Taxation - Income, Estate, and Gift

Tax loss harvesting may reduce the pain of stock market losses.

By Eva Stark, JD, LL.M.

Investing in the stock market exposes investors to risks and rewards. During a down turn in the market, an increasing number of stock-market investors may experience significant losses in their taxable brokerage accounts. While losses are painful, taking advantage of tax breaks with respect to these losses can diminish the true economic cost of the loss and potentially improve overall returns. As with any tax strategy, pitfalls and traps such as the wash-sale rule are plentiful, so it is always important to review any contemplated tax strategy with one's tax advisor.



Background on taxation of capital gains

In simplest terms, when a stock is sold, a gain or loss is calculated generally by subtracting the cost of the stock from the sales price. Because a stock is characterized as a "capital asset" under the tax code, gains realized upon the sale of stocks constitute "capital gains" that may enjoy preferential income tax treatment. Capital gains (or losses) are of two distinct types: short-term or long-term. If the stock was held for more than one year prior to its sale, a gain will generally be "long-term" and be taxed at preferential long-term capital gains rates. If the stock was held for less than one year, a gain will generally constitute a short-term gain, which is taxed at less-favorable "ordinary income" tax rates.

Long-Term Capital Gains Rates and Brackets (2024)

	Single	Married Filing Jointly
0%	$0-$47,025	$0-$94,050
15%	$47,025-$518,900	$94,050-$583,750
20%	Over $518,900	Over $583,750

Ordinary Income Rates and Brackets (2024)

	Single	Married Filing Jointly
10%	$0-$11,600	$0-$23,200
12%	$11,600-$47,150	$23,200-$94,300
22%	$47,150-$100,525	$94,300-$201,050
24%	$100,525-$191,950	$201,050-$383,900
32%	$191,950-$243,725	$383,900-$487,450
35%	$243,725-$609,350	$487,450-$731,200
37%	Over $609,350	Over $731,200

Capital gains may additionally be subject to a 3.8% net investment income tax above an income threshold of $200,000 for single filers and $250,000 for married filing jointly.

Tax treatment of losses

While losses are never desirable, if a stock is sold at a loss, the loss may produce an immediate tax benefit. As a general rule, capital losses offset capital gains and may even be deductible against ordinary income up to certain limitations.

If the taxpayer has capital gains in addition to the losses, losses will first offset gains of the same type. Long-term capital losses first offset long-term capital gains and short-term capital losses first offset short-term capital gains. For this reason, realizing short-term losses can be very valuable if the taxpayer has short-term gains that would otherwise be taxed at higher ordinary income rates.

To the extent that a taxpayer's losses exceed gains of the same type, the loss will next offset gains of the other type (long-term losses will offset short-term gains or short-term losses will offset long-term gains). If short-term losses would offset long-term gains, the tax benefit is generally not as valuable and advisors often recommend against such outcome. However, individual circumstances vary and realizing such a loss may still make sense in some cases.

If the taxpayer's capital losses exceed both long-term and short-term gains, the loss can generally be deducted against ordinary income, up to $3,000 per year. Any unused loss carries over to subsequent tax years.

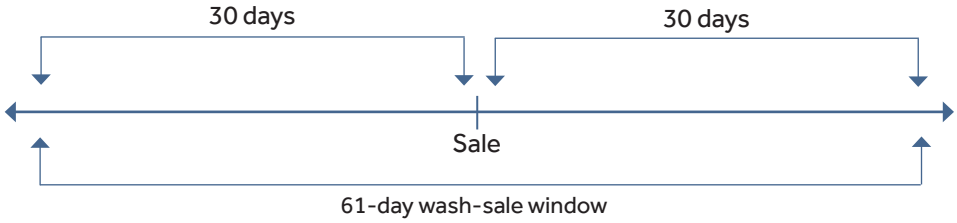
Wash-sale rule

The wash-sale rule is designed to prevent a taxpayer from benefitting from a tax loss if the taxpayer quickly reinvests into the same or "substantially identical" security. The rule is designed to prevent taxpayers from generating and benefitting from "paper losses" while maintaining the same or substantially similar investment position.

Under the rule, if a taxpayer sells a "stock or security" at a loss and purchases the same or a "substantially identical" stock or security within the 30 days before or after the sale, the taxpayer is prevented from recognizing the loss incurred. Instead, the basis and holding period of the newly acquired stock is adjusted to reflect the loss, which generally eliminates the immediate tax benefit that would otherwise result from the sale of a security at a loss. (*See example below.*)

Wash-sale rule considerations

- **"Stock or securities."** The wash-sale rule applies to sales of "stocks or securities." These generally include stocks, bonds, mutual funds, exchange traded funds, and contracts or options to purchase securities.
- **"Substantially identical."** The code or regulations do not define what "substantially identical" means for purposes of the wash-sale rule. It is generally accepted that the stock of a corporation is ordinarily not substantially identical to the stock of another corporation, even if both corporations are operating in the same industry. Ordinarily, bonds or preferred stock of a corporation are not substantially identical to the common stock of



EXAMPLE:



Tammy Taxpayer sells a share of stock in ABC corporation that had a basis of $100 for $70 on July 26th at a $30 loss. On August 3rd, she purchases a share of stock in ABC corporation for $80. Because she owns a share before and after the transaction, she arguably maintained the same position and the $30 loss is not a true loss. She is prevented from recognizing the loss by the wash-sale rule. Instead of immediately benefitting from the $30 loss, Tammy must adjust her basis in the new stock to $110, her total investment. If the new share had cost $65, the basis of the new share would be adjusted to $95. The holding period of the original share is also tacked onto the holding period of the new share. Her losses are deferred into the future by operation of the wash-sale rule, a generally undesirable outcome.

the same corporation. However, exceptions to these general rules exist. The question of what may or may not be substantially identical is even murkier when it comes to mutual funds or exchange traded funds. The issue of whether two securities may be substantially identical should be reviewed by the client's tax advisor.

- **Method for determining cost-basis.** The tax code and brokerage firms provide different methods for determining cost-basis where multiple lots of the same security are purchased. The actual cost method—which enables the taxpayer to designate the higher cost shares to be sold—is generally more advantageous for tax loss harvesting.
- **Other transactions.** Other transactions involving substantially identical securities by the taxpayer or certain related parties—such as purchases by a spouse, purchases inside a tax-deferred retirement account, vesting of restricted stock, or the exercise of options inside an employee stock purchase plan—during the wash-sale period could unexpectedly cause the taxpayer to run afoul the wash-sale rule. Therefore, other transactions involving substantially identical securities also should be reviewed by the client's tax advisor.
- **Harvesting tax losses typically only makes sense in a taxable account.** Accounts such as 401(k)s or IRAs are tax-deferred so "gains" or "losses" upon the sale of securities inside such accounts generally do not factor into income tax liability. Instead, these balances typically constitute ordinary income as they are withdrawn from the accounts.

It's not only about taxes

Strategic harvesting of losses for tax purposes can be very beneficial and may improve overall returns in some circumstances. However, it is important to emphasize that while taxes are an important consideration, planning and investment decisions should not be driven by tax-savings objectives alone.

Utilizing complex tax strategies can also increase the risk of falling into pitfalls and traps so professional advice is paramount. The potential advisability as well as the correct implementation of these strategies should be reviewed by the client's tax, investment, and other advisors.



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