Manage Taxes with Loss Harvesting

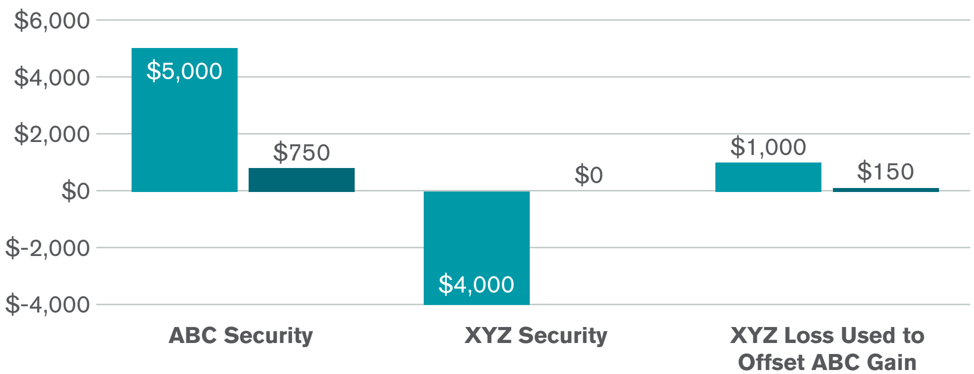
HARVEST TIME

Avantis Investors®
By American Century Investments®

We all get satisfaction when we make money on the sale of a stock, yet these gains can come with the surprise of hefty tax bills. Losses, on the other hand, can be hard to swallow. The good news is that losses may come with a silver lining in the form of potential tax benefits.

"Tax-loss harvesting," as it is known, allows investors to offset gains realized in one investment with losses incurred in another.* The following hypothetical example illustrates how this technique can help reduce an investor's tax liability.

Tax-Loss Harvesting: A Hypothetical Example



- The hypothetical long-term loss from the sale of XYZ partially offsets the long-term gain from the sale of ABC.
- This example assumes a capital gains tax rate of 15 percent. This rate varies by filing status and income.
- The offsetting loss results in a tax savings of $600.

This hypothetical situation contains assumptions that are intended for illustrative purposes only and are not representative of the performance of any security. There is no assurance similar results can be achieved, and this information should not be relied upon as a specific recommendation to buy or sell securities.

Some Dos and Don'ts of Tax-Loss Harvesting

Following a few guidelines could help you take advantage of this opportunity and avoid running afoul of the IRS's wash sale rule. Learn more about this rule on the following page.

Do	Don't
Use the strategy for taxable accounts only, as there is no tax benefit to harvesting losses in a tax-deferred account	Sell a security for a loss and then repurchase it within 30 days
Replace a security sold for a loss with another similar (but not identical) security in order to maintain desired exposure	Purchase a "substantially identical" security to replace one sold for a loss
Consider the relative advantages and disadvantages of using ETFs, active mutual funds, or indexed mutual funds to replace a security sold for a loss	Sell a security for a loss from a taxable account and then repurchase it within 30 days in a tax-deferred account
If losses exceed gains in any one year, carry over any unused losses to apply against gains in future years	Let taxes alone drive investment decisions – the decision to harvest losses should be made in concert with the overall investment plan.

*Long- and short-term capital gains are taxed at different rates. Long-term gains may only be offset by longer-term losses. Likewise, short-term gains may only be offset by short-term losses.

Bear in Mind

As year-end approaches, take the opportunity to review each portfolio's capital gains tax exposure as part of your holistic approach to financial planning.

And following is an overview of some recent changes in tax law that you should keep in mind in tax planning:

CARES Act Impacts

Charitable tax incentives for individual donors who are itemizing can elect to deduct up to 100% of your AGI. For those not itemizing, it allows for an additional above-the-line' $300 cash charitable gift.

Tax Cuts and Jobs Act (TCJA)

Many provisions of the TCJA are set to change or expire over the next eight years unless Congress acts, many of which will result in higher taxes for corporations and individuals over current levels.

The Long and Short of It

- There's a significant tax advantage to holding onto assets for longer than a year, since long-term cap gains tax rates (0%, 15%, 20%) are much lower than short-term cap gains tax rates (taxed as ordinary income).
- Most dividend income is taxed the same as long-term capital gains.
- If losses exceed gains in a given year, they can be carried forward until gains are depleted.
- Investors may also deduct up to $3,000 in losses from their income each year.
- Taxes apply on gains from the sale of a residence (net of improvements and exclusions), yet losses on their sale cannot be deducted.

Watch Out for Wash Sales

The IRS's wash sale rule is designed to keep investors from claiming artificial losses, so it's critical to understand it if you're planning to harvest losses.

The rule prohibits the sale of a security in order to claim a loss if the investor repurchases it—or a "substantially identical" security—within 30 days before or after the sale. Violating this rule could negate any potential tax benefits from the transaction.

How does the IRS define "substantially identical" security? Unfortunately, they have not identified specific criteria.* Nevertheless, to determine the potential for a wash sale violation, there are some factors that investors may want to consider, including the degree of holdings overlap and the difference in prospective returns. The greater the holdings overlap and the more similar the prospective returns, the greater the possibility of a wash sale classification by the IRS.

Many investors consider ETFs as well as active and indexed mutual funds as effective tools to gain desired portfolio exposures. Yet it's important to exercise caution to avoid violating the wash sale rule. The following framework provides an overview of the extent to which ETFs, active mutual funds, and index mutual funds may feature low portfolio overlap as well as differences in prospective returns under various scenarios.

Considerations for Tax-Loss Harvesting

Original Security	**Single Stock**	**Active Mutual Fund**	**ETF or Index Mutual Fund**		
Potential Replacement	• Active ETF • Index ETF • Active Mutual Fund • Index Mutual Fund	• Active ETF • Index ETF • Active Mutual Fund • Index Mutual Fund	• Active ETF • Active Mutual Fund	• Index ETF or Mutual Fund with different index	• Index ETF or Mutual Fund with same index
Considerations	• Little to no holdings overlap • Diversification of holdings means different prospective returns	• Little to no holdings overlap • Risk characteristics of an active mutual fund means different prospective returns		• Possible holdings overlap (similar sectors) • Potentially similar prospective returns depending on index	• Potential significant holdings overlap • Potentially similar prospective returns

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**As of 11/30/2018, the Internal Revenue Service has not released a definitive opinion regarding the definition of "substantially identical" securities and its application to the wash sale rule and ETFs. The information and examples provided are not intended to be a complete analysis of every material fact and are presented for educational and illustrative purposes only. Tax consequences will vary by individual taxpayer and individuals must carefully evaluate their tax position before engaging in any tax strategy.*

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