



## Tax-Loss Harvesting: A Potential Boon for Bond Investors

Now may be a particularly beneficial time to take advantage of investment losses in fixed income.

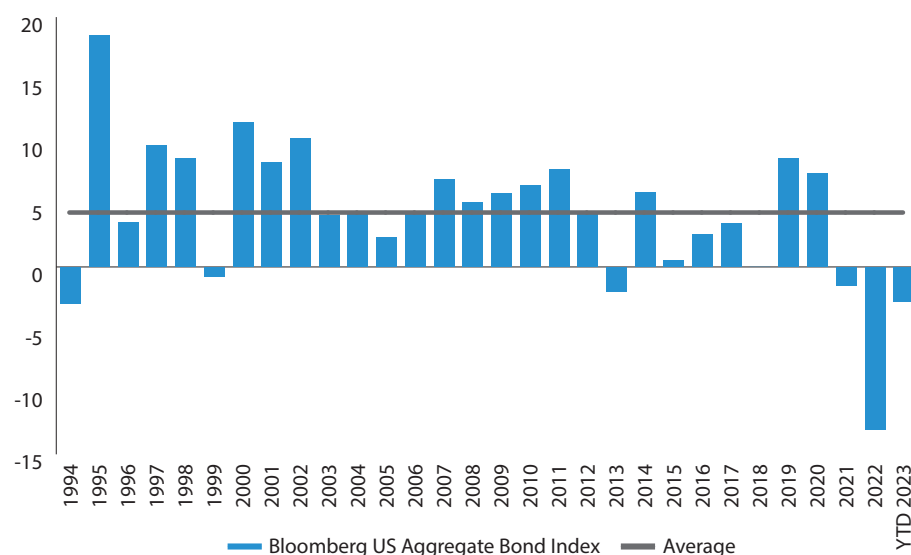
No one likes having their investments lose value or paying more in taxes than they have to. But investment losses can actually be an unlikely hero—one that helps lower your tax bill. Through a strategy known as tax-loss harvesting, once you sell, or realize, an investment loss, you can use the loss to reduce your overall taxable income or use it to help offset investment gains on which you'd owe capital-gains taxes.

### Got Losses? Bonds Certainly Do

After several rocky years for bond investors, now may be a particularly fruitful time to take advantage of tax-loss harvesting in fixed-income portfolios. Why? Bonds have been negatively impacted by rising interest rates for the last few years, since bond prices fall as interest rates rise. This means many fixed-income investors likely have some serious losses that could be applied toward lowering their tax liability.

### Recent Bond Performance Has Been Significantly Below Average

Annual Returns (%) 1994-2023



### Key Points

- Disappointing performance has likely created many opportunities for tax-loss harvesting in fixed-income portfolios.
- Tax-loss harvesting can make investment losses beneficial by helping investors minimize their tax liability, as well as helping to rebalance or improve their portfolio's holdings.
- It's best to work with a financial or tax professional to make the most of this complex strategy.

As of 10/31/23. Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment. Source: Morningstar, 11/23.

And despite some recent years of poor performance, there's still value in being a bond investor. For starters, bonds are priced at the most attractive point they've been in decades. In addition, bonds have a self-healing mechanism: If held to maturity (and if they don't default), they'll eventually recoup these current losses over time. Bonds currently offer attractive yields as well as opportunities for capital appreciation in the future.

This leads to another advantage of applying tax-loss harvesting to fixed-income portfolios today: The opportunity to not only rebalance allocations that have shifted, but also to upgrade to investments with better relative performance and fees—all in a more tax-efficient manner.

### The 411 on Tax-Loss Harvesting

To avoid running afoul of the IRS, there are important rules to know about tax-loss harvesting. First, how long you've owned an investment matters when determining whether you have long-term gains and short-term gains. Long-term gains, for assets held for a year or more, are taxed at lower rates (0%-20% depending on your income). Short-term gains, for investments held for less than a year, are taxed at your federal income tax rate (10-37%). You can offset long-term gains with long-term losses and short-term gains with short-term losses.

Second, if your losses exceed your gains, you can apply an additional \$3,000 per year to reduce your taxable income for that year. If you have even greater losses than that, you can hang on to those losses indefinitely to reduce your income and tax liability by up to \$3,000 per year in future years.

Third, you can't sell an investment to claim a tax loss and then immediately repurchase it. This is called a wash sale. The IRS requires you to wait 30 days to repurchase that asset, or, if you want to replace that asset sooner, you must find something that's not "substantially identical." Otherwise, you risk negating the tax benefits.

### Tax-Loss Harvesting Example #1

Your \$10,000 investment in ABC Core Bond Fund, which you've owned for the last five years, underperformed this year and has high management fees. Now it's worth only \$8,000. You could:

- Sell your ABC Core Bond Fund holding, take the \$2,000 in long-term capital losses, and look for another core bond fund with lower fees. You find QRS Core Bond Fund, which would serve the same purpose in your portfolio and has a strong track record and reasonable fees.
- You apply your \$8,000 in proceeds toward shares of QRS Core Bond Fund and avoid violating the wash-sale rule, since the funds serve the same purpose but aren't substantially identical. This maintains your tax-loss benefit.
- Then you claim your \$2,000 in losses to reduce your ordinary income on your taxes. Assuming you're in the 35% tax bracket, that would reduce your tax bill by \$910 ( $2,000 \times 0.35$ ).

Benefit: You've reduced your tax bill for next year by \$910 and lowered the management costs in your core bond portfolio.

## Tax-Loss Harvesting Example #2

Your \$10,000 investment in ABC Core Bond Fund is now worth only \$8,000, a \$2,000 loss. You also own XYZ Big Tech Stock Fund that you purchased in 2017 for \$10,000 and is now worth \$12,000, a \$2,000 increase. The asset allocation in your portfolio has shifted more toward equities than you prefer due to the bond fund's underperformance and the equity fund's outperformance.

- You think big tech stocks have peaked and won't continue to outperform as much going forward. You sell your ABC Core Bond Fund holding and claim the \$2,000 in losses and sell your XYZ Big Tech Stock Fund to claim the \$2,000 in gains.
- You pair the long-term \$2,000 gain with your long-term \$2,000 loss, offsetting the taxes on your capital gains from the sale of XYZ Big Tech Stock Fund.
- You use the proceeds of both sales (\$8,000 from ABC Core Bond Fund and \$12,000 from XYZ Big Tech Stock Fund) to reinvest in a mix of stock and bond funds; this allows you to rebalance your portfolio to your originally intended asset-allocation mix.

**Benefit:** You've rebalanced your portfolio without increasing your tax liability for the year.

## Enlist a Professional

Tax-loss harvesting is a powerful tool to help maximize your portfolio's tax efficiency. However, it can be a complex process. It's best to work with your financial or tax professional to make sure you're making the most of it without violating any IRS regulations or accidentally negating the intended benefits of the strategy.

## Talk to your financial or tax professional about the benefits of tax-loss harvesting in your fixed-income portfolio.

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