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Why 2020 Was the Perfect Year for Tax-Loss Harvesting

In an up-and-down market, selling losing funds creates losses that help offset capital gains

One 'good' result of a rough year—including a sharp drop in the markets earlier this year, followed by a rebound—is that many investors will have tax losses they can harvest. Shown, the NYSE on Jan. 27.

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This is the kind of year that was made for tax-loss harvesting.

The tactic, used to legally reduce or avoid altogether capital-gains taxes, is especially useful in years when a jarring market slide is followed by a strong rebound. That's why this year, with the market's plunge in March and subsequent recovery to record highs, was ideal for this strategy.

In January and February, New York money manager David Frisch sold winning stock positions in the brokerage account of client Mike Soffer, generating $20,000 in capital gains. In March, as the market plummeted, Mr. Frisch sold losing positions in Mr. Soffer's account, creating tax losses to offset the gain. Plus, he banked an additional $15,000 in tax losses that Mr. Soffer can use in the future to offset gains.

Mr. Soffer, a commercial mortgage broker in Old Bethpage, N.Y., can also use the banked tax losses to offset up to $3,000 a year in ordinary income. "It's money earned by not paying taxes," he says.

If you didn't sell stocks during the March market slide, it's too late to create tax losses from it now. But fret not. There will be more opportunities in the future. Even in up years for the market, there are dips where investors can book tax losses.

When those opportunities come around, here are a few things to keep in mind about harvesting tax losses.

1. Don't run afoul of the wash rule.

If you sell something and repurchase it or a substantially similar security within 30 days, the Internal Revenue Service won't allow you to count it as a tax loss. That's called the wash rule.

Money managers typically don't want to spend 30 days out of the market when they create a tax loss for a client. They could miss out on upswings, like April of this year. So as soon as they sell an investment to create a tax loss, they buy an equivalent investment that is different enough to satisfy the wash rule.

When money manager Joseph Favorito of Melville, N.Y., sold S&P 500 index funds in March to create a tax loss for clients, he frequently bought Russell 1000 index funds. Both types of funds own large-cap stocks and they perform similarly.

The switch allowed his clients to stay invested in the market. "After the market bottomed out in March, we had the 50 best days in market history," Mr. Favorito says. "If you missed that, you missed a lot."

2. Try to accomplish other goals as you create tax losses.

It's a good practice to rebalance your holdings regularly, selling stocks or funds that have climbed and buying ones that have lagged behind. That's a great time to create tax losses. To do this efficiently, you need to know the cost basis of your holdings (generally the price at which you bought a security), so you know if you're creating a loss or a gain when you sell them. If you bought shares of a certain company at various times, you will create a greater tax loss by selling the shares you acquired at the highest price.

If you've spent years working for a single company, your portfolio may be concentrated in a single stock. That's risky. Advisers would tell you to sell at least part of your holdings and replace it with a diversified portfolio of stocks. If you do this during a downturn, you may be able to create a tax loss that you can use to offset gains for years to come.

3. Harvesting tax losses can allow you to defer paying capital-gains taxes, and in some cases to never pay them.

Suppose you buy shares in Mutual Fund A for $100,000 and their value falls to $50,000. You sell the shares and buy $50,000 of Mutual Fund B and book a $50,000 tax loss. You use it to offset a $50,000 gain on the sale of a second home.

Five years later, the value of your Mutual Fund B shares has climbed to $100,000. You sell them. Your cost basis is $50,000, because that's what you paid for Mutual Fund B. If you sell it for $100,000, you will owe taxes on a $50,000 capital gain. What you've done is to defer the capital-gains tax you avoided five years earlier when you sold the home.

Even better is finding new opportunities to create tax losses during those five years to offset your $50,000 gain on Mutual Fund B so that it, too, is untaxed.

When you die, under current law your heirs will inherit your assets with a "stepped up" cost basis, meaning that any untaxed capital gains have been erased as far as the IRS is concerned. That's another reason why avoiding taxation on capital gains during your life is a smart strategy. That tax may never be paid.

4. When you expire, so do your tax losses.

A tax loss can be used anytime over the lifetime of the account holder, but not beyond. But there is an important wrinkle in the tax law that married couples should keep in mind. During the final year that a couple files jointly after one spouse dies, the losses from one spouse's brokerage account can be used to offset gains by the other spouse.

5. Will the election change the calculus?

President-elect Joe Biden has said he supports raising the top capital-gains tax rate to 39.6% and taxing appreciated assets at the time of death. Both would mean big tax increases over the current regimen, where the top capital-gains rate is 23.8% and appreciated assets are passed tax-free to heirs. Some investors may sell winners, figuring they're better off biting the bullet before tax rates rise.

Marianela Collado, a Plantation, Fla., money manager, says she won't tell her clients to take gains based on a Biden win. Even if the law changes under Mr. Biden, it could change back under the next president, she says.

For now, Ms. Collado is making hay under the current rules. She has a client who sold a building in January, generating a $1 million capital gain. She told her client to set aside $238,000 to cover taxes.

Then, in March, she sold mutual funds owned by the client and immediately bought different funds with similar aims. In doing so she created a $500,000 tax loss, which will offset half of her client's capital gain from the building sale.

"What we did in those few weeks is going to save him about half that tax," she says.

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