CREATIVE financial group

INSIGHTS

FINANCIAL PLANNING

What Is Tax-Loss Harvesting?

What You Need to Know About the Silver Lining of Portfolio Losses

THE BIG PICTURE

It's the nature of investing: Some of your investment choices can lead to significant financial reward, but others won't perform as hoped. But there's a silver lining when securities lose money: a strategy called tax-loss harvesting. Tax-loss harvesting is the practice of selling a security that has experienced a loss to offset taxes on investment gains and income.

This means that once you sell an underperforming security, you can use that loss to help offset investment gains, on a dollar-for-dollar basis, resulting in lower taxes.

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Tax-loss harvesting applies to any taxable, non-retirement investment accounts. IRAs, 401(k)s, annuities, and other non-taxable accounts don't qualify.

If you don't have gains in a tax year, you may be able to bank your losses from that year and use them against gains in the future. For example, the losses that investors incurred in the 2008 financial crisis could be offset against gains realized in the following, more lucrative years. In addition, if losses exceed gains, they may be able to also be applied to reducing taxable income by up to $3,000.

Tax-loss harvesting can help investors save substantial amounts of money on taxes. However, it's a strategy that your financial advisor, investment advisor, and accountant should be coordinating and executing together.

How it works

It is important to keep an eye on your gains and losses throughout the year with tax-loss harvesting in mind. Often, this strategy is implemented near the end of the calendar year. Come fall, it is time to make decisions about selling and consider, given your investment strategy and the performance of your portfolio, which gains and losses to realize. Criteria for which securities to sell include those that no longer fit your investment strategy and stocks you believe have limited future potential. This review is also an ideal time to consider rebalancing your portfolio, ensuring that you remain aligned with your asset allocation strategy.

If you don't show gains for that year, realizing a loss may still be beneficial. Up to $3,000 can be applied to reducing your taxable income, and you can apply losses against future gains.

Realizing losses may be a sound strategy, but don't let the tax strategy override your investment strategy. If a security is generally a good stock but shows a loss due to short-term trends, selling it solely for tax purposes may not be your best choice. This fact occasionally gets overlooked by investors who practice tax-loss harvesting on their own.

Terms to Know:

- **Realizing a loss or a gain** means to sell an asset either below or above its original price. Prior to a sale, the loss or gain is unrealized.
- **A long-term security** is one that an investor holds for at least a year and a day after purchase.
- The **Net Investment Income Tax** is a 3.8% tax that applies to taxpayers with an adjusted gross income of over $250,000.

Who should consider tax-loss harvesting?

Any investor, from long-term portfolio holders to day traders, can benefit from tax-loss harvesting. But there are some groups of people who might find it especially advantageous.

High net worth individuals

Individuals who fall into the highest income tax bracket pay a capital gains tax of 20% on long-term holdings. They are also required to pay a 3.8% Net Investment Income Tax. For short-term gains, the tax rate can be as high as 41.7%%. Using their portfolio's losses to offset this tax rate can save them significant amounts of money.

New retirees

When people enter retirement, they are likely drawing down on assets they've accumulated over the years. That can lead to significant realized gains. If they have losses to offset those gains, they'll save on taxes.

Asset liquidators

Anyone liquidating portions of their portfolio to pay for a large expense (such as a wedding, college tuition, or vacation home) can use losses to reduce their capital gains payments.

The pitfalls of tax-loss harvesting

Working with a financial advisor, an investment advisor, and an accountant can help investors avoid some of the following pitfalls while executing a tax-loss harvesting strategy.

Misconceptions about growing portfolios

Investors who operate on their own may lose out on opportunities. They may look at their account value and, because it's up, think they don't have losses to harvest. In reality, they may have losses amongst the gains they can take advantage of. Independent investors may also end up losing track of prior years' losses and miss out on tax reduction opportunities.

The wash rule

When you sell a losing security, you may want to buy some of it back because you believe it has a good chance of growing in the future. However, the wash rule dictates that you must wait 30 days, or you won't be allowed to use that loss. In the meantime, you might consider a purchase of a similar but not identical security.

Trading fees and commissions

Trading fees can add up when you're doing a lot of buying and selling. You may want to seek guidance on the most cost-effective ways to harvest losses while minimizing trading fees and sales loads.

The holistic approach

Being a tax-aware investor does not mean solely focusing on tax optimization. It does mean understanding the tax implications of your investment decisions. Contact CREATIVE today to learn more about smart tax management practices.

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