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FLASH REPORT

Eric D. Wheeler, CFP®
Branch Manager, Wheeler Wealth Management
306 Middletown Park Place, Unit B · Louisville, KY 40243
P (502) 200-7225 · F (502) 473-6562

Navigate the Complexities of Tax-Loss Harvesting

Tax-loss harvesting is a strategy used by many investors and their advisors as a way to reduce the amount of taxes owed. Despite tax-loss harvesting being a well-established tool, it remains controversial in some respects. For example, research continues and debate is ongoing as to the amount of value tax-loss harvesting adds to investors' returns and tax reduction efforts over time. One reason: There are multiple ways to implement tax-loss harvesting, some of which may be more beneficial than others depending on circumstances.

With that in mind, it's worth taking a fresh look at this tax mitigation strategy that has become important to many investors.

A Versatile Strategy

Mitigating taxes is a major goal of many affluent investors, and long has been. In conversations with financial advisors, for example, CEG Worldwide consistently finds tax mitigation to be among high-net-worth investors' top five financial concerns. Likewise, about two-thirds of people (67%) consider their federal income tax to be too high, according to a 2024 University of Chicago Harris/AP-NORC nationwide poll of 1,024 adults.[1]

Tax-loss harvesting is designed to address those concerns. As you may know, tax-loss harvesting involves intentionally incurring losses in a taxable investment account by selling one or more securities (stocks, mutual funds and ETFs are some examples) that have fallen in value to below the price you initially paid for them. By realizing that capital loss, you may offset capital gains that have been generated by other securities in the portfolio—for example, appreciated assets that you've sold at a profit or capital gains distributions made by a mutual fund.

Ideally, your harvested losses would cancel out any gains on which you'd be taxed. Additionally, the rules enable you to use those losses beyond the immediate gains. Say that your realized capital losses are greater than the capital gains in your portfolio this year. In that case, you can use as much as $3,000 of those losses to offset ordinary taxable income for the year.

As an added bonus, it's not a "use it or lose it" situation. If your realized losses exceed both the capital gains and the $3,000 income limit for the current year, you can carry those losses forward.

The effectiveness of tax-loss harvesting will depend on many factors—including each investor's circumstances and when the harvesting occurs. And while there are no guarantees, one study by academics at MIT and Chapman University suggested that tax-loss harvesting might boost a large-cap stock portfolio's returns by as much as 1.1% per year.[2]

[1] Source: AP-NORC Center for Public Affairs Research. (January, 2024). "Majorities view local, state, and federal taxes as too high and delivering too little value for people like them."

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BEING SMART WITH TLH

As with any investment strategy, tax-loss harvesting should be used in ways that reflect each investor's situation and needs in order to generate the optimal benefits. Consider some key issues and risks to think through before seeking to harvest investment losses, including:

1. Missing out on rapid gains. Investors often want to do a lot of tax-loss harvesting after a particular market sector, or even the market as a whole, has been nosediving. During corrections and bear markets, it's easy to believe more negative results are ahead and to therefore book losses. But rebounds have the potential to occur quickly, and the magnitude of those moves can be strong. Ditching investments to sidestep taxes can cause you to miss out on upside if those investments surge. And as you'll see, you can't simply sell a stock one day and rebuy it the next if you want the benefits of tax-loss harvesting.

2. Replacing the assets you sell. After you sell an investment at a loss in hopes of offsetting taxable gains, your next move is an important one. If you want to continue to have exposure to the type of asset you just sold, the obvious move would be to buy a similar investment. Example: replacing an S&P 500 ETF with another ETF that tracks that same index.

But here's where you come face-to-face with what's called the wash sale rule, which says that if you sell a security at a loss and buy the same or a similar security within 30 days before or after the sale, you can't claim the loss on your tax return. What's more, the wash sale extends to other accounts too—so if you sell a stock in your taxable account then buy the same stock right away in your retirement account, you still violate the wash sale rule.

The good news: You may be able to replace the sold security with one that is different enough to satisfy the IRS.

3. Overdoing it.

The thought of using tax losses to reduce your tax bill might sound wonderful, but it's entirely possible to let tax-loss harvesting get out of hand and end up diluting its potential benefits. For one, transactions such as selling securities, buying replacements and possibly even rebuying the initial securities likely come with costs. Getting overzealous with buying and selling can potentially erode a chunk of tax savings you might generate.

Only Part of the Equation

Tax-loss harvesting is a tool that most investors with taxable investment accounts should at least look into. That said, tax-loss harvesting should be just one possible move to consider when looking to mitigate taxes. Other strategies include converting a traditional IRA or 401(k) to a Roth IRA, taking advantage of tax-exempt or tax-managed investments, and implementing a charitable giving strategy with tax benefits.

The upshot: Don't treat tax-loss harvesting like it's a magic bullet. Examine and weigh your tax mitigation options—consulting with a trusted advisor about the benefits and risks—and see whether tax-loss harvesting may fit into a comprehensive plan for keeping more of what you make.

[2.] Source: Chaudhuri, Shomesh and Burnham, Terence C. and Lo, Andrew W., An Empirical Evaluation of Tax-Loss Harvesting Alpha (March 5, 2019). Available at SSRN: https://ssrn.com/abstract=3351382

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