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Determining If Tax-Loss Harvesting Is Right for You

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

So far this year the markets are broadly down. You likely have unrealized losses in your portfolio. Tax-loss harvesting may be a strategy to consider, but harvesting those losses now could have a negative outcome in the long run. The strategy depends on tax bracket arbitrage: your tax bracket at the time of realizing the loss versus at the time of realizing the future gain.

How Harvesting Works

Realizing capital losses in a year when you have capital gains to offset them can generate current tax savings. Harvesting the loss for tax purposes means selling the investment in order to take the loss and then purchasing the investment back again (more on the wash-sale rules to come).

Example

An investment was originally purchased for $20,000 but is now down 25% to $15,000. Harvesting generates a $5,000 capital loss. Assuming that there are current capital gains to offset that loss, harvesting will produce a $750 tax savings at a 15% long-term capital gain rate.

Let's say you take the $15,000 and purchase another investment. When the new investment eventually recovers to the original $20,000 value, the investor will face a future recovery gain of $5,000. If that is taxed at the same rate in the future, the net value is the same. There is an additional increase in value for being able to use the $750 tax savings now, by using it or investing and growing it, compounding over time.

Tax Impact of Harvesting a $5,000 Loss and Liquidating the Subsequent Gain at the Same Tax Rate

	Capital Gains Tax Bracket	Realized Amount	Year-End Tax Savings/ Liability	Net Tax Reduction
Year 1 Capital Loss	15%	$5,000	$750 Savings	
Year 2 Capital Gain	15%	$5,000	$750 Liability	$750 – $750 $0

Wealth can be created from the reinvested tax savings. If the investor is in a higher tax bracket in the future when the recovery gain is realized, the tax benefit may be smaller. Benefits are greater if the market decline is larger, which produces more losses to harvest and more tax savings generated in the first place. Benefits are also greater if subsequent returns are higher, allowing more compounding on the tax savings. Conversely, with smaller market declines, lower tax rates and lower returns, the benefit of tax-loss harvesting is diminished. This example does not include a discussion regarding transaction costs, which should be factored in as well.

Consider the case of an investor at peak wage-earning years now with income being taxed at the top tax brackets and a capital gain rate of 23.8%. The investor plans to retire in the next few years and the anticipated capital gain rate during retirement will fall to 15%. Wealth can be created by the difference between the current and future tax rates.

If there is an opportunity to harvest a loss at ordinary income tax rates, the tax arbitrage is greater. The spread could be 40.8% versus 23.8% at the top tax rates.

Not Always a Successful Strategy

Tax-loss harvesting can result in adverse tax bracket changes. For example, an investor could harvest losses for years at the lower capital gains rate of 15%, but in order to recover the original investment, the gain could be large enough to be taxed at the 23.8% bracket. This is negative tax arbitrage.

In general, capital losses can only be deducted to the extent the taxpayer has capital gains in the same year. Long-term capital losses offset long-term capital gains before they offset short-term capital gains. Similarly, short-term capital losses offset short-term capital gains before they offset long-term capital gains. You may use up to $3,000 ($1,500 for married filing separately) of total capital losses in excess of total capital gains as a deduction against ordinary income in computing your adjusted gross income (AGI). Any unused losses can be carried over to next year.

That begs the question: Should you bank a loss when you have no gains to offset it in the current year in hopes that there are future capital gains for the carryover losses to offset or until the ordinary income is eventually used up? Ensuring that you realize the benefit of taking a large realized loss means that you expect to have realized gains in the future to offset it. So, if you expect a large realized gain in the future, like the future sale of a business or other investment property, this strategy may work. If you cannot utilize the carryover losses, you may have exited an investment earlier than you would have, if not for the tax benefits you were hoping to realize.

Another risk is that if the taxpayer dies before all carryover losses are used up, the remaining losses do not carry over to heirs or surviving spouses. They are lost.

Be Aware of Wash-Sale Rules

To prevent tax-loss harvesting abuses, Congress created the wash-sale rules. These rules prohibit selling an asset to capture a deductible tax loss and then immediately buying it back to maintain the position. This applies if the taxpayer purchases what the IRS calls a “substantially identical” investment within 30 days before or after the day of the sale that resulted in a loss. The rationale is that the taxpayer has not substantively changed his/her economic position, so no loss should be allowed. Also, selling a security in a taxable account and then purchasing the same security within 30 days in an IRA of either spouse will likely trigger the wash-sale rules.

Here are some ways you can substantially preserve an investment position while realizing a tax loss:

- Sell the original holding and then buy the same security at least 31 days later. The risk is interim upward price movement.
- Buy more of the same stocks or bonds, then sell the original holding at least 31 days later. The risk here is interim downward price movement.
- Sell the original holding and buy similar securities in different companies in the same line of business. This approach trades on the prospects of the industry as a whole, rather than the particular stock held.
- For mutual fund shares or exchange-traded funds (ETFs), sell the original holding and buy shares in another mutual fund or ETF that uses a similar investment strategy. However, be careful in employing this strategy. The IRS guidelines for these are confusing as to what is deemed substantially identical for wash-sale purposes. Be cautious in pushing the limits with tax-loss harvesting of mutual funds and ETFs.

These strategies to preserve an investment position raise another question:
Is it even worth harvesting the tax loss?

The answer:

Only if the tax benefit outweighs the investment risk and is a sound investment decision.
Remember though, this is not just a tax issue. This requires being consistent with good investment planning.

Are You a Candidate for Tax-Loss Harvesting?

Ideal candidates	Not ideal candidates
• Taxpayers in the highest tax bracket. • Taxpayers with capital gains that can be offset by losses. Remember that some of the capital gains can come from sources outside of the portfolio, such as taxable gains from the sale of real estate or a business. • Taxpayers who have a longer time horizon for the reinvested funds to grow (the "recovery" gain) beyond the previous loss harvested. Especially useful if the taxpayer will be in a different tax rate when the loss is realized and the subsequent gain is realized. • Taxpayers who realize a capital loss with the intent that the repurchased security will be donated to charity or will never sell it. If it is donated to charity, there is no realized gain. At death, the stock will receive a step-up in basis and no tax on the subsequent recovery gain. • Investors with concentrated stock positions who could take advantage of losses to help diversify their portfolios.	• Taxpayers currently in the 0% tax bracket for capital gains (would not realize any upfront tax deduction). In essence, they could harvest a gain and receive a "free" step-up in basis from purchasing a replacement investment. • Investors who only have tax-deferred accounts and no taxable investments. • Investors who have a short investment time horizon.

Conclusion

Tax-loss harvesting can be a good strategy for some investors. Generally, it can be beneficial if there is positive tax bracket arbitrage. It also requires carefully navigating the wash-sale rules. The key here is that tax-loss harvesting requires thoughtful consideration with regard to the overall picture, including current and future tax rates and other circumstances that may be relevant. The goal of this strategy is to provide value, not just tax savings.

For more information, please contact your advisor.

About the Author

As the Director of Financial Planning for Key Private Bank, Tina is responsible for managing the Central Planning Team, as well as overseeing the National Advisory Committee, Monthly National Advisory Call and any financial planning literature developed internally and externally. She works with our Regional Directors of Planning to help facilitate our best thinking and advice delivery to clients.

Tina earned a B.S. in Bus. Admin. from the Univ. of Richmond and an M.Tax from Virginia Commonwealth Univ. She is a CFP® certificant, CPA/PFS, and is an AEP®. She is Treasurer of the Put-in-Bay Community Swim & Sail Program. Tina received the 2016 Exceptional Service Award from the Cleveland Estate Planning Council and the Circle of Excellence Award by Key Private Bank in 2016 and 2018.

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