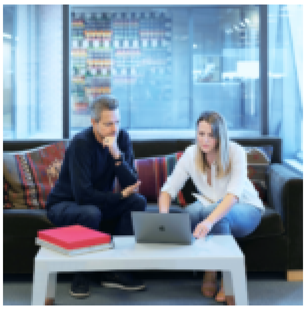
How to Tax Loss Harvest: Turning a Negative into a Positive for Investors



After a difficult year for the economy, advisors and clients are shifting their thinking toward taxes — specifically about gains and losses and ways to manage taxes in the year ahead. Recently, direct indexing has emerged as a way to help drive tax efficiency, making the topic of tax loss harvesting more relevant than ever.

In a recent survey* by FTSE Russell:

- 90% of the firms surveyed believe that delivering personalized solutions such as tax-loss harvesting via direct indexing will allow their advisors to better demonstrate value to clients.
- 95% of respondents stated tax-loss harvesting as by far the most important capability when implementing a direct indexing strategy.

So why is tax loss harvesting so important? Let's take a look at what it is exactly, how to do it, and who can benefit from this tax strategy.

What is Tax Loss Harvesting?

Tax-loss harvesting is a way to turn an investment that is a "negative" (meaning one that has lost value) into a "positive" (meaning one that can help positively impact your tax liability). It's an essential strategy to help investors reduce their taxes and keep more of what they earn.

When an individual purchases an investment and then sells it for more than they paid for it, they realize a capital gain. If they held the investment for less than a year before selling it, the profit from the sale is taxed at their ordinary income rate. If they held the investment for a year or more, the profit from the sale would be taxed at the long-term capital gains rate, which ranges from 0% to 20%, depending on income.

This is where harvesting comes into play and can help lower an investor's tax bill. If an individual purchased an investment and then sold it for less than they paid for it, they realize a loss. Investors can use the loss from the sale of one investment to offset the gain from another investment.

3 Things to Keep in Mind

1. Tax loss harvesting is only useful for taxable portfolios. It's not useful in retirement accounts, like a 401(k) or IRA, because those are tax-deferred accounts and losses generated in them cannot be deducted.
2. Sales to realize losses must be completed before the end of the tax year. Sales that were completed in 2022 can be used to offset gains for the year.
3. The holding period — whether short-term or long-term — is an essential component of tax loss harvesting. Wash-sale rules apply as well — meaning, if an investor sells a security at a loss and then buys the same, or "substantially identical" security within 30 days (before or after the sale), it becomes a wash-sale, which is typically not allowed for tax purposes.

What are the Benefits of Tax Loss Harvesting?

Selling an investment at a loss can have two benefits for investors:

Losses can be used to offset investment gains.

When harvesting losses to offset gains, any short-term losses must first be used to offset short-term gains and long-term losses must be used to offset long-term gains. After all of the available losses have been used to offset in-kind gains, investors can use any remaining excess losses to offset any remaining gains. If there are any remaining losses, they may be used (up to $3,000) to reduce ordinary income tax or roll a portion over into the following year.

During a down year, such as 2022, realizing a loss can be effective even if you didn't realize capital gains. The capital loss tax deduction and carryover provisions allow joint, single, and head of household filers to apply up to $3,000 a year in remaining capital losses after offsetting gains to reduce ordinary income.

And, if you still have capital losses after applying them to capital gains and ordinary income, you can carry them forward for use later down the road. Unused losses can be carried forward indefinitely.

The proceeds from the sale can be used to purchase additional investments.

Investors receiving proceeds from the sale can thoughtfully deploy the assets to stay invested and keep their money working for them. Whether the proceeds are used to rebalance a portfolio that has drifted, purchase an asset class or sector that is currently missing from the portfolio, or adding to an existing position that still has potential, keeping the money invested may help an investor stay on track to reach financial goals.

The Direct Indexing Connection

At a high level, direct indexing offers investors the ability to purchase the underlying shares of an index to create a customized portfolio. There are multiple benefits to direct indexing but one of the most significant is the potential for tax loss harvesting. Tax loss harvesting typically is not an option with an index-tracking fund because investors own interests in the fund versus individual securities with direct indexing.

Orion's direct indexing solution includes rebalancing and trading technology that can provide alerts to tax loss harvesting opportunities — among other tax optimization features — helping advisors and portfolio managers to provide quantifiable value to investors year-round.

The Impact of Taxes On Returns

Tax loss harvesting can be an effective strategy to help reduce the impact of taxes on an overall investment portfolio.

Researchers at MIT and Chapman University calculated that tax loss harvesting yielded almost an additional 1% annual return each year from 1928 to 2018.**

And while investors can benefit from leveraging their losses any time, down markets — such as 2022 was — may create more opportunity to realize losses and use the proceeds from sales to buy other securities at bargain prices. Investors can benefit from both offsetting gains with losses as well as purchasing new investments that could enhance portfolio performance as the market recovers.

Want to learn more about using direct indexing to leverage tax loss harvesting?

Find out how Orion Custom Indexing can help offer powerful personalization for every investor.

* The Direct Indexing opportunity 2022, FTSE Russell, November 2022

** “Can Tax Loss Harvesting Improve Your Investing Returns?,” Forbes, April 2022

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