During your next discussion with your financial advisor, we recommend that you ask them about how tax management strategies can help you achieve your goals. (UBS)

Tax loss harvesting: Reasons, tips, and strategies

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Over time, investments in your taxable accounts (your savings outside your IRA, 401(k), and other tax-advantaged accounts) will accumulate significant capital gains. When you transition from your working years into retirement and begin to tap into your portfolio growth to finance your spending, it will likely trigger capital gains taxes. Tax loss harvesting can help you to reduce this tax burden.

3 reasons to harvest capital losses

It may seem counterintuitive to sell investments after they've experienced a drawdown—after all, this goes against the adage "buy low, sell high"—but there are three good reasons why tax loss harvesting can be an effective strategy:

1. To lower your taxes this year
When you buy a security and then sell it at a higher price than your purchase price (your "cost basis"), it generates a capital gain. By contrast, selling a security at a lower price than your purchase price generates a capital loss. At the end of each tax year, you owe taxes based on the net capital gains (gains minus losses) that you lock in—or "realize"— that year.

2. To keep your "tax dollars" growing
Without tax loss harvesting, you will need to pay capital gains taxes to the IRS when you sell your investments. This depletes the amount you have left to invest today, but more importantly it reduces the dollars growing in your account. This can add up to significant shortfall over time.

3. To avoid capital gains taxes altogether

Tax loss harvesting is designed to help us defer paying taxes until later, but it is possible that the strategy will help you avoid paying capital gains taxes altogether. There are two ways to avoid paying capital gains taxes:

a) Give the investment away during your lifetime.
When you gift an investment, the recipient will keep your cost basis (in most circumstances). If the recipient is a charity or a family member with a low amount of taxable income, they will be able to sell the investment without incurring capital gains.
b) Keep the investment through the end of your lifetime.
When you pass away, your heirs get a step-up in cost basis, which means that the unrealized capital gains taxes are essentially forgiven.

3 implementation tips

1. Harvest capital losses throughout the year. When you realize capital losses today, you are building the potential for tax-free capital appreciation in the future. If you have unrealized capital losses in your portfolio today, but you don't realize them, you may miss out on this potential for tax-free growth in the future. Because markets tend to go higher over time, and losses tend to be short-lived, the best way to implement tax loss harvesting is to make small trades in the portfolio throughout the year as opportunities present themselves, rather than only looking to make a few large trades toward the end of the year.

2. Target specific tax lots. When looking for tax loss harvesting opportunities, we recommend looking at each specific tax lot in your portfolio (a new "tax lot" is created every time you purchase shares of a security at a different date or price, including reinvested income or dividends). When you sell shares in a security, you are able to select high-cost tax lots first, which allows you to minimize capital gains and maximize capital losses.

3. Watch out for the "wash sale rule." If you want to capture the capital loss, you need to abide by the "wash sale" rule: You cannot have both "buy" and "sell" trades in the same security (or any investment that the IRS considers "substantially identical," including warrants and call options)—within 30 days of one another. If you do execute both a buy and a sell within 30 days of each other—in any account that you or your spouse control, including IRA and 401(k) accounts—your capital loss will be disallowed, and these disallowed losses will be added to the cost basis of the newly purchased securities. This doesn't necessarily put you in a worse position than if you hadn't done the trade, but you may have missed the opportunity to realize the capital loss.

3 strategies to consider

1. **Tax swapping**
2. **Doubling down**
3. **Tax management overlay**

Click here to review those three strategies for implementing tax loss harvesting

Conclusion: How much could tax loss harvesting help you?

During your next discussion with your financial advisor, we recommend that you ask them about how tax management strategies can help you achieve your goals. Assuming that you are able to find a suitable replacement investment, and you can implement these trades without significant transaction costs, we don't see any reasons not to harvest capital losses in your taxable accounts.

In addition to the real financial benefits of realizing capital losses, tax loss harvesting can provide psychological benefits by cleaning up your balance sheet. After tax loss harvesting, your portfolio will only contain positions with unrealized capital gains—as irrational as it may be, refocusing your attention on the progress that you've made in your long-term investing journey can instill additional confidence and reinforce the fact that you're continuing to make forward progress on meeting your goals.

For more, see, Investment strategy insights: You should harvest capital losses now.

Important note: Tax strategies can be complex. In addition to federal taxes imposed on ordinary income and capital gains, there may be state and local taxes that must be considered before implementing a tax loss harvesting strategy. Also, transaction costs that may apply from buying and selling securities need to be carefully considered. Each investor should consult his or her own tax advisor concerning the tax consequences of any investment strategy they make or are contemplating. UBS does not offer tax advice.