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Tax-Loss Harvesting: Turn Market Volatility into Potential Opportunity

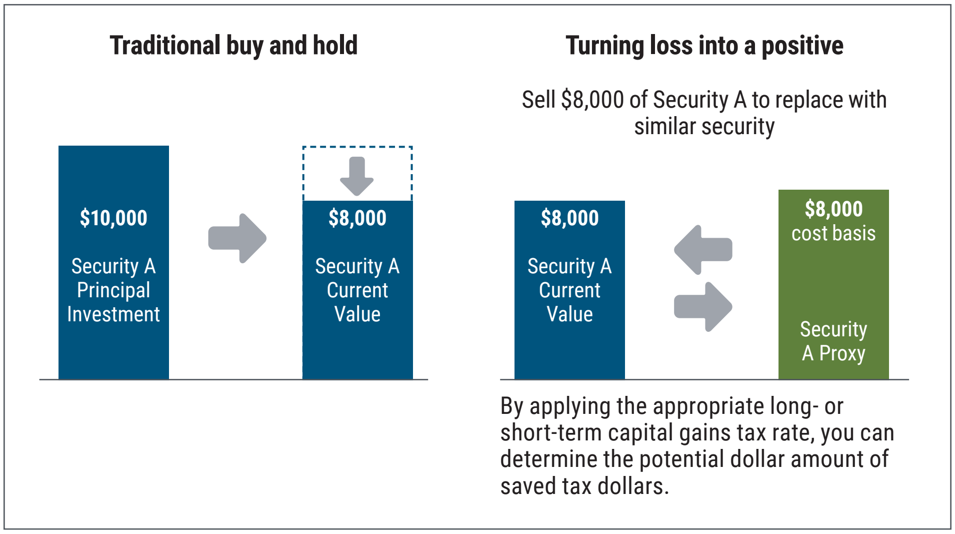
Market volatility produces financial and emotional stress in investor portfolios. Although periods of volatility often lead to investor uncertainty, they may also present effective planning opportunities for those interested in taking advantage of the current environment. One opportunistic strategy is tax loss harvesting.

Many investors find themselves holding assets that are worth less than they initially paid for them. These unrealized losses may provide some value – the ability to reduce a tax liability.

WHAT IS TAX-LOSS HARVESTING?

Simply put, tax-loss harvesting is the process of selling securities that have declined from the original cost basis and using the realized losses to offset capital gains tax due on other investments in a portfolio.

Many investors are keenly aware of the tax liabilities that accrue as they realize capital gains on their investments. The resulting tax bill can be substantial when assets have significant embedded unrealized capital gains.


Traditional buy and hold
$10,000
Security A Principal Investment
$8,000
Security A Current Value
Turning loss into a positive
Sell $8,000 of Security A to replace with similar security
$8,000
Security A Current Value
$8,000
cost basis
Security A Proxy

By applying the appropriate long- or short-term capital gains tax rate, you can determine the potential dollar amount of saved tax dollars.

***Examples for illustrative purposes only.**

The practice of tax loss harvesting allows investors to potentially reduce or eliminate accrued tax liabilities by selling securities that have depreciated in value and then using the losses to offset capital gains from appreciating assets in their portfolio.

As a reminder, a tax loss occurs when an asset is sold for less than what was originally paid. For example, selling a stock at a loss generates a capital loss for tax purposes.

Realized losses can offset realized gains, reducing an investor's tax burden. In addition, realized losses in excess of gains can offset up to $3,000 of other annual taxable income and further losses can be carried forward for future use.

THE BENEFITS OF TAX-LOSS HARVESTING

Investing is often not about what you earn, but what you keep, and taxes can take a sizable chunk out of your investment returns. Investors looking to reduce their tax burden can take advantage of the practice of tax loss harvesting to help offset capital gains.

Seeing losses in an investment portfolio never feels good emotionally. But it's important to keep in mind that losses can have a silver lining. In a nutshell, investors can take advantage of the following benefits:

1. Reduced tax burden, as realized losses can offset realized gains
2. Potentially offset up to $3,000 of other annual taxable income
3. Further investment losses potentially carried forward for future tax-loss harvesting opportunities

A "wash sale" in context

A wash sale occurs when an investor sells or trades a security at a loss and, within 30 days before or after the sale, buys a "substantially identical" security, or acquires a contract or option to do so. The wash sale rule is an IRS regulation that prevents a taxpayer from taking a tax deduction for a security sold in a wash sale.

Consider strategies that allow investors to remain invested and benefit from a realized loss without violating the wash sale rule:

- Purchase additional shares of an investment (essentially doubling the initial position) and liquidate the original position 30 days later. This approach creates additional risk during that period but maintains exposure to the position.
- Sell individual stocks and buy a correlated stock in another company in the same industry. For example, selling one airline stock and purchasing a different one can avoid a wash sale, but still maintain industry exposure.
- Sell an individual stock and replace it with a mutual fund or ETF holding that stock or others in the same industry. This approach may also provide greater diversification than investing in a single stock.

It's important to note that tax benefits from a realized loss may be delayed, and in some cases eliminated by violating the wash sale rule.

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