Understanding the Keys to Effective Tax Loss Harvesting

Counteract capital gains at year end with this effective strategy.

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While much to everyone's chagrin, 2014 may end up being an average year for stocks, you may yet end up realizing short-term capital gains. As with any financial crossroads one finds themselves at, the question is, which path will you choose?? You may find that the best path for you is one many savvy investors select – you could "cash in your losses" and practice tax loss harvesting. It may not sound appealing at first glance, but for investors of a certain level of sophistication, it might just be the equivalent of a financial flu-shot for your portfolio as we approach the heart of winter.

Selling losers to offset winners. Tax loss harvesting means taking capital losses (you sell securities worth less than what you first paid for them) to offset the short-term capital gains you have amassed.

While this does not reverse your losses, it can mean immediate tax savings. It can also help you diversify your portfolio, and help you to position yourself for improved long-term after-tax returns.

The tax-saving potential. You can use this technique to put your net gains at $0, but that's just a start. Up to $3,000 of capital losses in excess of capital gains can be deducted from ordinary income, and any remaining capital losses above that can be carried forward to offset capital gains next year.[1]

By taking the losses this year and carrying over the excess losses into 2015, you can potentially shelter some (or maybe even all) of your long-term and short-term capital gains next year. This gives you a chance to shelter winners you've held (even for less than a year) from being taxed at up to 39.6%.[2]

The strategy in action. It is really quite simple. Step A is to pick out the losers in your portfolio. Step B is deciding which losers to sell. Step C is giving the green light to those transactions. You must watch out for the IRS "wash-sale" rule, however. You cannot claim a loss on a security if you buy the same or substantially identical security within 30 days before or after the sale. (The window is actually 61 days wide in some instances.) In other words, you cannot just sell a security to rack up a capital loss and then quickly replace it.[1]

However, you might be able to avoid wash sales by using ETFs to make a tax swap: an ETF for a stock or mutual fund, or even an ETF for another ETF if the ETFs are linked to different indexes. *Although these tax swaps are widely done, this is still a gray area, so consult a qualified tax advisor first regarding the application of wash sale rules to your specific situation.*[3]

Watch the fine print on wash sales. The wash sale rule applies to your entire taxable portfolio, not just one taxable account within it. So as an example, if you sell individual holdings of stock in your individual account, you still must wait for the wash sale window to close before you can purchase shares of that same firm for your IRA.

The (minor) drawbacks. Tax loss harvesting can require significant adjustments to your portfolio. You may not wish to alter a carefully chosen portfolio to the degree that you must for tax loss harvesting, especially if it has been built for the long term. You might also end up missing a rally in which an investment you've sold might take off. And do not overlook the transaction costs – they can add up, so you will want to consider those costs versus the potential savings before you make any moves. (For that reason, a fee-based account might make sense when tax loss harvesting.)

Not just a year-end tactic … also a year-round strategy. Some investors harvest losses throughout the year, not just in December. You may want to ask the financial professional you know and trust how you can harvest losses to your advantage, this holiday season, and beyond.

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