Use portfolio losses to potentially make money

Year-end planning: tax loss harvesting

By Michael Carlin, AIF, WMS

When you invest, naturally you hate it when your portfolio loses money. Who wouldn't? If you're incurring losses throughout the course of an investment year, don't ignore them. We encourage you to take a proactive approach to the way your money is being managed and make the necessary changes that can help provide tax benefits and improve your long-term rate of return over time.

Now you may be asking yourself: how could a loss in my portfolio actually help me make money? Tax loss harvesting is a smart year-end financial move to start thinking about now.

Which accounts qualify?

For tax loss harvesting, we're really looking at accounts that qualified as "taxable" – an individual account in your name, a joint account with your partner or spouse or even a trust account. You know your account is taxable when you're getting a yearly tax statement for any gains, losses or income incurred throughout the year.

What is tax loss harvesting?

Throughout the course of any given year, month or quarter, certain investments go up and down in value. Most people and many financial advisors let their taxable investments move up and down without making any changes. However, there are many different ways to employ selling your investments while they're down, harvesting that loss and reinvesting in a similar investment vehicle.

If you don't actually sell your investment when it's down, then you're not doing anything with the loss that you incurred. But, as soon as you sell your investment for that loss, you can now use the loss to offset either income or other portfolio gains that you might have.

The wash sale rule

Before I get into the details of gains, let me describe to you what the tax loss harvesting rule is. If you're selling one of your investments to use a loss for tax purposes, you need to know about the "wash sale" rules because you don't want to violate them. The IRS says a wash sale happens when you sell or trade a security at a loss and, within 30 days before or after this sale, you buy a nearly identical stock or security. If this happens, then your loss is typically disallowed for tax purposes.

Capital gains

Let's cover a couple of different types of capital gains. The first thing you want to note is that there are short-term gains/losses for investments that you've held for less than one year and long-term gains/losses for investments you've sold that you've held for more than one year.

Here are the basic rules of the gain:

- Net short-term capital gain and net long-term capital gain: A short-term loss would be taxed at your ordinary income rate. A long-term loss would be taxed at your appropriate capital gains tax rate.
- Net short-term loss and net long-term loss after deducting each type of gain: You can use up to $3,000 to offset other income. You could carry any left over to future years.
- Net short-term gain that is greater than your net long-term capital loss: You will subtract the gain from the loss and the net amount is taxed as a gain at your ordinary income tax rate.

Now imagine, for example, that you have an investment in the Vanguard S&P 500 Index which is a broad, low-cost security that invests in large U.S. companies. Let's say you bought this when the market was high. Now the market is lower and you have a loss on this investment. Sure you could keep the investment and hope for the best long-term. However, if you were to sell that investment and then buy the iShares S&P 500 Index to replace it, you would have harvested the loss in Vanguard, stayed invested in the S&P 500 Index and avoided any problems with the wash sale rule.

Selling losses

Really what this is about is proactively selling your investments if there's a loss and trying to find equivalent replacements. By doing this over time, you will accumulate a bunch of losses while staying invested in the market in areas that you hopefully like and will perform well over time. And yet, these losses will offer you flexibility and potentially save you money. Again, you can use these losses to offset your future capital gains and you can carry the losses around with you indefinitely until they're all used up.

If you reflect over a long period of time, which by the way is what you should do when you're investing – use those losses you've accumulated to reduce your income or eat up the other gains you have in other parts of your portfolio. It would only serve to reduce your tax liabilities. And if we're talking about reducing your tax liabilities, then we're talking about putting more money in your pocket year after year.

Words of disclosure

Everyone has their own unique tax situation and should work with a tax advisor to see how to best navigate and optimize the tax loss harvesting strategy for their own portfolio. Also, finding and buying a replacement security when you are harvesting a loss is equally key to making this strategy work for you.

Michael Carlin, AIF, WMS, is the President and Founder of Wealth Management, LLC, an affiliate of Henry+Horne. He can be reached at (480) 483-3489 or mcarlin@wealthmgtllc.com.