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INVESTING

Tax Loss Harvesting

Even portfolios with big gains will likely have some positions that have taken losses over the course of the year. Though a loss may be hard to look at, there is a strategy that allows you to gain a tax benefit from **an investment loss.**

Tax loss harvesting is a strategy that takes your current investment losses and uses those to reduce your tax bill for the year. The strategy attempts to do this without disrupting your asset allocation. In short, you can take some of your investing lemons and make lemonade.

The Tax Benefit

Tax loss harvesting allows you to use current, taxable investment losses to pay less in taxes now and defer taxes on capital gains and income. When you realize a capital loss (by selling the position), you can offset capital gains you've realized for the year on your tax return. If you have a net loss, you are allowed to offset up to $3,000 of income. If you still have excess losses, those are carried forward onto future tax returns.

When you sell a security but repurchase shortly after, you are effectively trading paying taxes now for paying them later. The reason has to do with your cost basis in the security. For instance, if you purchase a single stock for $100, your initial cost basis in the security is $100—the amount you paid for it. Then, when you sell and repurchase it for $80, your cost basis becomes $80 rather than $100. Let's say the stock then increases to $150. Without tax loss harvesting, you would be paying capital gains on $50 dollars of gains ($150 minus $100). With tax loss harvesting, you get an initial tax benefit, but then pay taxes later on $70 ($150 minus $80) worth of gains.

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For many, there is great value in deferring taxes on their investments. Generally, money now is worth more than money later because you have the power to invest it. Furthermore, many people anticipate being in a

lower tax bracket in the future because they will be earning less or will be in a more advantageous tax situation for other reasons. In these cases, it makes sense to defer taxes so that you can pay them at potentially lower rates.

The Strategy

Tax loss harvesting goes beyond a simple sell strategy and attempts to take losses in your portfolio while not significantly disrupting your overall investment strategy. To do this, you would sell a security to capture the loss, then buy the same amount back shortly after in order to return to your original position. For example, if you originally purchased one share of stock for $100 and it is currently worth $80, you would sell the stock, taking a $20 loss, and then buy one share of stock shortly after, likely at a similar price. This gives you the capital loss for tax purposes, but then returns you to your original position in your portfolio.

In the meantime, however, you will have been out of the position you sold, so you may have missed out on potential gains made during that time. To alleviate this issue, an additional step would be to invest in a different, but correlated investment during the 30 days you are not invested in the sold position.

Avoiding Wash Sales

You must wait 31 days to repurchase a security after selling it due to the IRS wash sale rule, which disallows a loss on a "substantially identical" security purchased 30 days after or before the sale. This means that purchasing the same security you just sold within 30 days would violate the rule. As a result, the safest way to avoid a wash sale is to simply repurchase the stock 31 days later without replacing it in the meantime.

If you are going to replace the sold security with another during those 30 days, it's best to be cautious when choosing a replacement security. For instance, if you sell an S&P 500 index fund and replace it with another S&P 500 index fund from a different company, it is possible you may have violated the wash sale rule. The IRS does not clearly define a "substantially identical" security and hasn't issued any guidance on this specific example, but it would be a risky move nonetheless. Work closely with your financial advisor and accountant to determine the best course of action.

Risks

Because tax loss harvesting is not an exact science, there are risks to be aware of. One is that if you use the strategy to effectively defer paying taxes, there is a chance that your tax situation in the future may not be as favorable as it is now. Whether it's because you are earning more than expected or because future tax law changes will increase tax rates, a less favorable tax situation can mean paying more in capital gains taxes rather than less. While no one can tell the future, it's best to discuss this issue with your financial planner and accountant.

Another issue that can arise is due to switching to a temporary investment during the 30 days after you harvest your losses. If the temporary investment gets significant gains and is then sold, you'll be subject to short-term capital gains, which are taxed at higher rates than long term gains. Granted, you'll receive a net benefit from selling at a gain, but it would mean a higher tax bill for the year. Of course the opposite result is possible as well; that the temporary investment drops, creating greater losses.

Tax Gain Harvesting

While tax loss harvesting is helpful when you want to reduce the impact of a large tax bill, tax gain harvesting can be helpful when your tax situation is unusually good. The same general principles apply but in reverse. You would sell the security to realize gains for the year and then repurchase the security to be in the same position but with a higher cost-basis. You will pay less in taxes later because of the higher cost basis but will pay them this year when your tax situation is potentially more favorable. One major difference is that there are no "wash sale" rules for realizing gains. You may repurchase the security immediately after selling.

Ultimately, tax loss and gain harvesting can be powerful strategies when used well. However, there are risks involved, and because the future is unpredictable, the strategies may not end up being as effective as you intended. Talk to your advisor before implementing a plan to see if it makes sense for you.