EMPLOYING A TAX-LOSS HARVESTING STRATEGY

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It's not just all about capital gains boosting the bottom line. A smart and efficient investor focuses keenly on all the tools on hand, one of which is tax-loss harvesting. Tax-loss harvesting is a tax-engineering tool to mitigate both short-term and long-term tax liabilities. In other words, it allows one to minimize the impact of tax on a portfolio. It can also be used to reduce ordinary income taxes in a year with no capital gains, but this is only up to a loss of $3,000.

What Are the Mechanics of Tax-loss Harvesting?

Simply put, tax-loss harvesting entails an investor selling a security at a loss and buying another security of a similar investment profile. This will allow the investor to keep the portfolio's positions roughly the same while simultaneously getting to deduct the loss from any gains for that year. Once the 30-day window has passed following the sale of the losing security, it can be repurchased, which would result in a lower tax basis.

How Does it Work with ETFs?

For starters, ETFs are cheaper than using stocks or mutual funds for tax-loss harvesting because of their reduced fees and less frequent capital gains distributions. ETFs make tax-loss harvesting easier by allowing one to avoid breaking SEC's "wash-sale" rule. This simply dictates an investor may not repurchase an identical or notably identical security to the one being harvesting at a loss within the 30-day post-sale window. As ETFs are made up of baskets of securities, it's easier to find ETFs that are identical in tracking objectives, e.g., large-cap or small-cap stocks, yet individual ETFs can avoid the SEC rule by following different underlying indexes.

Real-life Example

Investor A just sold 1,000 shares of a MAMAA company (Meta, Apple, Microsoft, Amazon and Alphabet). To preserve the diversity of the portfolio post-sale, Investor A chooses to take the sale's proceeds and buys a larger tech industry focused ETF. This avoids the wash-sale rule without compromising portfolio's the investment thesis and diversification.

It's not Perfect

Tax-loss harvesting may yield in tax deferring at a later period than an actual tax break, which runs the risk of facing higher taxes in the future. But ultimately, it's a smart way of minimizing the tax impact on your bottom line.

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DEFINITIONS

Tax Loss Harvesting : Selling securities at a loss to offset a capital gains tax liability. Tax gain/loss harvesting is typically used to limit the recognition of short-term capital gains, which are normally taxed at higher federal income tax rates than long-term capital gains.

Wash-Sale Rule : An Internal Revenue Service rule that prohibits a taxpayer from claiming a loss on the sale or trade of a security in a wash sale. The rule defines a wash sale as one that occurs when an individual sells or trades a security at a loss, and within 30 days before or after this sale, buys a “substantially identical” stock or security, or acquires a contract or option to do so.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term “large market capitalization”. Market capitalization is calculated by multiplying the number of a company’s shares outstanding by its stock price per share.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

Diversification : A risk management strategy that mixes a wide variety of investments within a portfolio.