TAX LOSSES: How a Market Downturn Can Work for You

Staying the course and sticking to your financial plan in a bear market can be challenging. It is hard to resist the impulse to want to do something.

While you want to avoid panicked selling or changing your asset allocation if your investment goals and timeline haven't changed, you do have options. Buying when the market dips is an example of a strategy that seeks to take advantage of a down market. Another strategy to consider in a temporarily volatile market is tax-loss harvesting — realizing losses to offset taxes related to gains and income today and in the future.

At a high level, tax-loss harvesting takes today's losses and turns them into tomorrow's assets. Investors often derive the greatest benefit from this strategy when they incorporate it into their quarterly or semiannual account review and rebalancing. If you wait to the end of the year, market conditions may have changed and you may have lost the opportunity.

HOW IT WORKS

You sell an asset — such as a stock, bond, ETF, or mutual fund — when its price has moved below what you paid for it. This allows you to capture a loss that can be used to offset 1) any net capital gain you have realized in the current year and 2) once you have offset capital gains, you can offset up to $3,000 per year in ordinary income (for either single or married filing jointly filers). You can carry any additional losses forward indefinitely and use them to offset gains and income whenever it is most advantageous for you.

It is important to consult with your tax advisor to determine the strategy that works best for your specific situation. Typically, losses will first be used to offset short-term capital gains, which are taxed at higher rates, before seeking to offset long-term capital gains and ordinary income. Loss carryforwards stay with you indefinitely, but they can't be passed to beneficiaries, so it is crucial to use them in your lifetime.

SELL LOW, BUY LOW

One of the keys to successful tax-loss harvesting is to take the loss without disturbing your portfolio's asset allocation and long-term strategy. Typically, the strategy involves selling an asset and immediately buying another asset that maintains your target portfolio. But there are important rules to keep in mind.

Because of the IRS's "wash-sale" rule, you cannot sell an investment, realize the loss, and then buy a substantially identical investment for 30 days before or after that sale. While the IRS's definition of "substantially identical" is open to interpretation, it clearly means that you can't sell shares in one asset management firm's S&P 500 Index fund, for example, and replace it with another firm's S&P 500 Index fund if you want to deduct the loss.

But you can purchase a similar asset within that time period. For example, you may sell stock in a tech company and invest the proceeds immediately in a technology ETF, mutual fund, or another tech company that fits your strategy.

As always, taxes should be a consideration, rather than the main driver, of any investment decision.

RETHINKING LOSSES

By deferring taxes — and keeping more of your portfolio working longer — tax-loss harvesting could have a positive impact on long-term returns. For investors in the 35% tax bracket, a professor at George Mason University recently estimated that tax-loss harvesting can add as much as 4.5% to overall equity returns in a year when the stock market's return is negative. In a positive year for the stock market, that additional return is lower but still meaningful.[1]

Rather than thinking of tax-loss harvesting as a year-end strategy, it is best to include tax-loss harvesting as part of your regular portfolio reviews. And while it is an evergreen strategy, tax-loss harvesting can be particularly advantageous during a down market.

Like any investment strategy, you should practice discipline around tax-loss harvesting. For example, when considering which assets to sell, it can be advantageous to target investments that have poor prospects for future growth and can be easily replaced by other investments that fill a similar role in your portfolio yet may have more favorable growth prospects.

Speaking with your advisor is the first step in developing a tax-loss harvesting strategy that supports your investment goals while creating a more tax-efficient portfolio. Don't hesitate to reach out to BDO Wealth Advisors to discuss how tax-loss harvesting factors into your unique situation.

To learn more about how BDO Wealth Advisors can help you meet your investment and broader financial goals, please don't hesitate to contact us by visiting **www.bdo.com/wealthadvisors** or reach us by email at **wealthinfo@bdowealth.com**

1 "Just How Valuable is Tax Loss Harvesting?" The Wall Street Journal, December 4, 2021, accessed June 18, 2022.

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