you sell a security, whether it be an individual stock, bond or pooled investment like a mutual fund, the difference between what you paid (i.e. your basis) and what it sells for, usually results in a gain or a loss. Also important is how long you've owned the security – anything under one year, will be considered short-term, and anything over is considered long-term. Short-term capital gains are taxed at an individual's marginal ordinary tax rate, while long-term capital gains are taxed at a 15% (or 20% for higher income-earners) tax rate. This means that it can be more favorable to hold an investment for greater than 12 months to take advantage of the preferential rates. When filing an individual tax return for a given year, any capital losses are first used to offset any capital gains. If an overall net capital loss exists, you can deduct up to \$3,000 against your ordinary income.

WHY NOW

After over a decade of increasing market valuations, we now see volatility in our investment values. Many are experiencing a significant drop in value of the positions that they own. To be clear, losing money on an investment, at the surface, is not a good thing. However, we can use that loss to reduce our overall liability on other winning investments, while still putting the proceeds to good use in other investments. For example, consider a single individual with \$100,000 of wage income, and two stocks: A with a \$10,000 long term gain and B with a \$10,000 long term loss. At this level of income, when the individual sells stock A, he or she would owe \$1,500. With tax loss harvesting, he or she could sell stock B, and reduce his or her capital gain tax liability to \$0, only paying taxes on the ordinary wage income. Consider an identical scenario, except where the long term loss on stock B is \$13,000. In this case, not only can we net against the capital gain from A, we can also use up to \$3,000 of the remaining loss to offset our ordinary income. For someone with \$100,000 of wage income, this results in a tax savings of approximately \$720! (\$3,000 times their ordinary marginal tax bracket)

In the previous examples, we've simplified the netting process to explain the fundamentals of tax loss harvesting. The time period that you hold the securities is also important to consider, because short term loss must first offset short term gains, and the same goes for long term gains and losses. In a situation where you have harvested short-term losses but have unrealized long-term capital gains on securities you are considering selling, it may be best to hold off on doing so as to prevent using the short-term (and more valuable) loss against an income type taxed at the lower 15% or 20% rate. Any unused capital losses after applying \$3,000 to ordinary income can be carried forward to use in future years.

WHO ARE CANDIDATES FOR LEVERAGING THIS OPPORTUNITY

At a basic level, any investor with sizable gains might consider harvesting losses from their other positions where available. This can also be an opportune time for those who are looking to rebalance, especially where a large gain may have prevented them from selling in the past. Individuals might also consider the *type* of securities they hold, and consider if now is the time to change that, while losses are available. For example, you may have bought a mutual fund 10 years ago, and may now decide it is not the most tax efficient investment; however, the tax consequences of selling in a flourishing market had been quite daunting with the large capital gains tied to them. The market decline provides you with an opportunity to re-position your portfolios without extreme tax consequences.

In determining the diversification of an investment portfolio, many investors avoid the purchase of premium bonds. A premium bond is a bond which trades above its face value. Investors typically shy away from these since it is an immediate loss on the date of purchase; however, these bonds typically yield higher interest rates. One attribute that many investors overlook is the fact that taxpayers can offset their interest income by making an election to amortize the bond premium over the remaining life of the bond. This puts the individual in a better tax situation while still yielding them the increased interest income potential.

Lastly, clients with large investment income during the year, particularly those with Charitable Remainder Trusts (CRT), or those whom trustee a CRT, may look to harvest capital losses as a way to reduce exposure to the Net Investment Income surtax. In short, there is a 3.8% surtax assessed on certain types of unearned investment income (e.g. dividends, rent and royalties, taxable interest and capital gains) once modified adjusted gross income exceeds \$250,000 for a married couple filing jointly (\$200,000 for single or head of household filing status). For trusts or estates, this income threshold is much lower and applies when there is undistributed net investment income (accumulation trusts). In harvesting losses, you can keep the capital gain income lower, with the potential to offset the other types of investment income up to \$3,000 during the tax year.

CONSIDERATIONS AND NEXT STEPS

When using tax-loss harvesting strategies, it is important to be cognizant of the wash sale rule. The wash sale rule states that if a security, or substantially identical security, is purchased 30 days prior to or 30 days after the date the security is sold, the loss generated from the sale cannot be utilized for tax purposes. Instead the loss is added to your basis in the newly acquired asset. The wash sale rule can be avoided by buying a comparable asset that you would anticipate having similar performance. By doing this, you can benefit from the realized loss while still allowing your investment portfolio to experience similar growth. Investors also should be mindful of the type of replacement security they are considering. As a rule of thumb, avoid swapping out securities that track the same index— by their very nature, index funds are meant to replicate the same investments at the approximately the same weight, and as such, they can be viewed as substantially equal. The wash sale rules also apply across different accounts and different account types. For example, if you sell a security at a loss in your taxable account and buy it back in your IRA, the loss will be disallowed. This is especially ill-advised, because the intention of repurchasing is often to capture the upside, and when this happens in an IRA, or other pre-tax account, the loss is effectively gone forever. If you opted to buy back in taxable account within the 30 day window, you've simply deferred the loss by adding it to the basis of the new shares, but any sale and distribution with an IRA is taxed at ordinary marginal rates, instead of the preferential long term capital gains rate.

To determine if this strategy is right for you, contact your Baird Financial Advisor.