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Key Benefits of Year-End Tax Loss Harvesting

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In a perfect world, investors would only see gains when checking their accounts. But in the real world, the stock market can be volatile and doesn't always trade on a straight upward trajectory. No one wants their investments to decline, but when the market does trade lower, it's possible to convert those losses into valuable tax assets. This process is called tax-loss harvesting and involves selling underperforming investments to create capital losses, which can offset current-year taxes or be carried forward. This process typically occurs at year-end when investors review their annual portfolio performance and the potential tax implications.

The chart below explains how tax-loss harvesting works. It compares two portfolios that start with a $100,000 value and generate both a $10,000 gain and a -$5,000 loss during the year. In Scenario A, the investor realizes the $10,000 capital gain by selling the profitable investment but doesn't sell the unprofitable investment with a -$5,000 loss. The result is a net $10,000 capital gain, which, at a 25% tax rate, would incur a $2,500 tax liability. In Scenario B, the investor realizes the $10,000 capital gain but also sells the investment with a -$5,000 loss. The investor has both a $10,000 capital gain and a -$5,000 capital loss, which offset to create a net $5,000 capital gain. At the same 25% tax rate, the investor faces a $1,250 tax liability, saving $1,250 in taxes.

Tax-loss harvesting offers tax advantages for investors with significant capital gains or losses, but there are special considerations. The IRS created the wash sale rule to discourage investors from selling securities at a loss solely for tax deductions. The rule states that if you sell a security at a loss, you can't purchase the same or a "substantially identical" security within 30 days before or after the sale. Additionally, tax-loss harvesting is only applicable to taxable investments, not tax-advantaged retirement accounts. Finally, it's important to keep in mind that the trading costs of selling and buying a new security could offset a portion of the tax benefits.

In summary, when done correctly, tax-loss harvesting can convert market selloffs into tax benefits. It's a tool you can use to sell investments and rebalance portfolios in a tax-efficient manner, but it shouldn't outweigh other financial considerations, jeopardize your long-term goals, or cause you to sell an attractive long-term holding. However, when the opportunity arises and you're reviewing portfolios, tax-loss harvesting can be a powerful tool to rebalance and diversify a portfolio.

Figure 1 – Tax-Loss Harvesting Example

Scenario A – No Action	
Starting Portfolio Value:	**$100,000**
Gains on Sold Positions:	+$10,000
Loss on Positions (Not Sold):	-$5,000
Net Taxable Gain:	**+$10,000**
Tax Rate:	25%
Taxes Paid:	**-$2,500**

Unable to use the loss unless you sell the position →

Scenario B – Tax Loss Harvesting	
Starting Portfolio Value:	**$100,000**
Gains on Sold Positions:	+$10,000
Losses on Sold Positions:	-$5,000
Net Taxable Gain:	**+$5,000**
Tax Rate:	25%
Taxes Paid:	**-$1,250**
Taxes Saved:	**+$1,250**

← Sold positions with losses can offset your year-end taxable gain

← Saved from Tax Loss Harvesting

The graph shown above represents hypothetical investments and is not representative of an actual client's portfolio. This information is provided for illustrative purposes, is not tax advice, and is not intended to be a recommendation or suggestion to engage in or refrain from a particular investment strategy. Actual results will vary.

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Disclosures

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