NOW MAY BE THE TIME TO DISCUSS TAX-LOSS HARVESTING WITH CLIENTS

With both equity and bond returns down significantly for 2022: clients may want to lock in tax losses and move on.

The process of tax-loss harvesting is relatively simple, you sell portions of your portfolio and recognize a loss. You then purchase a similar, though not identical, investment to replace it. The losses that are recognized can be used to offset gains on the current tax return and up to $3,000 in ordinary income. The losses also can be carried forward indefinitely and used on future tax returns. For taxpayers who file Married Filing Jointly, losses not used on the final join return and attributable to the surviving spouse also may be carried forward on tax returns.

For clients with losses, this may be an opportunity to adjust the portfolio and apply the loss against ordinary income, including a Roth conversion. However, watch out for these tax "gotchas."

Remember the "Replacing with Substantially Similar Investment" Rule

This rule states that the new investment must not be substantially similar to the one sold. One could sell ABC growth and income fund and replace with XYZ Growth Fund as they are unlikely to hold identical investments.

However, one can't sell the ABC S&P 500® index fund and replace it with XYZ S&P 500 index fund as the indexes are substantially similar. For this reason, actively managed funds, both equity and fixed income, are typically chosen as replacements.

Be Wary of Wash Sales

A wash sale results when a security is sold for a loss and is replaced with a substantially identical security within 30 days prior to or after the sale. This includes options contracts on said securities.

There are two areas in which investors often make errors. The first is failing to consider that dividend reinvestment can be considered a wash sale. The second is monitoring IRA and Roth IRA transactions. The wash-sale rule will apply even if the substantially identical security is purchased in an IRA or Roth IRA, even though the tax loss harvest is to place it in a taxable account.

There is, however, no wash-sale rule for gains. An investor is free to sell and repurchase securities immediately. Some investors in the 0% Long-Term Capital Gains bracket may do this to recognize gains at 0%, then repurchase to raise their basis.

Example

John purchased ABC corporate income fund in January 2022 for $100,000. Today, that investment is worth $85,000. If John sells today, he can recognize a short-term capital loss on his investment. He can then use that loss to offset short-term capital gains, long-term capital gains, and ordinary income taxes up to $3,000 this year.

Any unused loss may be carried forward against gains on future tax returns. John's advisor suggests another corporate income fund from a competitor because he is concerned about wash-sale rules.

Tax-Loss Harvesting—a Good Reason for a Year-End Call to Clients

As we close out a tumultuous year in the markets, now may be the time to assist clients with losses and secure tax savings. Just be mindful not to replace the fund that had a loss with a substantially identical holding. We're happy to answer any questions as you add further value to the business you do with clients.

Additional Resources and Links

IRS Publication 550

Til Death Do Us Part: Dealing With Carryovers When a Spouse Dies

For more information about retirement planning, please contact our Retirement Strategies Group at RSG@PacificLife.com or (800) 722-2333, ext. 3939.
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