Reap the Benefits of Tax-Loss Harvesting to Lower Your Tax Bill

By RANDE SPIEGELMAN | DECEMBER 05, 2016

Even in the best of times, not every investment will be a winner—some losses are inevitable. But there's a silver lining to capital losses: You may be able to use them to lower your tax bill and better position your portfolio going forward. This strategy is called **tax-loss harvesting**, and it's one that many investors should consider.

Here's how it works.

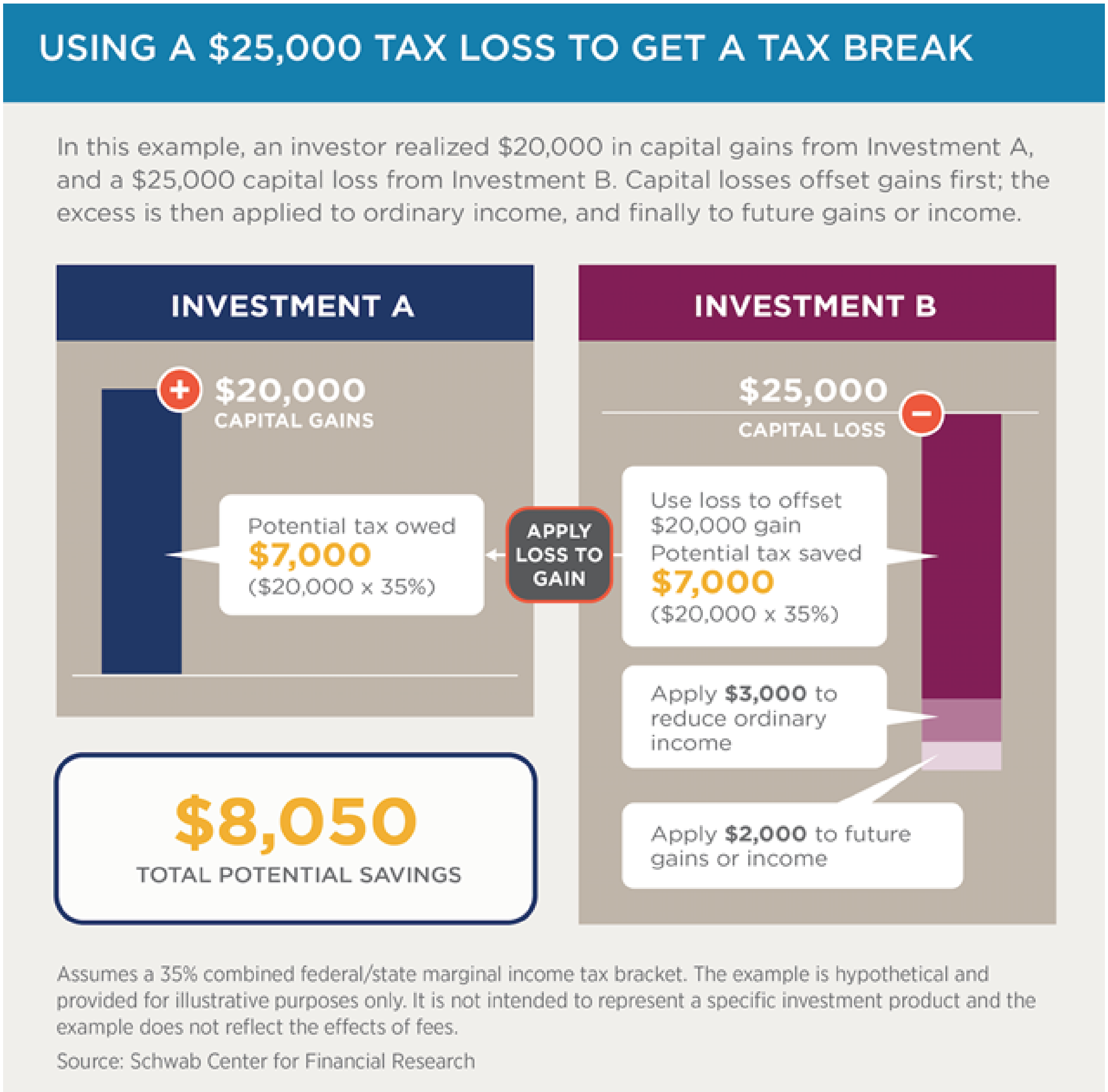
Tax-loss harvesting basics

Say you're reviewing your portfolio, and you see that several of your investments are up, but a few have dropped in value since you bought them. In the process of rebalancing your holdings to your target asset allocation, you may have to sell some of the winners to get your portfolio back in proper alignment. But that means generating some taxable capital gains. Depending on your tax bracket and how long you held that security, the tax rate on those capital gains could be as high as 43.4%.[1]

Enter tax-loss harvesting. If you also sell the investments that have declined in value, the Internal Revenue Service (IRS) lets you use those losses to offset your gains and the tax liability those gains created.

Even better: If your capital losses exceed your capital gains in a given year, you can use the losses to reduce your ordinary taxable income by up to $3,000 (for married persons filing separately, the annual net capital loss deduction limit is only $1,500). And any losses left over can be used in future years, without expiration during your lifetime—up to the yearly limits.

For example, suppose you sold shares of a stock for $20,000 more than you originally purchased them less than a year ago. This would be a short-term capital gain, taxed as ordinary income. But now suppose you also sell shares of another stock for $25,000 *less* than you paid. Your loss would offset the full $20,000 gain—you'd owe no taxes on the gain and would have $5,000 left over to offset ordinary income (up to $3,000 in the current year, with $2,000 left for use in the following year).



Some rules and restrictions

Of course, there are a few caveats that accompany this strategy.

- First, tax-loss harvesting can only be used in taxable accounts, not in an IRA or 401(k).
- Second, there are restrictions on using specific types of losses to offset certain gains. A long-term loss (from the sale of a security held one year or more) would first be applied to a long-term gain. A short-term

loss (held less than one year) would be applied to a short-term gain. If there are excess losses in one category, these can then be applied to gains of either type.

- Then, in the process of conducting these transactions, you must abide by the so-called **wash sale rule**.

The wash sale rule states that if you sell a security at a loss and buy the same or “substantially identical” security within 30 days before or after the sale, the loss is typically disallowed for current income tax purposes.

As much as you might want the tax loss, you may not want to be out of the market for an entire month just to avoid the wash sale rule. Likewise, you may be reluctant to increase your exposure by doubling your loss position, then waiting 31 days to sell your original shares.
Fortunately, you have an alternative. You could take the loss and immediately replace the security you sold with a similar (but not “substantially identical”) investment that suits your asset allocation and long-term investment plan.

With this strategy, you can sell investments that are no longer a good fit, and reinvest in more suitable, better-rated and/or more tax-efficient securities in the same asset class to better position your portfolio going forward.

A tax break for ordinary income

Here’s a hypothetical example. Even if you don’t have capital gains that you want to offset, tax-loss harvesting could still help you reduce your ordinary income tax bill. Let’s say Sofia, a single income-tax filer, holds XYZ security. She originally purchased XYZ for $6,000, but it’s now worth only $3,000, a 50% decrease in value.

Sofia is reluctant to sell and recognize the loss, especially if it means upsetting her investment plan or being out of (or doubling) the position for 31 days to avoid the wash sale rule. What can she do?

Sofia could find a suitable replacement. For instance, she may find that security ZZZ is as good as or better than XYZ, given her overall goals and objectives. She could simultaneously sell XYZ (a $3,000 loss) and purchase ZZZ for $3,000 (minus any fees or commissions), avoiding the wash sale rule while maintaining her investment plan.

As far as her portfolio is concerned, Sofia is in the same financial position now. But, if Sofia has a combined federal/state marginal income tax bracket of 35%, she could also receive a current income tax benefit of up to $1,050 ($3,000 × 0.35). In effect, her loss would be reduced from 50% to 32.5% ($3,000 – $1,050 = $1,950, or 32.5% of $6,000).

It’s important to keep in mind that, assuming a loss sale and subsequent purchase at lower market levels than the original purchase, tax-loss harvesting will have the effect of lowering overall portfolio cost basis and thus potentially increasing future gains. Of course, any future gain is offset by the current loss so that you’re no worse off than before, assuming that your replacement security performs as well as the original, transaction costs are immaterial, and future tax rates remain the same (lower future rates would increase the benefit, while higher future rates would decrease it).

So why harvest losses at all? The potential benefit lies with the time value of money and your ability to invest current tax savings for additional future growth.

Harvesting losses as part of your long-term planning

Harvesting losses regularly and proactively—when you rebalance your portfolio, for instance—can save you money over the long run, effectively boosting your after-tax return.
For example, imagine a $100,000 portfolio of 10 stocks, each holding worth $10,000. The portfolio returns 8% for the year as a result of six stocks gaining 20% on average ($12,000 in gains) and four stocks losing 10% on average ($4,000 in losses).

Assuming you can find better prospects elsewhere—the investment decision should always come first—replacing the four losers makes $4,040 ($40 in hypothetical commissions) of realized losses available to offset realized short-term gains.

Supposing you could use the entire $4,040, a combined federal/state marginal tax bracket of 40% would result in a net savings of $1,576 ($1,616 tax savings, less $40 commissions paid). You might also have a potentially better-positioned portfolio going forward.

Even in a combined marginal bracket of 30%, just taking advantage of the annual $3,000 capital- loss limit against ordinary income means an extra $900 per year in your pocket (minus commissions, if any). Assuming an average annual return of 6%, reinvesting $900 each year would amount to approximately $35,000 after 20 years.

That would more than offset the additional capital gain tax should you end up selling the replacement securities with their lowered cost basis. In fact, if you donate shares to charity or bequeath shares to heirs who receive a step-up in basis, the tax savings from loss harvesting would be permanent.

[1] Short-term capital gains are taxed as ordinary income. The top federal income tax bracket is 39.6%. And an additional 3.8% surtax applies to net investment income for taxpayers with adjusted gross income (AGI) over $200,000 (single filers) or $250,000 (married filing jointly).

What you can do next

- Taxes are important, but don’t make them your first consideration when it comes to investing. Focus on your investment goals, overall asset allocation and investment performance, while keeping costs as low as possible.

- If you want to take advantage of tax-loss harvesting, consider an automated investment advisory service like Schwab Intelligent Portfolios™, offered through Schwab Wealth Investment Advisory, Inc. With a qualifying minimum ($50,000), clients can enroll in automated tax-loss harvesting.*
- As always, when dealing with your personal tax situation, consult an experienced tax professional to determine what's best for you. Talk to a Schwab Financial Consultant at your local branch, or call us at 800-355-2162 to learn more.

Important Disclosures

The information provided here is for general informational purposes only and should not be considered an individualized recommendation or personalized investment advice. The investment strategies mentioned here may not be suitable for everyone. Each investor needs to review an investment strategy for his or her own particular situation before making any investment decision.

All expressions of opinion are subject to change without notice in reaction to shifting market conditions. Data contained herein from third-party providers is obtained from what are considered reliable sources. However, its accuracy, completeness or reliability cannot be guaranteed.

Examples provided are for illustrative purposes only and not intended to be reflective of results you can expect to achieve.

This information is not intended to be a substitute for specific individualized tax, legal or investment planning advice. Where specific advice is necessary or appropriate, Schwab recommends consultation with a qualified tax advisor, CPA, Financial Planner or Investment Manager.

*Clients must enroll in tax-loss harvesting to receive this service. See intelligent.schwab.com for more information on the qualifying minimum.

Please read the Schwab Intelligent Portfolios™ disclosure brochures for important information.

Brokerage Products: Not FDIC Insured · No Bank Guarantee · May Lose Value

Schwab Intelligent Portfolios™ is made available through Schwab Wealth Investment Advisory, Inc. ("SWIA"), a registered investment advisor. Portfolio management services are provided by Charles Schwab Investment Advisory, Inc. ("CSIA"). SWIA and CSIA are affiliates of Charles Schwab & Co., Inc. ("Schwab") and subsidiaries of The Charles Schwab Corporation.

Charles Schwab & Co., Inc. and Charles Schwab Bank are separate but affiliated companies and subsidiaries of The Charles Schwab Corporation. Brokerage products, including the Schwab One® brokerage account, are offered by Charles Schwab & Co., Inc., Member SIPC. Deposit and lending products are offered by Charles Schwab Bank, Member FDIC and an Equal Housing Lender.

(1216-RFJX)

Thumbs up / down votes are submitted voluntarily by readers and are not meant to suggest the future performance or suitability of any account type, product or service for any particular reader and may not be representative of the experience of other readers. When displayed, thumbs up / down vote counts represent whether people found the content helpful or not helpful and are not intended as a testimonial. Any written feedback or comments collected on this page will not be published. Charles Schwab & Co., Inc. may in its sole discretion re-set the vote count to zero, remove votes appearing to be generated by robots or scripts, or remove the modules used to collect feedback and votes.