Tax-Loss Harvesting

As we approach the end of the year there is something you can do now to improve your tax situation. For many investors a helpful strategy is "tax-loss harvesting." If you are picturing your financial planner on a tractor with a straw hat that is not the case. Tax-loss harvesting is — the selling of securities that show a tax-loss to potentially offset a capital gains tax liability, or even regular income. Notice the word "tax" before the word loss. This is not necessarily an investment that has done poorly, although it could be, but it is one that you have paid taxes on more than the current value.

For example, you purchased a mutual fund at $10,000 and over the years it had dividends and capital gains distributions of $2,000, making your total taxable cost basis $12,000. If today's value is $11,000 it may be beneficial to sell the mutual fund, realizing the $1,000 tax-loss. You made money on the investment, the gain from $10,000 to $11,000, but the distributions from the fund over the years means your taxable basis was higher than the current value. The difference between the cost basis of $12,000 and the value if you sold and received $11,000 of proceeds, would be a $1,000 tax-loss that could help lower your taxes.

The example above demonstrates why the first focus for tax-loss harvesting is cost basis. There are different options for calculating your cost basis, such as FIFO (first in first out), or LIFO (last-in, first-out). If you have acquired multiple lots of the same security over time, through additional purchases or reinvestments of dividends and distributions, you can calculate your cost basis as a per share average of all the purchases (average cost method) or by keeping track of the actual costs. The actual cost method has the advantage of allowing you to designate a specific, higher cost share to sell, which increases the amount of the potential loss to be realized. The cost basis method must be selected prior to selling the holdings, so at Wagner Planning we take care to select the appropriate method for cost basis calculation based on your financial situation.

The second area of focus is the holding period. A short-term holding period is a year or less and a long-term holding period is longer than one year. According to the tax code, short- and long-term losses must be used first to offset gains of the same type. The good news is, if your losses of one type exceed your gains of the same type, you can apply the excess to the other type. For example, if you sell a long-term investment at a $15,000 loss but had only $5,000 in long-term gains for the year, the remaining $10,000 can be applied to any short-term gains. Realizing a capital tax loss can be useful even

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if you do not have any capital gains this year because of the capital loss tax deduction and carryover provisions. If you file a joint tax return, you could potentially apply up to $3,000 a year in capital losses to reduce your ordinary income.

The final focus area is estimated capital gains. Around the 4th quarter investors can start to receive estimates for year-end capital gains distributions. The key is, not all capital gains come from investment portfolios. If you sold a property or received a stock award, selling an investment in your portfolio to realize a tax-loss can help offset those events, so you do not wind up in a higher tax bracket than you intended. Even if you do not have any capital gains for the current year you can carry forward any losses indefinitely, so that you could use them later to offset future gains. At Wagner Planning we take in to account the entirety of your financial situation and pay attention to the capital gains estimates and begin looking for tax-losses to offset these projected gains.

There are many areas to consider when using the strategy of "tax-loss harvesting." It is important to be aware of the wash-sale rule, consider your overall tax situation for the year, review estimated capital gains, and remember this strategy only applies to taxable investments. Having a proactive and knowledgeable CERTIFIED FINANCIAL PLANNER™ can be extremely valuable to your overall financial situation, including taxes. When done properly tax-loss harvesting can mean less of your money goes to taxes and more may be able to stay invested and working for you, helping you reach your goals even faster.

This article written by Sandra J. Wagner, CFP®. Sandra has been helping people with their finances since 2001. She is a CERTIFIED FINANCIAL PLANNER™ professional and CEO of Wagner Planning.

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