Tax-Loss Harvesting

In a recent **article** for Financial-Planning.com, **Kimberly Foss** discusses the basics of tax-loss harvesting, something many investors may be facing as the end of the year draws near.

Tax-loss harvesting occurs when an investor sells a position for a loss. These losses can first be used to offset any gains they generated for the current year. However, even if the investor does not have any gains to offset, up to $3,000 in losses can still be deducted from their ordinary income. Since capital gains for most tax brackets are taxed at a lower rate than the corresponding ordinary income tax rates, the opportunity to offset ordinary income creates the potential for even greater tax savings than if the investor had $3,000 of gains to offset. According to Foss, the exceptions are the top income tax bracket, 39.6%, which has a 20% tax on capital gains, and the lowest two brackets of 10% and 15%, which pay no tax on capital gains.

Beyond that, any losses that exceed the investor's gains for the year, plus $3,000 in ordinary income, can be carried over and used to offset capital gains the following year and the year after that, and the one after that into perpetuity if the losses are great enough.

As Foss explains, though, investors need to be aware of wash sales. The IRS' washsale rule prohibits a taxpayer from claiming a loss on the sale of an investment if they buy the same or a substantially identical investment within 30 days of the sale date.

Foss offers a few tips for though considering tax-loss harvesting:

- Consider what the capital gains rate is today versus where it may be in the future. If you think your rate could fall from where it is now, the amount of tax savings from tax-loss harvesting could increase.
- Invest the tax savings. According to Foss, "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 (less commissions, if any). Assuming an average annual return of 8%, reinvesting $900 each year would amount to an extra $41,185 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."
- Don't harvest losses less than a few thousand dollars, as transaction costs will consume much of those savings.
- Foss suggests harvesting throughout the year, not just in December. During periods of

volatility, selling to harvest losses gives investors opportunities to adjust their allocations.

To help AAII members with the tax implications of investing, AAII publishes a variety of articles and guides, including:

- The Individual Investor Guide to Personal Tax Planning 2014
- Keeping Transactions Clean From the Wash-Sale Rules

If you are not an AAII member and want to become an effective manager of your investments, simply take a **risk-free 30-day Trial AAII Membership** and AAII's informative content and all of our other membership benefits will be available to you.