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Tax-Loss Harvesting: Turning a Negative Into a Positive

Conventional investing wisdom is to buy low and sell high. But you may be able to lower your tax liabilities by going against that wisdom and selling investments at a loss.

In a non-retirement account, tax-loss harvesting is the process of intentionally selling investments that have lost value. There are a variety of reasons it may be a strategy worth considering. For example, it could help you:

1. Pay less in taxes by reducing your overall income by up to $3,000 per year
2. Offset the taxes owed from selling other investments at a profit
3. Reduce your income and/or tax liabilities in future years (losses greater than $3,000 per year carry forward)
4. Rebalance your portfolio and/or adjust your asset allocation

By paying less to Uncle Sam today, you can keep more of your hard-earned money working for you in the market rather than putting it toward taxes. And by selling weaker-performing investments, you may be able to improve your portfolio's overall returns in the long term.

Tax-loss harvesting is a strategy you can use whether the market is up or down. However, it can be especially beneficial following a market correction (a decline of 10% or more from a peak high) or a sharp decline in a particular holding.

What You Need to Know

Your portfolio's value fluctuates often, both up and down. But those changes aren't locked in until you sell an asset, or "realize" the difference. Selling an investment at a profit is considered a **realized capital gain**; selling it for less than the purchase price is considered a **realized capital loss**.

Each year, the IRS allows you to weigh out capital gains and losses and deduct up to $3,000 in net capital losses to reduce your income or offset realized gains on your tax return. If your losses exceed $3,000, you can carry the additional amount forward indefinitely.

Key Points

- Tax-loss harvesting involves intentionally selling investments that have lost value to reduce your tax liabilities today and in the future.
- By paying less in taxes, you can maximize your portfolio's efficiency and keep more money working for you in the market.
- Since it's a complex strategy, tax-loss harvesting is best done with the help of your financial or tax professional.

If you're selling a holding but want to replace it with another that serves a similar purpose, be careful to avoid a wash sale (replacing what you sell with another holding that's too similar within 30 days). If you violate the wash-sale rule, the capital loss is no longer considered tax deductible (see "Wash Sale Dos and Don'ts").

Things to Keep in Mind

To successfully harvest losses for tax purposes, you'll need to know how long you've held an asset and the price at which you originally purchased it (its cost basis).

If you've held an asset for more than a year, it's considered a long-term holding; less than a year is considered a short-term holding.

The IRS treats long-term investing more favorably: Long-term capital gains are taxed at 0%, 15%, or 20% depending on your income level. Short-term capital gains are taxed at the same rate as your regular income, from 10%-37% using current tax brackets.

There are many ways to determine cost basis, from "first in, first out" to average cost. Frankly, it can get a little tricky. It's best to work with your financial or tax professional to review records before selling investments for tax-loss harvesting purposes.

Tax-Loss Harvesting: A Benefit for Both Boom and Bust Years

Remember, tax-loss harvesting can help whether your portfolio has had a boom or bust year. Even in a down year without many gains to offset, it could still make sense to harvest your losses to reduce your overall income for the tax year. Any additional losses can be used in future years, too. Think of it as a tax-deduction piggy bank: You can store extra losses from this tax year for another year's gains down the road.

A final word: Tax savings are certainly a benefit, but one that comes second to your ultimate financial goals. Tax-loss harvesting can be a powerful tool to tune up your portfolio, but ultimately, a well-designed portfolio is even more powerful. It can also be complicated, so it's best to enlist the help of a professional to maximize the strategy and keep your portfolio on track.

Wash Sale Dos and Don'ts

The wash-sale rule is designed to prevent abuse of tax deductions. Here are some examples of what would and wouldn't violate the rule.

Example: You bought 100 shares of XYZ Technology at $30, a software design company. But after bungling their latest product release, shares are selling for $20. You sell all your shares and realize the loss. A week after you sell, the company replaces the CEO responsible for overseeing the flop and shares begin to recover. You could:

- Repurchase shares immediately because you believe in the company's long-term prospects and now think it's priced at a bargain. Because you're repurchasing the same company in less than 30 days, you'd **violate the wash-sale rule and negate your tax deduction** from selling at a loss.
- Explore other options in the technology space to maintain your allocation. Perhaps some competitors design software but also offer cloud-computing services. As long as the new company is not "substantially identical" to the original one, you would **not violate the wash-sale rule and would maintain your tax advantages**.
- Wait a few more weeks to see if the rally has legs. If the company seems to have recovered from its missteps after 31 days, you could repurchase the shares. This would **not violate the wash-sale rule and you could maintain your tax deduction.**

Ask your financial or tax professional if your portfolio could benefit from tax-loss harvesting.