
Tax Loss Harvesting

It is inevitable that at some point you will experience losses in your investment portfolio. However, through tax loss harvesting, you can use these losses in your portfolio to reduce your total tax bill.

Tax loss harvesting is a strategy you can utilize to reduce your total end-of-year tax bill. This is done by using the losses your portfolio experienced by some investments to reduce the capital gains of other investments on a newly purchased portfolio. By offsetting your capital gains in your current portfolio with past portfolio losses, taxation in the current year will be reduced.

How Tax Loss Harvesting Works

If you have an investment that experiences a loss, you can sell your current investment and reinvest the remainder into a new position. Then, you can use the net amount of the loss from your initial portfolio to offset taxation on any capital gains that you have realized throughout the year.

For example, let's say you have \$100,000 invested in a particular position and it loses \$10,000. You then decide to sell this position and reinvest the remaining \$90,000 into a new position. Any taxation on capital gains incurred from other investments can be offset by that \$10,000 loss. Additionally, if the capital gains you incurred are less than the loss itself,

you can use up to \$3,000 (or \$1,500 per spouse if Married Filing Separately) of losses to reduce your ordinary taxable income. If there is still any remaining loss after being applied to the capital gains and ordinary income, the remainder can be carried forward to future years for additional tax reduction.

However, if you use the money from your initial investment to buy a new investment, this will lower your cost basis. In the aforementioned example, the new cost basis of your investment will be \$90,000. Therefore, any future gains that you realize will be taxable by \$10,000 more than your current position. Because of this, many people think of tax loss harvesting as a tax deferral. By paying fewer taxes now and possibly more in the future, harvesting loss essentially functions as a temporary, interest-free loan from the government

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When to Harvest Tax Loss

Harvesting tax loss is most often used when tax amounts for the current year are higher than anticipated. This way, you can incur a break when you need



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it and defer the taxes to a year when your rate might be lower.

Additionally, if you are experiencing losses in your portfolio and are looking to reinvest anyway, harvesting losses is a sort of double positive: you change your unwanted position and leverage your losses to lower your tax bill.

Tax loss harvesting is often utilized by individuals who have a more volatile investment strategy. These investments would be more susceptible to significant losses. Offsetting taxation is a way to minimize total losses that may be incurred fairly regularly.

Limitations of Tax Loss Harvesting

Though there are many benefits to tax loss harvesting, there are also limitations when utilizing this strategy. When you take a loss, you cannot invest in what the IRS categorizes as a “substantially identical” investment within 30 days (before or after) the sale of the security. This rule is in place to limit selling and repositioning in the same or an extremely similar investment in an attempt to avoid taxation. If the new investment is “substantially identical” to the initial investment, the IRS deems this as a “wash sale” and you will not be able to leverage any losses to improve your tax situation. Some investors think that putting a new investment similar to the initial investment under their spouse’s name can circumvent the wash sale rule; however, the rule also applies to spouses of those doing the investing. If you violate the time restriction and commit a wash sale, the IRS will prohibit you from claiming a loss but will add the loss value onto your new cost basis. (All things being equal, this means your cost basis would return to its pre-loss value.)

When considering tax loss harvesting, it is also important to make note of the

current cost basis of your investments, as well as any administrative fees that this process will trigger. It is possible that the administrative cost of repositioning your portfolio compounded with a significant loss in cost basis outweighs the advantages of attempting to harvest your loss.

Tax Gain Harvesting

In addition to being able to sell at a loss for tax, you can also strategize how you harvest your investment gains. In years when you find yourself in a lower tax bracket than anticipated, you can sell your capital gains so that they are taxed at a lower rate than usual. Then, you can immediately reposition with a similar portfolio, as tax gain harvesting is not subjected to the wash sale rule.

Tax loss harvesting can be a very useful tool in reducing your tax bill. Since there are limitations, benefits and risks to this process, consult with your Donaldson Capital Management advisor to see if tax loss harvesting would work for you.

