Reaping the Benefits of Tax-Loss Harvesting

By Kristi Mathisen

Kristi Mathisen, JD, CPA, PFS

Kristi is LNWM's managing director of tax and financial planning. An attorney and CPA, she has more than 20 years of experience providing analysis and guidance on tax and wealth planning strategies.

At LNWM, we have a deep bench of expertise dealing with extreme market turbulence. Especially during down markets, we pro-actively apply what is known as tax-loss harvesting to improve the after-tax returns on client portfolios. Because there are several steps to this strategy, I thought I would explain what tax-loss harvesting is, how we implement it at LNWM, and the benefits it can provide to taxable portfolios at times when the markets are highly volatile.

What is tax-loss harvesting? It is a way to benefit from a down market while staying invested to profit from the eventual rebound. There are two major steps:

Step 1: As we make tactical shifts in taxable accounts, LNWM reviews opportunities to sell some positions at a loss. These losses can be used to offset gains already realized this year, as well as gains generated in the coming months. Losses that cannot be used to reduce taxes in the current year can be carried forward into future years.

Especially advantageous are short-term losses, those generated on investments held for one year or less. That's because short-term losses can be used first to offset short-term gains, which are taxed like ordinary income (at your highest income tax rate). What is left can then be used to offset long-term gains. If any short-term losses remain after all gains are offset, up to $3,000 can be used each year to reduce household taxable income (adjusted gross income or AGI). Beyond that, excess losses can be carried forward into future years indefinitely and treated

Result of Trade	Taxes	Other Considerations
Short-term capital gain (investment held under 1 year)	Taxed as regular income at your highest marginal tax rate	Amount of gain can put you in higher income tax bracket
Long-term capital gain (investment held over 1 year)	Taxed at capital gains rates — 0%, 15%, 20% depending on household income level	Amount of gain can put you in higher tax bracket
Short-term loss	Can offset in this order: 1) all short-term gains; then 2) any long-term gains	Can be applied to future years; excess up to $3,000 can offset taxable income
Long-term loss	Can offset in this order: 1) all long-term gains; then 2) any short-term gains	Can be applied to future years; excess up to $3,000 can offset taxable income, but only after short-term losses carried over from past years have been exhausted

Step 2: We replace the investments sold with similar ones to maintain each portfolio's targeted asset allocation and risk/ return attributes. Our goal is to keep you invested in a diversified portfolio that can benefit from up moves in the market, while using tax-loss harvesting in the near term to increase future after-tax returns.

Minding the "Wash Sale" Rule

When replacing securities, we are very careful to abide by the IRS' "wash sale" rule, so that any losses reported are not disqualified. The rule is basically this: you cannot claim a loss if you buy a "substantially identical" security (directly or through contracts or options) within 30 days — before and after – of selling at loss. This rule also applies to securities bought by your spouse or a company that you control, and to taxable (including joint accounts) and retirement accounts. A "gotcha" when selling part of a mutual fund are the automatically reinvested dividends, which can trigger a wash sale designation.

What happens when a loss is disallowed? The account custodian reports it as such on Form 1099 issued to you. And the amount of the loss is added to the cost of the substantially identical shares recently bought.

When Tax-Loss Harvesting Works Best

We find that the best candidates for tax-loss harvesting are positions in funds in liquid markets (such as US large-cap stocks) where you have a significant loss, either in dollar amount or percentage (20% or more). The specific funds should be easily replaceable with a fund that is similar although not identical, so that similar performance can be expected in terms of risk and return. We maintain a list of similar but not identical funds ("proxies") for many of our investments, so we can be prepared to execute when we see opportunities for tax-loss harvesting.

Positions in actively managed funds require special consideration. There are rarely good proxies for these funds, and they often have restrictions on re-purchasing after a sale. For some of these funds, we may forego tax-loss harvesting if we won't be allowed to buy back into the fund after the 30-day wash sale period has passed. For index funds, the proxy fund is usually a good substitute, and we might not re-purchase the original security. In making such moves, we are mindful of new short-term gains that may be generated if the market rises.

Just as important, we try as much as possible to minimize fees that apply to tax-loss harvesting transactions, such as redemption fees on fund sales and higher management fees on the replacement funds. And we are careful to abide by the time restrictions that some fund companies place on selling and buying funds. And if the transactions happen in the last quarter of the year, we are mindful of the timing of capital gains distributions that mutual funds make at year-end.

Your Big Picture

Ultimately, tax-loss harvesting works best when the transactions are aligned with your entire asset base, your tax situation, and your cash flow needs. The following are things we consider carefully as we look for opportunities for tax-loss harvesting that will benefit you:

- Do you already have losses carried forward from previous years?
- What amount in realized gains and losses has your LNWM portfolio generated this year?
- What other realized gains/losses are likely for you this year (sales of business or property)?
- Potential future gains – could you generate meaningful losses to carry forward that could be used to offset a significant gain in future years?
- Your taxable income – could generating additional losses move you into a lower tax bracket for income and/or capital gains, help you avoid the 3.8% Net Investment Income tax, and minimize your exposure to higher Medicare Premiums (for those 65 and older)? Working with your CPA if necessary, we can ascertain the various outcomes so you can see if this works for you.

2020 Income and Capital Gains Rates

The capital gains — 0%, 15% or 20% — is based on total taxable income, including the gains.

Regular Income Tax			Long-Term Capital Gains Tax		
Rate	Taxable Income Single	Taxable Income Married, Filing Jointly	Rate	Taxable Income Single	Taxable Income Married, Filing Jointly
37%	> $518,400	> $622,050	20%	> $441,450	>$496,600
35%	$207,350 — $518,400	$414,701 — $622,050			
32%	$163,301 — $207,350	$326,601 — $414,700	15%	$40,001 — $441,450	$80,001 — $496,600
24%	$85,526 — $163,300	$171,051 — $326,600			
22%	$40,126 — $85,525	$80,251 — $171,050			
12%	$9,876 — $40,125	$19,751 — $80,250	0%	Up to $40,000	Up to $80,000
10%	Up to $9,875	Up to $19,750			

What Works Best for You

As trying as they may be, down markets provide opportunities, including tax-loss harvesting to maximize net return during the current year or in the future. We can help you make the most of those opportunities. Your LNWM Advisory team will be reviewing your portfolio and finances to see if and when a tax-loss harvesting strategy makes sense for you.

About the Author

Kristi Mathisen, JD, CPA, PFS is Managing Director of Tax and Financial Planning at Laird Norton Wealth Management. In addition, she provides guidance and advice on philanthropic strategies and estate planning to the firm's client services team and to clients directly. An attorney, CPA and Personal Financial Specialist with more than 20 years of finance-related experience, Kristi has a bachelor's degree in business administration from the University of Washington and a Juris Doctor from the University of Washington School of Law. She is a member of the Washington State and King County Bar Associations, the Washington State Society CPA and the American Institute of CPAs.

About Laird Norton Wealth Management

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