HoyleCohen WEALTH MANAGEMENT

Tax Loss Harvesting

An Overview and its Benefits

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Tax loss harvesting is a tax strategy used to systematically or opportunistically sell specific securities at a loss to offset prior or planned realized capital gains. The loss harvesting reduces taxable capital gains or, in some cases, other types of income.

How Tax Loss Harvesting Works

- **Identify Losses:** Portfolios are reviewed to identify investments that are currently valued at less than their purchase price. These assets can potentially be sold to realize a capital loss.
  - *This can include assets that have underperformed for longer periods, or newly purchased assets that have dropped in value due to recent market conditions.*
- **Reduce Current-Year Capital Gains:** The realized capital loss can be used to offset realized capital gains from any other investments. For instance, if an investor has built up $50,000 in realized capital gains from investment sales, but realizes $25,000 in losses from other investment sales, the net capital gain subject to tax would be $25,000.
- **Use Excess Capital Losses to Reduce Taxable Income:** Up to $3,000 of excess Capital Losses in a tax year or carryforward losses from prior years can be used to reduce taxable income.

Benefits of Tax Loss Harvesting

- **Immediate reduction of Tax Liability:** While tax on realized capital gains is typically less than the tax on income, reducing overall realized capital gains reduces an investor's tax liability.
  - *Less tax liability lessens cash outflow from the portfolio, which allows for additional/improved investments, or cash flow for personal financial needs.*
- **Future Reduction of Tax Liability:** Capital losses can be carried forward to future years. This means that if the losses exceed the capital gains taken in a given year, excess losses can be used to offset gains in future years. This deferral can be beneficial as it allows the investor to potentially reduce future tax liabilities.
- **Improved After-Tax Returns:** By strategically managing capital gains and losses, investors can enhance after-tax returns. The ability to reinvest the proceeds from sold assets can lead to potential growth and returns that are more favorable after accounting for tax impacts.

Tax-Loss Harvesting Strategies

- **Reinvest:** After an asset sale, to maintain a desired investment strategy or allocation, many investors choose to immediately reinvest the sale proceeds into **similar, but "not substantially identical, assets".** This distinction is to avoid violating the IRS "wash sale rule," which disallows the deduction of losses if the same or substantially identical security is purchased within 30 days of the sale transaction.
    - *This can be tricky and as such it is advisable to consult an advisor to help ensure that you adhere to the wash sale rule.*
- **Planned Portfolio Rebalancing:** Tax loss harvesting provides an opportunity to reassess and rebalance an investment portfolio, helping to maintain alignment with long-term goals and risk tolerance.
    - *Paring back significantly overweighted positions, w/o creating significant tax liability.*
    - *Selling underperforming or misaligned assets.*
- **Banking Capital Losses:** Take advantage of significant market volatility to realize capital losses when the opportunity arises, even if they are not needed in the current year. Capital losses can be carried forward indefinitely (up to $3,000 annually at the time of this writing) and can be applied against realized gains later in the tax year, or many years in the future.
- **Advance loss planning:** If you are planning to harvest losses, adding to the targeted position(s) more than 30 days in advance of the transaction keeps an investor in the specific investment (if is still desirable) w/o needing to sort out a suitable replacement, and can solve the IRS Wash Sale issue.
- **Inter-family gifting of investments held at a loss:** While not a Tax Loss Harvesting strategy, it is worthy keeping in mind that an unrealized loss may be more valuable to another family member. This could be across a generation and/or between generations depending on the specific circumstances.

Considerations and Limitations

- **Wash Sale Rule:** The wash sale rule is a regulation established by the Internal Revenue Service (IRS) to prevent taxpayers from claiming a loss on an investment for tax purposes, immediately repurchasing the same security, w/o ever fundamentally changing their investment position.

A few things to note regarding the wash sale rule:

- **Time Frame:** The wash sale rule applies to transactions occurring within a 61-day period, which includes 30 days before the sale, the day of the sale, and 30 days after the sale of the security. For example, if an investor sells a stock at a loss on November 15, they cannot have bought the same or substantially identical security stock 30 days before or 30 days after November 15th without triggering the wash sale rule. Accurate record-keeping is essential for compliance with the wash sale rule.

    - **Substantially identical Securities:** The rule applies not only to the exact same security but also to securities that are substantially identical. This can include options, warrants, or convertible securities related to the sold stock. It also covers situations where the security is repurchased by a spouse or a partnership in which the taxpayer has an interest.
    - **Disallowed Losses:** If a sale is deemed a wash sale, the loss on the sale cannot be deducted in the current tax year. However, the loss is not permanently lost. Instead, the disallowed loss is added to the cost basis of the repurchased security. This adjustment increases the cost basis of the new investment, effectively deferring the recognition of the loss until the repurchased security is sold.
        a. **Example 1 - Wash Sale Violation:** An investor sells 100 shares of Company ABC at a loss on April 1. If the investor repurchases 100 shares of Company ABC on April 15, the loss from the initial sale is disallowed due to the wash sale rule. The disallowed loss is added to the cost basis of the shares purchased on April 15.
        b. **Example 2 - Correct Tax Loss Harvesting:** An investor sells 50 shares of Company ABC at a loss on June 10 and buys 50 shares of a similar but not identical company (e.g., a competitor or alternatively an ETF that targets the same industry) on June 20. In this case, the wash sale rule does not apply, and the loss can be claimed on the tax return.

- **Long-Term Strategy:** While tax loss harvesting can provide immediate tax benefits, it should be part of a broader long-term investment strategy.
    - **Haphazard trading:** To realize capital losses might lead to unintended tax consequences, unintended allocation and/or position changes that negatively impact overall returns in both the short and long-term.
    - **Costs:** Frequent trading typically increases transaction fees and may outweigh the expected benefits.

In summary, tax loss harvesting can be a valuable tool for managing taxable income and improving after-tax returns. By strategically realizing losses and offsetting gains, investors can enhance their financial outcomes while maintaining or adjusting their investment strategies.

Disclosures: *The information in this report is educational and general in nature and is not intended to be, nor should it be construed as, specific investment, tax, or legal advice. Individuals should seek advice from their wealth advisor or other tax advisors before undertaking actions in response to the matters discussed.*

Investments involve risks. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. All investments include risk of loss that clients should be prepared to bear.

On 09/01/24, HoyleCohen, LLC ("HoyleCohen") merged with and into The Colony Group ("Colony"). Clients of HoyleCohen assigned their advisory agreements to Colony.