TAX-LOSS HARVESTING

A proactive strategy that aims to maximize tax efficiency

Investing in the capital markets is one of the best ways to build wealth over time, but paying taxes on investment gains can significantly reduce overall portfolio return. To understand the impact of taxes, investors should focus on after-tax returns, the returns that are based on how much money they ultimately keep after paying taxes.

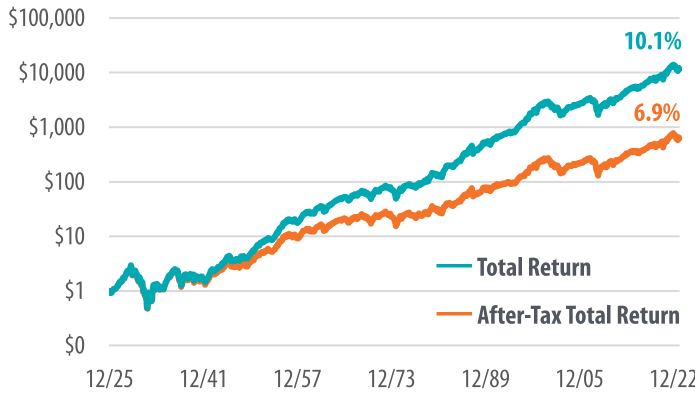
Since 1926, large company stocks have had a compound annual return of **10.1%** before taxes. Historically, however, that return would have been just **6.9%** after taxes. By utilizing tax-loss harvesting, a strategy that may help reduce "tax drag" (the negative impact of taxes), the tax burden might have been lower, potentially improving the overall growth of the portfolio.

When investments experience a drawdown, tax-loss harvesting allows investors to capture and use losses to their advantage by offsetting capital gains realized elsewhere in a taxable portfolio. Additionally, market volatility can present trading opportunities in both up and down markets to help offset taxes owed on investments, making tax-loss harvesting a year-round strategy that seeks to maximize tax efficiency.

Ibbotson Associates SBBI Large-Cap Stocks Compound Annual Return[1]

1926-2022 | U.S. Dollars

Tax drag on large company stocks since 1926 has amounted to **3.2%**, nearly one-third of the average annual total return.



Past performance is not a guarantee of future results.

How Tax-Loss Harvesting Works

Offsetting Gains with Losses

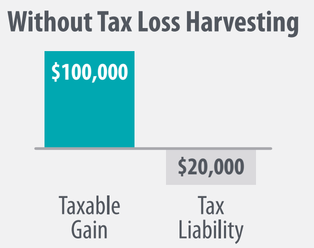
Tax-loss harvesting can be used in taxable accounts to minimize tax liabilities by strategically selling capital assets that have experienced a capital loss. By realizing these losses, investors can offset capital gains and potentially reduce their overall taxable income.

- Offset capital gains
- Offset up to $3,000 of ordinary taxable income in one year
- **Unused losses can be carried forward to future tax years**

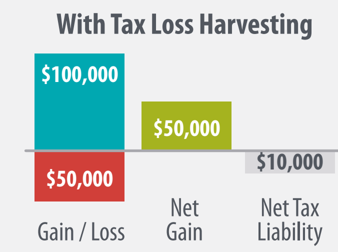
For example, assume an investor sold **Investment A** and incurred a $100,000 long-term capital gain. At the 20% capital gain tax rate, the tax liability would be $20,000.

Now assume the same investor implements a tax-loss harvesting strategy and sold **Investment B**, realizing a loss of $50,000. The result would be a net capital gain of $50,000 and the net tax liability would be reduced to $10,000.

Without Tax Loss Harvesting



With Tax Loss Harvesting



Capital Assets may include the following: Investment securities (stocks, bonds, ETFs, mutual funds, etc.), real estate, collectibles (coins, stamps, art), jewelry, precious metals (gold, silver, etc.), businesses, intangible assets such as patents, copyrights and trademarks.[2]

[1]Sources: Ibbotson Associates, Tax Foundation. Data is as of 12/31/2022. SBBI: Stocks, Bonds, Bills and Inflation. Hypothetical value of $1 invested since 1926, with taxes paid monthly. Annual income tax and capital gains tax rates assume a Consumer Price Index (CPI) equivalent income increase every year to the max social security tax income ($160,200 in 2023). Historical tax rates calculated using historical income tax, capital gains tax rates and qualified dividend income tax rate since 2003. For illustrative purposes only and not indicative of any direct index account. An investment cannot be made directly in an index. This should not be construed as a representation that any account will, or is likely to, achieve profits, losses or tax savings similar to those reflected in this example.

[2]Source: IRS.gov.

Tax-Advantaged Solutions with Direct Indexing

Execute tax-loss harvesting opportunistically with Direct Indexing, a strategy that seeks to closely track the performance of a market index while creating tax savings to increase after-tax returns. Direct Indexing allows investors to own individual securities in a portfolio via a separately managed account ("SMA"). By holding individual securities rather than a single fund, investors can customize their exposure to the initial index according to their needs while allowing for greater tax efficiency. With continual portfolio review and intra-day tax-loss harvesting, our goal is to keep more of your money working for you and less of your money spent paying taxes.

Potential Advantages of Tax-Loss Harvesting

Tax deductions

If capital losses exceed capital gains, up to $3,000 of net capital losses can be deducted against ordinary taxable income in a given tax year.[2]

Future tax savings

Any remaining losses can be carried forward to future tax years indefinitely, helping to offset future capital gains or income. Carrying losses forward can result in substantial tax savings over the long term, especially if investors have a high-income tax bracket or anticipate significant capital gains in the future.

Flexibility in timing

Tax-loss harvesting allows investors to strategically time the realization of losses, depending on their tax situation. Tax swapping may also be an effective tool for managing taxes during periods when markets are up. For example, investors may choose to offset capital gains in a high-income year or accelerate the recognition of losses to offset a large capital gain.

Rebalancing opportunities

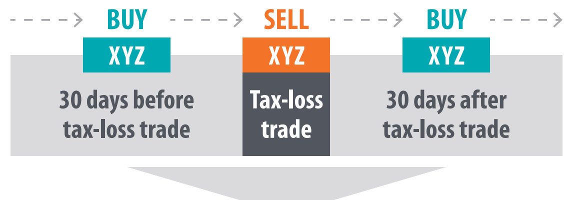
Tax-loss harvesting may provide an opportunity to rebalance an investment portfolio. By selling assets that have experienced losses, the proceeds can be reinvested in similar, but not identical, investments. This practice allows an investor to maintain their desired asset allocation while potentially capturing tax benefits.

Long-term growth potential

By minimizing tax liabilities through tax-loss harvesting, investors can potentially reinvest the tax savings into their portfolios. Over time, this additional investment has the potential to compound and contribute to long-term growth.

Beware of the Wash Sale Rule

It is important to pay close attention to the wash sale rule, a regulation imposed by the IRS. If a security is sold at a loss and a substantially identical security is purchased within a 30-day period (before or after the sale), the loss cannot be deducted for tax purposes. By disallowing the deduction, the IRS aims to ensure that losses are legitimate and not used solely for tax avoidance.[2]



WASH SALE PERIOD

[2]Source IRS.gov.

It is important to note that tax rules and regulations can be complex and subject to change. Refer to IRS guidelines for specific, up-to-date information on the wash sale rule and its implications.

This summary is not intended to be tax or legal advice. This summary cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. This summary is being used to support the promotion or marketing of the transactions herein. The taxpayer should consult an independent tax advisor.

Investors or financial professionals should consult with a tax professional regarding the potential application of loss deferral regimes, such as wash sales and straddles, to these securities and potential transactions along with other securities and transactions in the broader portfolio.

The information presented is not intended to constitute an investment recommendation for, or advice to, any specific person. By providing this information, First Trust is not undertaking to give advice in any fiduciary capacity within the meaning of ERISA, the Internal Revenue Code or any other regulatory framework. Financial professionals are responsible for evaluating investment risks independently and for exercising independent judgment in determining whether investments are appropriate for their clients.

The strategy was previously managed by First Trust Direct Indexing ("FTDI"). Effective October 31, 2024, FTDI merged into First Trust Advisors L.P. ("FTA"). All business activities, including portfolio management and business records are now performed under FTA.