Eagle Strategies LLC

Investment

PLANNING ESSENTIALS

Tax-loss harvesting

A silver lining during a market correction

No one—except the rare contrarian investor—is ever happy about a falling stock market. The damage inflicted by large, rapid corrections can wreak havoc on both taxable and tax-deferred portfolios. Market corrections can be especially troublesome for those investors approaching retirement who may not have enough time for the markets to fully recover before they begin transitioning from saving to spending.

KEY TAKEAWAYS:

During periods of market correction, investors may potentially benefit from "locking in losses" by selling certain investments and purchasing similar ones.

This process (known as tax-loss harvesting) can be used to help offset current (and potentially future) portfolio gains and reduce your tax liability.

Working together with your tax advisor and your Eagle Strategies advisor can help you identify tax-loss harvesting opportunities and make sure you adhere to all rules and restrictions.

For most investors, the best thing to do is usually nothing at all! Avoid the urge to panic if you have time on your side, and simply ride out the storm. Attempting to time the markets (e.g., moving to cash before a steep decline and then moving back into stocks before a recovery) will, more often than not, leave you worse off than if you did nothing.

Bear markets do, however, present a unique opportunity for investors to realize some extensive tax benefits through the process of tax-loss harvesting.

What is tax-loss harvesting?

Tax-loss harvesting involves selling securities held in your taxable accounts which have declined in value (recording a paper loss for tax purposes) and then reinvesting the proceeds to purchase a similar but not substantially identical security that meets your investment needs and asset allocation strategy. Any losses you realize are first used to offset any capital gains you incurred during that same calendar year. Any remaining losses (up to $3,000 per year) can then be deducted from ordinary income when you file your income taxes. And losses that exceed the $3,000 annual limit can be carried forward into future tax years.

The following is a simple hypothetical example to demonstrate how the process of tax-loss harvesting might potentially benefit an investor:

Step 1.

Let's assume that this past November you invested $100,000 in an ETF that tracks the S&P 500® Index. In March, however, the market dropped 20% and the original investment is now worth $80,000.

Step 2.

As a result, you decide to sell the investment to lock-in the $20,000 loss for tax purposes, and then turn around and use the $80,000 sale proceeds to purchase a similar (but not substantially identical) ETF that tracks the NASDAQ 100 Index.

Now, suppose that by the end of this year, the stock market has substantially rallied and the value of the NASDAQ 100 ETF you bought has climbed to $110,000. Effectively, you would have successfully realized a substantial loss to use for tax purposes, while the value of your original investment would have ultimately increased–a clear win/win scenario.

Avoiding wash sales
When deciding on one or more investments to replace an investment you sell to harvest a loss, it's critical that you pay close attention to the similar but not substantially identical requirement. You can't simply turn around and buy the same security or even one that's nearly identical (e.g., selling a Vanguard S&P 500 fund and buying a Fidelity S&P 500 fund) unless you wait at least 30 days between the original sale and subsequent purchase. If you do, the IRS wash-sale rule states that your tax write-off from the sale would be disallowed.

Offsetting short- and long-term gains
It's important to understand that there are certain rules and restrictions regarding how investment losses may be used to offset investment gains. Long-term losses must first be applied against long-term gains, and short-term losses against short-term gains. Any excess losses in one category can then be applied to the other (with remaining losses carried forward to be used in future tax years).

Even if you don't have gains in a particular year, the IRS allows you to apply up to $3,000 of harvested tax losses to reduce your taxable ordinary income each year.

Periodic and proactive tax-loss harvesting can be an effective way to reduce your tax burden and effectively boost your after-tax return. It's a practice that can be especially helpful when the markets experience a swift and sudden correction. As with any strategy that has tax implications, however, you should always consult your tax advisor before initiating any tax-loss harvesting transactions.

Interested in learning more about tax-loss harvesting and whether it may be an appropriate strategy for you? Talk to your Eagle Strategies Financial Advisor.

ES.PE.TaxLossHarvesting
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Eagle Strategies LLC

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