# Making Lemonade Out of Losses: Tax-Loss Harvesting

### KEY TAKEAWAYS

- An investor can opportunistically sell investments that have lost value to lower both capital gains and ordinary income taxes.
- Tax-loss harvesting provides an opportunity to lower taxes and rebalance an investor's portfolio for future growth potential.
- When purchasing new securities after tax-loss harvesting, be mindful of the IRS wash sale rules which eliminate tax savings if an investor purchases the same or "substantially similar" security within 30 days.

## In an ideal world, each stock in an investor's portfolio would increase in value every year.

But in reality, we know that some investments will have declined in value at any given point in time. When this happens, an investor may be able to turn a negative into a positive through a technique called tax-loss harvesting. When the value of a stock decreases below the value at which it was purchased, an investor can sell those shares at a loss. That loss can be used to offset ordinary income or capital gains on other investments that are subject to taxes.

Opportunities for tax-loss harvesting can arise throughout the year, including during periodic portfolio rebalancing, strategic portfolio adjustments, or during market downturns. By implementing an effective tax-loss harvesting strategy, an investor's tax savings can instead be invested in the market, creating the potential for portfolio growth.

## Lowering Your Tax Bill

When a stock falls below its purchase price, it is considered "paper" loss on an investor's account statement which typically has no impact on the investor's taxes. If the investor then sells that stock that has declined, they can convert the paper loss into an actual, or realized, loss. Through this process of "harvesting" losses, an investor can potentially lower their tax bill. Here's an example.

- Let's assume an investor buys stock A for $100. Over the next few months, stock A more than doubles in value to $250. The investor then sells the stock, generating a capital gain of $150.
- At the same time, let's also assume the investor buys stock B for $100. Later, the the stock drops in value to $50. By selling the stock, the investor generates a loss of $50.

- The $50 capital loss can now be offset against, or subtracted from, the $150 capital gain. Therefore, the investor only has to pay capital gains taxes on the $100 net gain.

- Assuming the investor’s capital gains are taxed at 20%, the tax bill would be reduced from $30 to $20.

In addition to offsetting capital gains, harvested losses can also be used to offset up to $3,000 of ordinary income when filing a joint tax return or $1,500 for single tax filers. Even if an investor doesn’t currently have any realized capital gains to offset, they still might want to consider tax-loss harvesting today because they can carry over any unused investment losses to offset future gains.

### WITHOUT TAX-LOSS HARVESTING


### WITH TAX-LOSS HARVESTING


## Types of Capital Gains

There are two types of capital gains and losses: short-term and long-term.

Short-term capital gains and losses apply to investments that an investor has owned and sold within one year or less. Short-term gains are taxed at the same rate as ordinary income. For many investors, the short-term capital gains rate is significantly higher than the long-term capital gains rate.

Long-term capital gains and losses apply to investments sold after at least one year of ownership. The long-term capital gains tax rate is much lower than the short-term rate. If an investor falls into a high-income tax bracket, they can decrease the amount of taxes owed on any profits generated from selling a security by ensuring that they have held the security for at least one year.

According to the tax code, losses must first be used to offset gains of the same type - e.g. short-term losses are first used to offset short-term gains, and long-term losses are first used to offset long-term gains. But if an investor’s short-term losses exceed their short-term gains, the excess can be applied to long-term gains, and vice versa.



1. Assuming a 20% capital gains tax rate.

## Reinvesting Wisely & Improving Your Portfolio

Investors can also use tax-loss harvesting as an opportunity to upgrade their portfolio. Selling investments that have declined in value frees up funds to reinvest in new securities that may be more aligned with current goals. In this way, one can use a volatile market to their advantage. A financial advisor can help identify new investments that will:

- Fit an investor's individual financial objectives and risk preference (target asset allocation)
- Be appropriate for each account type (taxable, tax-deferred, qualified tax-free)
- Capitalize on favorable valuations and minimize less attractive valuations
- Reflect changing financial conditions and economic outlook
- Position their portfolio for long-term growth

When selling current holdings to buy new securities, investors should be mindful of IRS wash-sale rules. These rules eliminate the tax savings associated with tax-loss harvesting when an investor sells a stock at a loss and purchases the same stock or a "substantially similar" stock within 30 days. This rule applies not only to an investor's personal investments, but also those owned by a spouse or a company owned by the individual investor. Consult a financial professional or tax advisor for guidance on specific situations.

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