Introduction: Welcome to the Paragon Financial Partners podcast, where we discuss the markets, our strategies and how to live better today while planning for tomorrow.

Elean Mendoza: Hello and welcome to the Paragon podcast. I'm here with Evan Shorten, the firm's founder and principal.

Evan Shorten: Hello, this is Evan Shorten, and I want to thank everyone for tuning into this episode. If you would like to listen to our previous episodes, you can do so at paragonfinancialpartners.com/media. To subscribe to our podcast, you can find us on iTunes or Stitcher Radio.

Elean: Now that the end of the year is approaching, it's time to start thinking about potential tax liabilities that may be due. For this episode, we specifically want to focus on capital gains taxes and how using a strategy called tax-loss harvesting can help you reduce your capital gains tax liability. To get the discussion started, let's explain what capital gains and losses are. Evan?

Evan: So the simple definition of capital gain or loss is that it's the realized profit or the realized loss from the sale of property or an investment. The term realized is important because it means you actually sold a specific asset and no longer own it. The sale of this asset triggers a taxable event and if you had a realized capital gain, you may owe capital gains taxes on that property.

Elean: We also want to mention that capital gains taxes can be incurred on many asset types. Most people typically think about capital gains with respect to their brokerage accounts. It may come as a surprise to some people that selling your home or other real estate may trigger a capital gains tax; selling a collectible, such as a piece of art or an automobile, or even selling a business can trigger a capital gains tax liability.

Evan: Yes and different asset types have different capital gains tax rates. As I mentioned, the capital gain triggers a tax liability and fortunately a capital loss provides you with the ability to offset potential capital gains - and that is the basis of tax loss harvesting. In other words, if you had a substantial capital gain in a given year due to selling a highly appreciated stock while rebalancing your portfolio or because you sold your home after it substantially appreciated over several decades, you can look for underperforming assets you own to sell at a loss. Capital losses offset capital gains on a one to one basis, meaning if I sold a specific asset and had a capital gain of a thousand dollars, I can look for positions to sell that generate a loss of a thousand dollars, my total capital gain would be zero and I would have no tax liability.

Typically, you look for potential losses in your taxable or brokerage account, simply because it's easy to sell a stock, mutual fund or bond. Capital losses in an asset class like equities can offset capital gains in real estate and collectables as well. Now what's important to recognize, is making sure that you're focusing on being aware that you're matching up long term capital gains and losses with short-term capital gains and losses. Short-term capital gains are more valuable because they're taxed at a higher rate and they can be used to offset long-term capital gains, but the inverse is not the case.

Elean: Okay, and what happens if you have realized capital losses, but no realized capital gains in a given year?

Evan: So, if you itemize your tax deductions, you can apply up to $3000 of realized capital losses to reduce your ordinary income tax. If you have capital losses greater than $3000, you can carry over that loss into future years.

Elean: Okay, so let's say you realized capital losses in order to offset capital gains or to reduce your ordinary income. Now what? Am I giving up that position entirely?

Evan: That's up to you. If you sold an underperforming asset or position in your brokerage account that you no longer see a point in owning, you can certainly sell it and never look back. On the other hand, if the underperforming position is part of your long-term asset allocation, you can repurchase the position in 31 days.

Elean: So, would you be out of the market and holding cash for those 31 days? And what's the significance of the 31 days?

Evan: You could keep the proceeds from the capital loss sale in cash for that time period; that is certainly an option or you could buy a position that helps maintain your asset allocation. For example, let's say I hold Kinder Morgan, ticker symbol KMI, which had a significant price drop since last December. I could buy an oil and gas ETF or the Hennessy Gas and Utility Fund to maintain my asset allocation for the time being. On the 31st day after the original sale, I would then sell the ETF or Fund and buy back Kinder Morgan. I also want to be clear that we are not recommending that our listeners buy Kinder Morgan or to use any specific mutual fund or ETF mentioned in this podcast. We are simply picking these securities as examples to illustrate a specific point.

With respects to the second question regarding the 31 days, if you sell security at a loss and buy the same or similarly identical security within 30 calendar days before or after the sale, the loss is disallowed for income tax purposes and you will not be able to offset the loss against the gain. Once

the 31st calendar day hits, you're good to repurchase if it's part of your overall plan. The IRS created that rule specifically to prevent taxpayers from taking losses on securities they hold in order to avoid paying taxes. Additionally, the wash sale rule stretches across all of your accounts and this is important because if you sell a position to generate a loss and repurchase that position within the 30-day period in a different account, the loss is still disallowed. If you sell a position to generate a loss in a taxable account and repurchase that position in a tax-deferred or tax-exempt account, like the traditional or Roth IRA, again, the loss is disallowed. If you sell a position in your brokerage account to generate a loss and your spouse buys that position within the wash sale period in their account, again, the loss is disallowed.

Elean: Now, waiting 31 days to re-buy a specific security has some risks, right? We've seen some pretty big price fluctuations in the market the last few years, and that can happen multiple times over a 31-day period. Essentially, you may not be able to repurchase as many shares as you originally owned.

Evan: As the saying goes, "There's no such thing as a free lunch." Tax-loss harvesting may add some risk into your portfolio along with some added costs. As you mentioned Elean, you may not be able to buy the same amount of shares as you once held if the price were to move up during the wash sale period. Additionally, depending upon where you hold your brokerage account, you may have a transaction fee on each sale and purchase. Finally, one last thing to keep in mind: as your portfolio grows in value, tax-loss harvesting becomes more difficult. Tax-loss harvesting ultimately lowers the cost basis of each position used in the strategy. If those positions grow in value over time, they will generate larger capital gains. Also, there's a lot more that can and should be reviewed on this specific topic so please consult with your financial and tax advisors.

Elean: Okay great. Thanks Evan. We hope you enjoyed this episode of the Paragon podcast. If you would like to learn more about a specific topic, feel free to write us on our Facebook page, or by emailing us at info@paragonfinancialpartners.com. For a pdf transcript of this episode please check our blog at paragonfinancialpartners.com/blog where we post each episode's transcript. Again, thank you for listening in.

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