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How does tax-loss harvesting work?

Selling investments for a profit is good news for your portfolio, but it often comes with an unwelcome side effect: a bigger tax bill. Capital gains can add up fast, and many investors don't realize there's a strategy that can help offset them.

That strategy is called tax-loss harvesting, and it can be a useful part of year-end tax planning. Here's what to know about how it works, when it makes sense, and what to weigh before using it.

How Tax-Loss Harvesting Works

Tax-loss harvesting is a strategy that involves selling investments in your portfolio at a loss to offset capital gains. If your losses outweigh your gains, the IRS also allows you to reduce your taxable income by up to $3,000. You can carry forward excess losses to future tax years.

If you opt to harvest your losses, keep in mind the wash-sale rule. The IRS does not allow you to deduct the losses from a wash sale, which occurs when you buy "substantially identical stock or securities" within 30 days, before or after, of the sale at a loss.

When to Use Tax-Loss Harvesting

Tax-loss harvesting can be advantageous for taxable accounts in your portfolio, such as a taxable brokerage account. It cannot be used for tax-advantaged accounts, such as your IRA or 401(k).

You may reap more benefits from tax-loss harvesting if you have significant capital gains or if you are in a higher tax bracket.

Pros and Cons of Tax-Loss Harvesting

Like any strategy, this one has trade-offs worth weighing.

On the upside, it can potentially lower your overall tax bill and offer a chance to trim high-risk positions from your portfolio.

On the downside, it doesn't help if you don't have enough losses to harvest, and trading fees can sometimes outweigh the tax savings.

Questions about whether this strategy fits your portfolio? Get in touch anytime.

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