Tax-Loss Harvesting

Tax-loss harvesting is a strategy that can help preserve portfolio value while also reducing the cost of capital gains taxes. If you have capital losses for the year that exceed capital gains, you can deduct up to $3,000 in net losses from your total annual income. However, you cannot deduct more than your total capital losses for the year. If your net losses exceed $3,000, the IRS allows the additional losses to be carried forward into the following tax years.

Tax-loss harvesting can be assessed at any time during the year. But most of this may happen at the end of the year, so you can review your annual portfolio performance and see the impact on your taxes. Although your previous position cannot be restored, it can reduce the severity of the loss. For example, a loss in the value of one security can be sold to offset the increase in the value of another security. Ultimately eliminating the capital gain tax liability altogether.

As with any tax-related topic, there are rules and limitations:

- Tax-loss harvesting cannot be used inside retirement accounts, such as a 401(k) or an IRA. This is because you can’t deduct the losses generated in a tax-deferred account.
- Specific types of losses can only be used to offset certain gains. A long-term loss is first applied to a long-term gain. A short-term loss is also first applied to a short-term gain. If one category has any excess, these can be applied to either type's gains.
- You also need to be aware of the wash-sale rule, which states that if you sell a security at a loss and buy the same or a “substantially identical” security within 30 days before or after the sale, the loss is typically disallowed for income tax purposes.

Realizing a capital loss can still be effective even if you didn’t realize any capital gains for the year. The IRS allows 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. If you still have capital losses after applying them first to capital gains and then to ordinary income, you can carry them forward for use in future years.

Tax-loss harvesting is a good opportunity to offset other taxable gains and take advantage of lessening your tax burden. It’s important to balance your tax planning strategies and investment objectives. Both are very important for your overall financial health.