Eagle Strategies LLC

Investment

PLANNING ESSENTIALS

How Offsetting Gains Work

In an ideal world, the stock market would continue to gradually climb. Inflation would be steady at 2%. Unemployment would be low and every one of our investment choices would pay off. However, this is the real world—where markets fluctuate (sometimes wildly) and periodic downturns are inevitable.

No one really enjoys experiencing investment losses. In fact, behavioral finance studies have found that the psychological pain associated with a loss has been measured to be more than 2x the pleasure experienced with a gain.[1] However, in some cases, losses can actually be beneficial to your overall financial picture—a way to gain a valuable tax benefit.

KEY TAKEAWAYS

Each year, investors have the opportunity to use realized losses to help offset realized capital gains.

If your realized losses exceed your realized gains, up to $3,000 of additional losses can be used to offset up to $3,000 of ordinary income each year on your joint tax return.[2]

Any additional investment losses can then be carried forward into future tax years to help offset future gains and income.

There's a specific process that should be followed when offsetting gains with losses. Any investment sale can have unexpected tax implications, so plan carefully with your financial advisor and tax specialist.

PUTTING INVESTMENT LOSSES TO WORK

Realized investment losses (securities sold for less than their cost basis) can essentially serve two vital purposes. They can be used to offset your investment capital gains, as well as up to $3,000 of ordinary income each year on your joint tax return. Any unused losses can then be carried forward indefinitely into future tax years.

'Harvested losses,' therefore, may help to significantly lower tax obligations and provide investors with more money in their pockets. However, in order to avoid any missteps that might negate these important tax benefits, it's important to work closely with both your financial advisor and tax specialists who can help you not only comply with the IRS' Wash Sale Rule, but ensure that you properly apply any losses to offset gains.

APPLYING LOSSES TO OFFSET GAINS

When offsetting gains, realized gains and losses can be put into one of two categories:

- *Long-term gains and losses*—any investment held for more than one year. Long-term capital gains are taxed at a separate rate (either 0%, 15% or 20% depending on your income and filing status).[3]
- *Short-term gains and losses*—any investments held for exactly one year or less. Short-term capital gains are taxed as ordinary income (depending on your income subject to a top marginal tax rate of 37%).[3]

Gains and losses in each category can be matched up using the following sequence:

1. **All long-term losses must first be used to offset long-term gains; and all short-term losses must first be used to offset short-term gains.**
2. **Any excess losses that remain in one category can then be applied to the other.**
3. **If you have any leftover unused losses (i.e., your combined total losses for the year exceed your combined total gains), those can be carried forward to offset gains in future tax years.**

To better understand this process, let's examine a hypothetical example. At the end of the year, you calculate that your stock sales have generated $18,000 in gains and $25,000 in losses broken down this way:

- *$10,000 in short-term gains;*
- *$5,000 in short-term losses;*
- *$8,000 in long-term gains; and*
- *$20,000 in long-term losses*

First, you should offset your net short-term gains with losses ($10,000 – $5,000) which nets you a $5,000 short-term capital gain. Similarly, you'll want to offset your net long-term gains with long-term losses ($8,000 – $20,000), leaving you with an additional $12,000 in long-term capital losses. You can then use $5,000 of your remaining $12,000 in long-term losses to offset the leftover $5,000 in short-term gains.

This process would not only eliminate all your capital gains for the year, it would leave you with $7,000 in long-term losses—$3,000 of which you could use to offset ordinary income, and the remaining $4,000 carried forward as a long-term capital loss to be used in subsequent tax years.

PLAN THOUGHTFULLY BEFORE HARVESTING LOSSES

Keep in mind that whenever you sell investments, you'll need to pay taxes on any realized capital gains. The IRS, however, is only concerned with 'net gains' for each tax year—how much your total gains exceed your total realized losses. So, if you know you're going to incur significant gains in a particular year, consider exploring ways to capture portfolio losses to offset some of those gains.

Annual portfolio rebalancing can help—affording you an opportunity to sell shares of stocks, mutual funds and ETFs which have lost value since you acquired them and replace those securities with similar but not 'the same or substantially identical' securities. Once again, given the potential tax impact, make sure you talk with both your financial advisor and tax specialist before engaging in any sales transactions.

[1] Klotz, Michelle. "Loss Aversion – Everything You Need to Know." Insider BE. Accessed November 1, 2024. https://insidebe.com/articles/loss-aversion/.
[2] "Topic no. 409, Capital gains and losses." IRS.gov. October 16, 2024. https://www.irs.gov/taxtopics/tc409.
[3] "Capital Gains and Losses." Intuit TurboTax. October 16, 2024. https://turbotax.intuit.com/tax-tips/investments-and-taxes/capital-gains-and-losses/L7GF1ouP8?srsltid.

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