

An Early Harvest?

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The past year has presented an enormous challenge to all investors. The repercussions of aggressive Federal Reserve interest rate hikes, the highest level of inflation in decades, massive labor demand and the first major war in Europe in 80 years has strained financial markets and prompted the threat of global recession. As a result, the September plunge in the U.S. stock market offers an unusual opportunity to harvest losses. Before investors dive in and start selling, however, there are a variety of important strategies and critical tax concepts that should be considered.

ANALYZE CURRENT FINANCIAL MARKET CONDITIONS

The Fed is expected to continue raising interest rates as long as inflation remains elevated. Labor costs also remain quite high which will likely stifle corporate profitability. If the financial markets continue to project lower earnings, valuations and stock prices will likely continue to plummet.

Asset allocation is always paramount but particularly so during volatile market swings. In bear markets, stocks in defensive sectors tend to perform a bit better while more-risky asset sectors may encounter greater headwinds. Now that interest rates are well off of their historic lows and with the Fed contemplating even more rate hikes, it may be a good time to consider shifting some assets from equity to bond securities.

LOCK IN LOSSES

Advisors need to select securities that offer the best opportunities for locking in losses. Certainly, if there's a loss on an investment in which you have lost confidence, that should be among the top of the list to sell. If the underlying security is a mutual fund or ETF, then consider the industry or asset class on which the fund/ETF is targeted and whether it is consistent with the target allocation.

Remember that losses can be harvested simply by trimming holdings as opposed to divesting entirely. Extra attention should be paid to tax lots as each will often have separate tax consequences.



EVALUATE THE TAX IMPLICATIONS

It is imperative to consider each client's personal tax situation. Remember that if there are insufficient capital gains to be offset by losses, \$3,000 of accumulated losses per year can be applied against ordinary income. As a result, the client's current and future expected marginal tax rate is an important consideration. Before beginning to harvest gains and losses, be sure to review the client's prior tax return to understand their current capital gain/loss tax position. If a client's income and tax rate is expected to be lower in the future, capital loss harvesting may yield only a limited benefit.

Particular attention should be paid to the nature of the capital losses, specifically whether they are short- or long-term. Optimally, capital losses should offset short-term capital gains which are taxed as ordinary income.

CONSIDER THE WASH SALE RULE

Perhaps the trickiest area of capital loss harvesting is the IRS wash sale rule. Put simply, after selling an investment at a loss, investors must wait 30 days before or after the day of sale. If the investor disregards this rule, the loss is not deductible; instead, the loss is added to the cost basis of the underlying replacement security. The wash sale rule also prohibits the acquisition of a security 30 days prior to the sale which, in essence, creates a 61-day wash sale window.

The wash sale rule may apply if a taxpayer sells a security and then, within the allotted 30-day period, acquires a security that is deemed to be "substantially

identical." The IRS is rather ambiguous with their definition of this term, particularly as it pertains to mutual funds and ETFs. Tax and financial professionals should discuss this with clients and establish the position they are willing to take before committing to further trades.

Note that the wash sale rule applies to both taxable and qualified retirement accounts for both the taxpayer and spouse. In other words, in the event of a sale of a security in a taxable account, the taxpayer and spouse are prohibited from acquiring a substantially identical security in any investment account for 30 days. Otherwise, the loss will be disallowed for tax purposes and there will be no cost-basis adjustment in the applicable qualified retirement account. (Refer to Revenue ruling 2008-5.)

As an additional consideration, any unused capital losses must be leveraged in the year of the taxpayer's death, or they will be lost entirely. Tax and financial professionals should certainly keep this mind with clients who are encountering severe health issues and consider locking in losses while they remain useful.

Taking all of these factors in consideration, advisors may be able to help clients find a silver lining in what has been an otherwise difficult year. 📊

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