Tax-Loss Harvesting in 2022 and Beyond

By Kristi Mathisen

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As trying as down markets may be (and they certainly have been that in 2022), we also know from experience that they provide opportunities for us to enhance after-tax returns. How? One strategy we apply, especially in down markets, is tax-loss harvesting. Basically, this means taking losses on certain investments to offset current or future gains, while maintaining market exposure to those same investments to profit from a rebound.

For tax-loss harvesting to be most beneficial and effective, careful coordination is necessary. It is best to have input from LNWM client advisors, our investment team, our in-house tax strategists and a client's CPA(s). Considering the context of your other assets, current and future tax situation, and cash flow needs, we can more accurately assess whether tax-loss harvesting would benefit you. Specifically:

- 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 likely 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 when necessary, we can propose various outcomes to determine what would work best for you.

Two-Step Process

Because there are several steps to tax-loss harvesting, I thought I would explain what these are and how they can benefit taxable portfolios during times of high downside volatility.

STEP 1: As we make tactical shifts in taxable portfolios, LNWM client advisors review opportunities to sell some positions at a loss. These losses can be used to offset gains realized this year or in the future.

Especially advantageous are short-term losses (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 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 taxable income. Beyond that, excess losses can be carried forward into future taxable years indefinitely (see chart below).

Result of Trade	Taxes	Other Considerations
Short-term capital gain (investment held 1 year or less	Taxed with ordinary 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 taxable income	Amount of gain can put you in higher income tax bracket
Short-term capital 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 capital 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.

When Tax-Loss Harvesting Works Best

We find that the best candidates for tax-loss harvesting are positions in liquid markets (such as U.S. large-cap stock funds) where we might have a significant loss in the position, 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 equivalent performance can be expected in terms of risk and return. We maintain a list of proxies -- similar but not identical funds -- for most of our portfolio investments, so we can be ready to execute when we see opportunities for tax-loss harvesting.

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 – selling at a 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 tax basis of the substantially identical shares recently bought.

Positions in actively managed funds require special consideration. There are rarely good proxies for these funds, and they often have restrictions on re-purchases. 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 (see box). 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. 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.

Tax-Efficient Investment Management

Tax-loss harvesting is just one of the strategies we apply to make taxable portfolios at LNWM more tax-efficient and thus enhance long-term net returns. Many of our clients have a complex array of assets and investment accounts with varying degrees of taxability. We take a comprehensive look at each client situation so we can invest in a way that maximizes overall tax efficiency.

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.

2022 Income and Capital Gains Rates

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

Regular Income Tax		
Rate	Taxable Income Single	Taxable Income Married, Filing Jointly
37%	> $539,901	> $647,851
35%	$215,951 - $539,900	$431,901 - $647,850
32%	$170,051 - $215,950	$340,101 - $431,900
24%	$89,076 – 170,050	$178,151 - $340,100
22%	$41,776 - $89,075	$83,551 - $178,150
12%	$10,276 - $41,775	$20,551 - $83,550
10%	Up to $10,275	Up to $20,550

Long-Term Capital Gains Tax		
Rate	Taxable Income Single	Taxable Income Married, Filing Jointly
20%	> $459,750	>$517,200
15%	$41,676 - $459,750	$83,351 - $517,200
0%	Up to $41,675	Up to $83,350

ABOUT THE AUTHOR

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