



APRIL 2024 CLIENT QUESTION OF THE MONTH

TAX-LOSS HARVESTING

By Francesca Lanza | Associate Portfolio Manager



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The IRS deadline for most taxpayers to submit 2023 tax returns (or file for an extension) is Monday, April 15, 2024. If you are a resident of Maine or Massachusetts, you have until April 17th to file because of the Patriots' Day and Emancipation Day holidays. For those granted an extension, you have until Tuesday, October 15, 2024 to file. (Source: [IRS](#))

When it comes to taxes, 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](#), then you may recall last year's challenges, aka the "wall of worry", involving sticky inflation, rising interest rates, regional bank issues, geopolitical conflicts, and risk of an economic recession.

These challenges led to periods of heightened volatility throughout 2023. Despite macroeconomic uncertainties, the economic environment proved better than anticipated. Signs of inflation easing prompted the Fed to pivot from keeping interest rates "high for longer" to lowering interest rates in 2024. The market reacted positively to this news, causing both stocks and bonds to rally into year-end. While 2022 endured more volatility, there were still periods that presented opportunities to make lemonade (realize losses) out of lemons (volatile dips in the market). By actively managing client assets and using market fluctuations to realize losses, we sought to offset some or all realized gains in many portfolios, while also intentionally rebalancing portfolios to better position portfolios toward client's objectives for the future. Rebalancing a portfolio may cause investors to incur tax liabilities and/or transaction costs and does not assure a profit or protect against a loss.

What is Tax-Loss Harvesting?

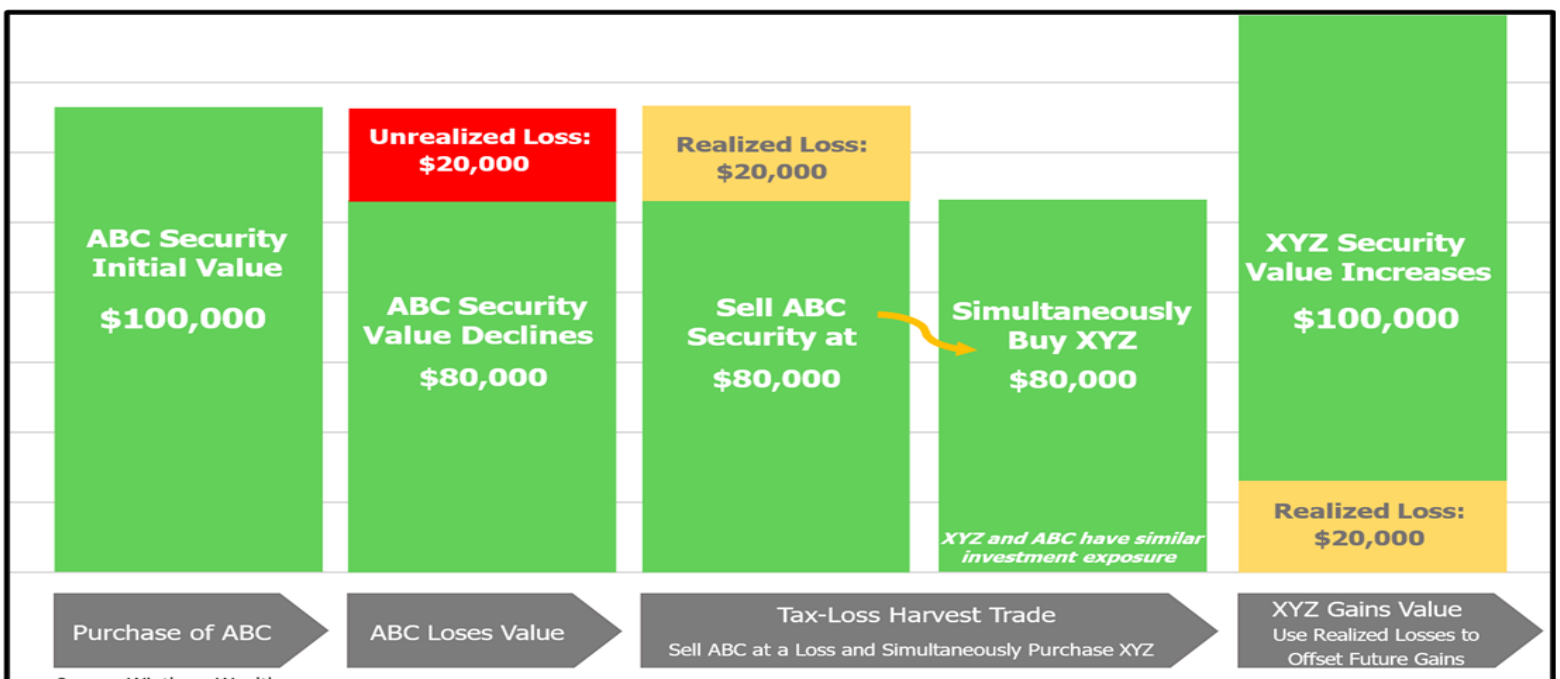
Tax-loss harvesting is a method of selling an investment (in a non-qualified taxable account) with a loss and immediately purchasing a different security with similar (but not identical) exposure. Tax-loss harvesting does not protect against loss and may not be suitable for your individual situation. 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 ideally 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, Sofia had an unrealized loss in her taxable account. To avoid a year-end capital gain distribution from a position with an unrealized loss (and in efforts to mitigate taxes owed), she sold the security and actively harvested \$30k of losses while simultaneously purchasing a reasonably similar investment – replacing the existing exposure within her portfolio. Of those losses, \$3k was applied to lower her 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 Sofia 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 x 20% rate) results in a \$4.6k tax liability on this transaction... saving Sofia \$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 (\$3k) Utilized (\$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

This is a hypothetical example and is not representative of any specific situation. Your results will vary. The hypothetical rates of return used do not reflect the deduction of fees and charges inherent to investing.

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, Jack had an unrealized loss in his taxable account, but did not harvest any of the losses. At the end of the year, he received a capital gains distribution of \$10k.

Even though Jack’s account value was down for the year, he still had to pay tax on the income he 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 Jack 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

This is a hypothetical example and is not representative of any specific situation. Your results will vary. The hypothetical rates of return used do not reflect the deduction of fees and charges inherent to investing.

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. Sophia 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 her excess losses, neither of which Jack had benefitted from. Taking it a step further, the tax savings allows Sophia to have more money invested over a long-term time period, potentially benefiting from the power of compounding.

Recap

Tax-loss harvesting provides a silver lining when navigating through the storms of market volatility. We believe 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 +12.1% 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 where we see opportunities to do so. We believe these activities can provide significant benefits by capturing losses and/or reallocating to securities that will better position portfolios toward clients' objectives 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.

The economic forecasts set forth in this material may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

All indexes mentioned are unmanaged indexes which cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

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.

Financial planning is a tool intended to review your current financial situation, investment objectives and goals, and suggest potential planning ideas and concepts that may be of benefit. There is no guarantee that financial planning will help you reach your goals.

Asset allocation does not ensure a profit or protect against loss. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio.

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

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