
WINTHROP WEALTH

APRIL 2023 CLIENT QUESTION OF THE MONTH

# TAX-LOSS HARVESTING

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The filing deadline to submit 2022 tax returns or an extension to file and pay taxes owed is Tuesday, April 18, 2023, for most taxpayers. That is due to April 15th falling on a Saturday this year and the next weekday, April 17th, is recognized as Emancipation Day in Washington, DC. (Source: *IRS*)

During tax season, it's important to understand the potential advantages of tax-loss harvesting – a strategy we were/are able to implement during times of market volatility. If you have been reading and staying up to date on our educational pieces (the Monthly Market Recaps, Client Questions of the Month, and Quarterly Market Reviews), then you already know last year was a difficult year for virtually all asset classes – stocks, bonds, commodities (ex. energy), gold and cryptocurrencies.

With the bond market having its worst calendar year in 50 years and the S&P 500 falling more than -18%, tax-loss harvesting provided a silver lining. Active management paired with volatility in the market presented opportunities to make lemonade (realize losses) out of lemons (volatile dips in the market). This lead to effectively offsetting some or all realized gains, while intentionally rebalancing to better position portfolios for the future.

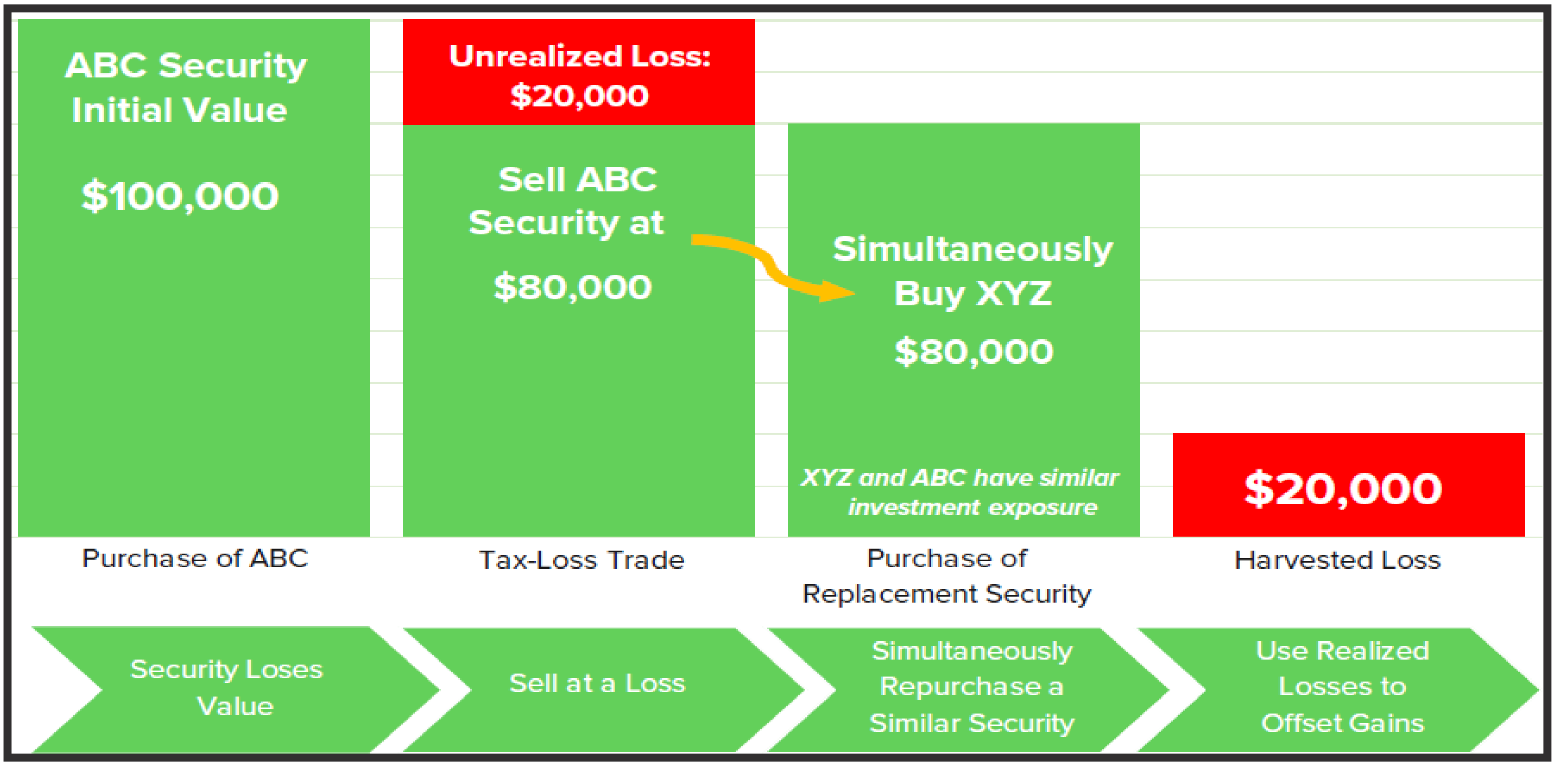
**What is Tax-Loss Harvesting?**

Tax-loss harvesting is a method of selling an investment (in a non-qualified taxable account) with a loss and immediately purchasing a different security with similar (but not identical) exposure. Tax-loss harvesting does not protect against loss and may not be suitable for your individual situation.  The two key points are:

1. The loss on the sold security can be used to offset taxable gains.
    - If there are losses in excess of any gains for the given year, up to $3,000 for an individual or married filing jointly ($1,500 for married filing separately) can be used against ordinary income.
    - Any unused tax losses can be carried forward to future years. The IRS rules on capital gains and losses can be found here.
2. Since we simultaneously sell a security to capture a loss and purchase a different security with similar exposure, the client is never out of the market.
    - We can capture losses during declines, and when the market potentially recovers the new security may also recover PLUS the client has a tax loss to offset future gains.

**How does it work?**

The illustration below is a hypothetical example of the methodology where a client buys $100k worth of ABC security and two months later the price has declined by -20%. The client can sell the entire position of ABC for $80k and immediately buy a similar (but not identical) position for that same amount, let's say the new position is XYZ security. Now assume that the value of XYZ security increases back to $100k. The total value of the position is unchanged, but the client has a $20k tax loss that can be used to lower (or eliminate) taxes owed that year and/or against future gains.




*Note, the IRS has put in place the "Wash Sale Rule" to ensure that investors do not sell a security to capture a loss and immediately buy it back. The rule prohibits an investor from selling an investment at a loss and then buying a "substantially identical" security within 30 days before or after the sale.*

**The Net Effect**

To better understand the value of the strategy, we will compare two hypothetical investor scenarios where one investor had an active portfolio manager that utilized tax-loss harvesting and the other did not.

*Example 1: An investor in a 20% capital gains Federal tax bracket who utilized Tax-Loss Harvesting in his portfolio.*

In year 1, Steven had an unrealized loss in his taxable account. To avoid a year-end capital gain distribution from a position with an unrealized loss (and in efforts to mitigate taxes owed), he sold the security and actively harvested $30k of losses while simultaneously purchasing a reasonably similar investment – replacing the existing exposure within his portfolio. Of those losses, $3k was applied to lower his adjusted gross income in the year in which it was realized, resulting in a net loss carryforward of $27k.

The following year the market rebounded, and Steven had a liquidity need of $100k. The sale generated a $50k long-term capital gain.

When the excess losses from Year 1 are applied, the net capital gain of $23k ($50k realized gain– $27k capital loss carryforward from prior tax year) at a 20% Federal capital gains tax rate ($23k realized capital gain × 20% rate) results in a $4.6k tax liability on this transaction… saving Steven $5.4k in taxes in year 2.

| | Capital Gains Tax Rate | Realized Amount | Year-end Tax Savings/Liability | Net Tax Outcome |
|---|---|---|---|---|
| Year 1 | 20% | ($30k) Capital Loss<br>*($3k) Utilized*<br>*($27k) Carryforward* | $3k Loss x 20% Tax Rate = $600 Tax Savings | Take $3k of capital losses and deduct $600 from ordinary income on the current year tax return |
| Year 2 | 20% | $50k Gain from Sale - $27k Carryforward = $23k Capital Gain | $23k Gain x 20% Tax Rate = $4.6k Tax Liability | Take $27k loss carryforward against current year capital gain of $50k, saving $5.4k in taxes |

*Example 2: An investor in a 20% capital gains Federal tax bracket who did not utilize Tax-Loss Harvesting in her portfolio.*

In year 1, Susan had an unrealized loss in her taxable account, but did not harvest any of the losses. At the end of the year, she received a capital gains distribution of $10k.

Even though Susan's account value was down for the year, she still had to pay tax on the income she received. The $10k capital gain at the 20% Federal capital gains tax rate ($10k gain x 20% rate) will create a $2k tax liability.

The following year the market rebounded, and Susan had a liquidity need of $100k. The sale incurs a $50k long-term capital gain.

This results in a net capital gain of $50k ($50k realized gain– $0 capital loss carryforward from prior year) at a 20% Federal capital gains tax rate ($50k realized capital gain x 20% rate) results in a $10k tax liability on this transaction for year 2.

| | Capital Gains Tax Rate | Realized Amount | Year-end Tax Savings/Liability | Net Tax Outcome |
|---|---|---|---|---|
| Year 1 | 20% | $10k Capital Gain from Distribution | $10k Gain x 20% Tax Rate = $2k Tax Liability | No deductions used to offset $10k capital gain from distribution, owing $2k in Federal taxes |
| Year 2 | 20% | $50k Capital Gain from Sale | $50k Gain x 20% Tax Rate = $10k Tax Liability | No deductions used to offset $50k capital gain from sale, owing $10k in Federal taxes |

As the scenarios demonstrate, an investor's net federal tax outcome can be greatly impacted by having an active portfolio manager that strategically executes tax-loss harvesting decisions during volatile market environments. Steven was able to avoid receiving a capital gains distribution (from selling the position that was held with a loss) and utilize $3k of realized losses to arrive at a lower AGI (Adjusted Gross Income) in year 1 while reducing the amount owed in capital gains tax for year 2 by carrying forward his excess losses, neither of which Susan had benefitted from. Taking it a step further, the tax savings allows Steven to have more money invested over a long term time period, potentially benefitting from the power of compounding.

**Recap**

Tax-loss harvesting provides a silver lining when navigating through the storms of market volatility. Having a dynamic process and the appropriate technology to tax loss harvest is critically important as market declines happen frequently. The S&P 500 has averaged a peak-to-trough decline of about -15% each year since 1928 despite producing a total annualized return of +9.4% over the same period (Source: Bloomberg). Historically, equity markets have recovered from recessions and downturns. It is important to consider your risk tolerance and time horizon and let your advisor know of any changes, or liquidity needs.

When inevitable market declines occur, we try to make lemonade out of lemons by tax-loss harvesting and rebalancing portfolios. These activities provide significant benefits by capturing losses and/or reallocating to more attractive securities that will better position portfolios going forward. Please remember that no strategy assures success.

At Winthrop Wealth, we apply a **total net worth approach** to both comprehensive financial planning and investment management. We believe financial planning helps drive the investment strategy and provides a roadmap to each client's unique goals and objectives. The comprehensive financial plan defines cash flow needs, is stress tested for various market environments, seeks to optimize account structures, considers tax mitigation strategies, and helps evaluate financial risks as circumstances and/or goals change. The investment management process is designed to provide well-diversified portfolios constructed with a methodology based on prudent risk management, asset allocation, and security selection. Diversification does not protect against market risk. All investing involves risk which you should be prepared to bear.

*Note, net capital losses (the amount that total capital losses exceed total capital gains) can only be deducted, to offset ordinary income, up to a maximum of $3k in a tax year ($1.5k for married filing separately). Net capital losses exceeding the $3k threshold may be carried forward to future tax years until exhausted (or upon the passing of the account holder). There is no limit to the number of years there might be a capital loss carryover.*

*Two states, PA & NJ don't have carryover provisions, which means use or lose. For PA and NJ residents it is not beneficial to tax-loss harvest unless it is strategically done the same year gains are realized.*

**DISCLOSURES:**

Content in this material is for general information only and not intended to provide specific advice or recommendations for any individual.

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The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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Diversification does not protect against market risk. All investing involves risk which you should be prepared to bear.

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