Tax Loss Harvesting

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Brain Teaser of the Month: *What English word has three consecutive double letters?*

Answer on Page 4

Tax efficiency is an important component of a sound investment strategy. For taxable investors, the after-tax return on a portfolio matters more than the pre-tax return.

We look to help mitigate the impact of taxes on portfolios by investing in tax-efficient securities and being mindful of capital gains tax. We also seek to harvest tax losses throughout the year.

Below, we discuss tax loss harvesting in more detail. First, it's important to step back and understand how capital gains and losses are dealt with for tax purposes.

Understanding capital gains and losses

Capital gains are the profits realized when securities are sold. For example, if an investor buys a stock for $10 and holds it until the stock is worth $15, they have an "unrealized gain" of $5. The gain is considered "unrealized" because the stock hasn't been sold yet. Once the stock is sold, the gain becomes "realized," and will be reported to the IRS at the end of the year on an IRS Form 1099.

At the end of the year, long-term capital losses are used to offset long-term capital gains and short-term capital losses are used to offset short-term capital gains. Combining capital gains and losses in each of the respective categoires results in a "net" number. For example:

- A portfolio with $10,000 in capital gains and $4,000 in capital losses results in a $6,000 net capital gain. This capital gain will be reported and taxed accordingly.
- A portfolio with $10,000 in capital gains and $15,000 in capital losses results in a $5,000 net capital loss. In this case, capital losses exceed capital gains. When this happens, capital losses generally may be used to offset up to $3,000 in ordinary income each year. Any capital losses beyond that may be carried forward to subsequent years.

The tax rate on capital gains is dependent on three factors: the asset type, the length of time the asset was held (holding period), and the investor's income tax bracket[1].

- **Asset type** - you will pay a different rate based on the type of asset you've sold (i.e., selling a home or a piece of art vs. selling a stock). Please note that this article only deals with capital gains on investments.
- **Short-term vs. long-term** - a capital gain is considered "short-term" if a capital asset is held for less than one year. Otherwise, the gain is referred to as "long-term capital gain."
- **Investor's Income** - your AGI (adjusted gross income), as reported on IRS Form 1040, will determine your tax rate on capital gains.

Short-term capital gains are considered "ordinary income," and are taxed at your applicable marginal tax rate. The top marginal tax rate on ordinary income in 2024 is 37%. Long-term capital gains rates are significantly lower and depend on the investor's AGI, as laid out in the table below[2]:

Long-Term Capital Gains Tax Rate (2024)	Single Filers	Married Filing Jointly
0%	$0 - $44,625	$0 - $89,250
15%	$44,626 - $492,300	$89,251 - $553,850
20%	Over $492,300	Over $553,850

Source: www.IRS.gov

Note that the table above does not include Net Investment Income Tax (NIIT)[3]. For those subject to NIIT of 3.8%, the highest marginal short-term capital gains rate is 40.8% compared to the highest long-term capital gains rate of 23.8% (exclusive of any state and local income taxes that may also apply).

Tax loss harvesting

Tax loss harvesting is the process of realizing capital losses in a portfolio, specifically to offset capital gains.

Imagine a portfolio with $10,000 in realized capital gains. Within the portfolio is an energy ETF (exchange-traded fund) with an $8,000 <u>unrealized</u> capital loss. If that position is sold, the $8,000 capital loss is now realized.

Since capital gains are offset by capital losses, the investor now has a $2,000 realized capital gain instead of a $10,000 realized capital gain.

The proceeds from the sales of the energy ETF can, subject to the wash sale rules described below, now be used to buy a different energy ETF. This maintains the market exposure to the energy sector. "Harvesting" the loss may resulted in a lower tax liability, without sacrificing potential future performance.

In a situation where capital losses exceed capital gains, investors may utilize up to $3,000 to offset ordinary income and carry forward any excess to be used in future years. For this reason, realizing a capital loss may be effective even if the investor does not realize any capital gains in the same year.

Wash Sales

When tax loss harvesting, it's important to be mindful of the IRS wash sale rules. A wash sale occurs when a security is sold at a loss, and then a substantially identical security is bought within 30 days[4]. The IRS website gives the following example:

"You buy 100 shares of X stock for $1,000. You sell these shares for $750 and within 30 days from the sale you buy 100 shares of the same stock for $800. Because you bought substantially identical stock, you cannot deduct your loss of $250 on the sale."

In our tax loss harvesting example, the investor purchased a substantially different energy ETF with the proceeds from the initial sale. If the investor sold and then bought the same ETF, the sale may have been considered a wash sale, and therefore a deduction for the loss may not be allowed.

Conclusion

While being tax efficient with investments can improve long-term after-tax returns, it is important to keep in mind that tax savings should not dictate your investment strategy. Rather, an investment strategy first and foremost needs to reflect your long-term goals, time horizon and risk tolerance, while tax strategies can be implemented to complement the long-term plan.

If you have any questions or would like to discuss, please feel free reach to out to us. As a reminder, Morgan Stanley and its affiliates do not provide tax advice, and you always should consult your own tax advisor regarding your personal circumstances before taking any action that may have tax consequences.

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Brain Teaser of the Month Answer – *Bookkeeper*

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Tax-loss harvesting. IRS rules stipulate that if a security is sold by an investor at a tax loss, the tax loss will not be currently usable if the investor has acquired (or has entered into a contract or option on) the same or substantially identical securities 30 days before or after the sale that generated the loss. This so-called "wash sale" rule is applied with respect to all of the investor's transactions across all accounts.

This illustration are hypothetical and shown for illustrative purposes only. The illustration is not intended to predict the returns of any particular investment, which will fluctuate with market conditions. Actual results may differ from those depicted in the illustration.

Information contained herein has been obtained from sources considered to be reliable, but we do not guarantee their accuracy or completeness.

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Sources:

1. "Capital Gains and Losses" – IRS.gov
2. "Capital Gains and Losses" – IRS.gov
3. "Net investment income tax" – IRS.gov
4. "Case Study 1: Wash Sales" – IRS.gov