Tax Loss Harvesting 101 and Managing Tax Liabilities

Learn why some investors may choose to apply the practice of tax-loss harvesting when individual securities experience price volatility.

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For many individuals, the ultimate goal of investing is to earn positive returns; rarely, if ever, will an investor seek investments for the express purpose of incurring losses. However, given that in the short term individual securities may experience price volatility which could lead to a short-term decrease in valuation, some investors may choose to apply a practice commonly called tax-loss harvesting.

Tax-loss harvesting is a practice wherein an investor will sell a security which has decreased in value from when they initially purchased it and, in doing so, incur a capital loss. Subsequent to the sale of this asset, the investor will use the cash from the sale of their security to purchase a similar asset to the one that they just sold (similarity can be defined in many ways, including asset class, risk, or geographic exposure). By taking this two-step approach, the investor may retain their original portfolio strategy while also realizing a capital loss, which can help offset capital gains and reduce taxes. A word of caution is necessary here. It is important when using this strategy to avoid triggering the "wash sale rules" which (if triggered) can limit the investor's ability to use the loss realized on the sale of an asset.

While tax loss harvesting may seem relatively complex, by working with an advisor an individual may be able to attain their goals sooner than they would without tax-loss harvesting because of the compound impact of reducing tax liabilities over time. We recommend that investors consult with a tax professional whenever considering the implications of an investment strategy on their unique financial situation.

> A capital loss, which is the opposite of a capital gain, occurs when an investor sells an underlying asset at a price which is lower than the cost basis at which it was purchased. These losses may be highly valuable to investors because they can be used to offset tax liabilities that are caused by profits from the sale of other capital assets, dividends, and a limited amount of ordinary income.
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> Capital losses can be carried forward by investors such that if an investor does not use all of the capital losses incurred in the current tax year, they maybe be able to use them in subsequent years. It is important for investors to work with investment and tax advisors as they consider how capital-losses may affect their personal financial situation

To illustrate this concept, consider the following two circumstances which show the power of tax-loss harvesting (assume that all assets have been held for at least one year):

> Jane starts the year with an investment portfolio valued at $1 million. During the course of the year, the financial markets experienced some short-term volatility and the value of her investment portfolio at one point had fallen by 10%, leaving her portfolio at a value of $900,000. Jane's investment advisor helped Jane to capitalize on this short-term volatility by selling the individual securities which had contributed to the $100,000 reduction in her portfolio value, thereby generating a $100,000 long-term capital loss for Jane. Further assume that Jane reinvested the proceeds of the sale in similar assets to those that had been sold and did not trigger the wash sale rules. After Jane's advisor rebalanced her portfolio, the market rebounded and Jane's portfolio increased in value by 17%. Through the course of the rebound, Jane's advisor actively managed the portfolio — which generated $50,000 in realized long term capital gains — and left her portfolio at the end of the year with a value of $1.05 million When it came time for Jane to file her tax return, she did not owe any capital gains tax on her portfolio because she was able to utilize $50,000 of her $100,000 long-term capital loss to use against her $50,000 capital gain. Jane also now has $50,000 in capital losses that she is able to carry forward to subsequent years for future use against capital gains or (to a limited extent) ordinary income.
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> Now consider a different investor: John. Like Jane, John also has an investment portfolio that started the year at $1 million, which subsequently lost 10% at one point in the year. However, unlike Jane, John did not sell any of the securities that lost value in the course of the year, but did make changes to his portfolio as it recovered 17% throughout the remainder of the year. These changes resulted in $50,000 of long-term capital gains and left John's portfolio value at the end of the year at $1.05 million, just like Jane's portfolio. When John prepared his tax return he owed $7,500 in capital gains taxes ($50,000 in capital gains multiplied by the 15% long-term capital gain tax rate assumed for purposes this example).

Jane and John had similar results in how their portfolios declined and then regained value. Their portfolios ended with the same value, but since Jane's advisor proactively harvested losses during the year, her after-tax return on her portfolio was actually higher (5.0% for Jane versus 4.25% for John). She also created a future tax benefit in the form of the deferred capital loss that she will be able to use in the future.

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Conclusion

There are many different technical considerations to take into account when considering how to utilize a tax-loss harvesting strategy (including timing of asset sales, asset-class allocations, and investment selections). By partnering with an advisor to undertake tax-loss harvesting, investors can increase the likelihood of achieving their financial goals by managing their tax-liabilities in the context of their unique financial situation.

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