Key Private Bank

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Navigating Market Volatility and Tax-Loss Harvesting

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The global coronavirus outbreak has caused record-setting market volatility. But that volatility could allow investors to reduce their tax liabilities.

A strategy known as tax-loss harvesting, an approach that involves selling investments that have declined in value to offset gains elsewhere in your portfolio, presents investors with an opportunity to blunt the sting of recent losses.

Capital Gain & Loss Basics

In describing tax-loss harvesting and its potential benefits, we first need to review some basics about how capital gains and losses work for tax purposes.

Capital gains and losses are classified as short-term or long- term. Generally, if you hold the asset for more than one year before you dispose of it, your capital gain or loss is long-term. If you hold it for one year or less, your capital gain or loss is short-term.

To determine your net capital gains or losses, the following netting rules apply:

- Short-term gains/losses are netted against each other.
- Long-term gain/losses are netted against each other.
- If both short-term and long-term calculations are gains, ordinary income tax rates are used for short-term gains and long-term capital gains rate, shown in the following table, are applied to long-term gains.
- If one type is a gain and the other is a loss, the two are netted.
- If both short-term and long-term calculations are losses, $3,000 ($1,500 if married filing separately) can be used to offset ordinary income and unused losses carryover to future years.

Losses will retain their character as short-term or long-term. Net short-term capital gains are taxed as ordinary income at graduated tax rates up to a top rate of 37%.

Net long-term capital gains are generally taxed at 15%. Some or all net long-term capital gains may be taxed at 0% if a taxpayer is in the 10% or 12% ordinary income tax brackets. However, a 20% rate on net long-term capital gains applies to the extent that a taxpayer's taxable income exceeds the thresholds set for the 37% ordinary tax rate: $441,450 for individual taxpayers and $496,600 for married taxpayers filing jointly. There are a few other exceptions where long-term capital gains may be taxed at a rate greater than 20%, but these situations are beyond the scope of this article.

Long-Term Capital Gains Taxes for 2021			
Filing Status	0% Rate Applies	15% Rate Applies	20% Rate Applies
Single	Up to $40,000	$40,001 - $441,450	Over $441,450
Married Filing Jointly	Up to $80,000	$80,001 - $496,600	Over $496,600
Married Filing Separately	Up to $40,000	$40,001 - $248,300	Over $248,300
Head of Household	Up to $53,600	$53,601 - $469,050	Over $469,050

Source: IRS

There is a 3.8% surtax on net investment income (including capital gains) for individual taxpayers whose modified adjusted gross income exceeds $250,000 for joint filers and surviving spouses,

$125,000 for separate filers, and $200,000 in all other cases. It results in a tax rate of either 18.8% (15% + 3.8%) or 23.8% (20% + 3.8%) on the adjusted net capital gain, depending on taxable income.

Generally, losses are only valuable if you have gains. When you are evaluating your capital gain/loss position for taxes, make sure you account for all gains and losses you may have already booked or expect to experience in the same tax year. This includes real estate or business gains and losses along with your securities transactions.

How Tax-Loss Harvesting Works

Tax-loss harvesting is the process of selling a security at a loss and using the proceeds to purchase a similar but not substantially identical security. The tax-loss harvesting process allows you to retain essentially the same market exposure while generating deductions for federal income tax purposes. These deductions can be used to offset recognized capital gains and up to $3,000 of ordinary income per year. Additional recognized losses can be carried forward into future years if you do not use them in the year in which they occurred.

While tax-loss harvesting does not eliminate tax liabilities, it has the potential to reduce current tax liabilities.

Understanding Wash-Sale Rules

To preserve the advantages of tax-loss harvesting, it's important to understand the IRS wash-sale rule. A wash sale occurs when an investor sells a security at a loss and then purchases the security — or a substantially similar one — within 30 days before or after the sale. The IRS wash-sale rule disallows deductions for losses related to wash sales, thereby preventing you from selling a security for a loss simply to claim a tax benefit.

However, there are techniques you can use to preserve an investment position following a sale while realizing a tax loss:

- Double up: Buy more of the same stocks or bonds, then sell the original holding at least 31 days later. However, you are exposed to the risk of further declines in the security's price.
- Sell the original holding and buy similar securities in different companies in the same industry. This approach focuses on the prospects of the industry rather than the particular stock held.
- In the case of mutual fund shares, sell the original holding and buy shares in another mutual fund that has a comparable investment strategy. This approach can also be used with exchange-traded funds.
- The wash-sale rule has a wide scope. For example, acquiring a similar holding by a "related" party is treated as an acquisition by the taxpayer. Selling at a loss in your taxable account followed by an acquisition of a substantially identical stock in your retirement account would cause the loss to be disallowed for tax purposes.

Conclusion

Tax-loss harvesting can have a significant impact on your taxes. A thorough review of your investment positions — with a focus on holdings that have had the largest declines — can identify the largest opportunities for managing tax liabilities.

As important as planning for capital gains and losses in the current year is, you need to assess the full range of investments within the context of your long-term plan. Working with your accountant, your Key Private Bank advisor can help you chart a strategy that makes the most sense for you.

For more information, please contact your Key Private Bank advisor.

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