
Tax Loss Harvesting: A Primer for Investors

Ashley Cruz
Investment Strategist and Vice President

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KEY TAKEAWAYS

- ▶ Tax loss harvesting may lower tax bills by deferring capital gains, reducing taxable income, or offsetting future gains and income.
- ▶ Investors considering tax loss harvesting trades should be mindful of the wash-sale rule, potential costs, and their goals.
- ▶ Dimensional's active, systematic ETFs offer tax-efficient, value-added solutions for investors considering replacing existing allocations.

Table of Contents

Tax Loss Harvesting Basics >

What is tax loss harvesting? >

Why tax loss harvesting? >

Consider investor goals >

Consider costs >

Consider wash sales >

Investment Vehicles for Loss Harvesting >

Replacing securities with tax-efficient ETFs >

Using unified managed account (UMA) solutions to go beyond tax loss harvesting >

Tax Loss Harvesting Basics

What is tax loss harvesting?

Tax loss harvesting is a common strategy that investors can use to potentially lower or defer their tax bills by realizing losses on certain investments and using those realized losses to offset gains or income elsewhere in their portfolio. The strategy involves three steps:

1. **Monitoring** investments to identify securities held at a loss
2. **Selling** securities at a loss
3. **Replacing** securities sold with an alternative

Why tax loss harvesting?

Tax loss harvesting may help investors lower their tax bills by reducing or deferring capital gains, reducing taxable income, and offsetting future gains and income. Investors who use loss harvesting to defer taxes today may also achieve higher ending wealth through the potential growth of assets not used to pay taxes.

- **Reduce or defer capital gains**

Capital losses can be used to offset realized gains in the current year. When offsetting, the “character” of the loss—whether the loss was short- or long-term in nature—matters. Securities sold within a year of when they were purchased will result in a short-term gain or loss, while securities sold more than a year from purchase will result in a long-term gain or loss.

If an investor harvests a short-term capital loss, that loss will first offset against any realized short-term capital gains. After offsetting all short-term capital gains, the loss can then be applied against long-term capital gains. Similarly, if an investor harvests a long-term capital loss, the loss first offsets long-term gains and then can be used to reduce short-term gains.

- **Reduce taxable income**

After offsetting any capital gains, remaining losses can be used by individuals to offset up to \$3,000 in personal income in the current year.

- **Offset future gains and income with capital loss carryforwards**

Remaining losses can be carried forward into future years to offset capital gains or personal income of up to \$3,000 per year.

Consider investor goals

It is important to note that the potential benefits of tax loss harvesting are dependent on unknown future conditions, such as changes to tax rates and the rate of return over the investment horizon. While not usually discussed with much emphasis, these unknown future conditions are important for investors to consider when conducting tax loss harvesting. For example, if tax rates stay the same over time, tax loss harvesting simply defers a capital gain today to a capital gain later at the same rate. Loss harvesting in this scenario can still be beneficial for investors if they have increased growth in assets due to not paying taxes. However, if tax rates increase over time, tax loss harvesting can result in an investor paying higher taxes on the deferred gains.

Potential benefits may also erode as the portfolio ages. As the investment horizon lengthens, individual securities in the portfolio are more likely to have appreciated, which limits loss harvesting opportunities without continued inflows. Ultimately, the benefits of tax loss harvesting vary depending on the expected evolution of tax rates, the expected return on deferred taxes, opportunities to harvest losses as the portfolio ages, and the ultimate goals of an investor (e.g., consumption or donation of ending assets).¹

Consider costs

Tax loss harvesting also incurs costs. Trading to harvest losses requires trading more than the harvested loss. For example, \$1 of harvested losses might require selling a position worth \$100 and then buying another position with the \$100. To harvest \$1 of losses, one is trading \$200. While certain custodians may offer zero transaction fees, these trades may still generate implicit trading costs, such as bid-ask spreads. Further, loss harvesting may impact an investor's ability to maintain a desired asset allocation and exposure to premiums. It's a phrase you've likely heard, and the colloquial advice remains relevant: "Don't let the tax tail wag the investment dog."

Ultimately, investors should evaluate the expected benefits of loss harvesting against the potential costs.

1. To learn more, see Savina Rizova and Ashish Bhagwanjee, "[Dimensional's Multifaceted Tax Management of SMAs](#)" (research paper, Dimensional Fund Advisors, July 2022).

Consider wash sales

While the mechanics of tax loss harvesting can be simple, it's important for investors to not be tripped up by the wash-sale rule. The rule results in a "washed" or deferred loss if investors buy the same security or one that is substantially identical 30 days before or after the sale of a security sold at a loss.

EXHIBIT 1: Wash-Sale Rule



The wash-sale rule has a few implications for investors considering tax loss harvesting:

1. **Target replacements that are not substantially identical:** Investors who want to avoid a wash sale should avoid swapping into the same or a substantially identical investment within the wash-sale period. This means that an investor may want to consider:
 - a. Swapping an *individual security position* for a *broadly diversified Dimensional ETF*
 - b. Swapping a *passive index fund* for a *systematic, active Dimensional ETF*
 - c. *Holding a broadly diversified SMA to allow flexibility in tax loss harvesting activity*
2. **Swap back:** Investors may have good reason to maintain their original exposure. To swap back into their original investment, these investors will need to wait until after the wash-sale period to sell the replacement security they bought and buy back the original investment. If buying back after 30 days but before a year, investors should be mindful of realizing short-term capital gains on the investment that could mitigate the benefits of their loss harvesting activities.

Investment Vehicles for Tax Loss Harvesting

Replacing securities with tax-efficient ETFs

Consider tax-efficient ETFs when choosing a replacement security. Dimensional ETFs offer broadly diversified exposure to their targeted asset class and go a step further by pursuing higher expected returns. These systematic, active strategies offer a value-added alternative to passive mutual funds or ETFs, provide exposure across a wide range of asset classes, and are competitively priced within the lowest quartile among Morningstar category peers.²

EXHIBIT 2: Dimensional ETFs, as of September 30, 2024

Morningstar Category	Dimensional ETF
US Large Blend	US Equity Market ETF (DFUS)³ >
	US Core Equity Market ETF (DFAU) >
	US Core Equity 1 ETF (DCOR) >
	US Core Equity 2 ETF (DFAC) >
	US Sustainability Core 1 ETF (DFSU) >
	US High Profitability ETF (DUHP) >
US Large Value	US Large Cap Vector ETF (DFVX) >
	US Large Cap Value ETF (DFLV) >
	US Marketwide Value ETF (DFUV) >
US Mid-Cap Value	US Vector Equity ETF (DXUV) >
US Small Blend	US Small Cap ETF (DFAS) >
US Small Value	US Small Cap Value ETF (DFSV) >
	US Targeted Value ETF (DFAT) >
US Real Estate	US Real Estate ETF (DFAR) >
Foreign Large Blend	International Core Equity Market ETF (DFAI) >
	International Core Equity 2 ETF (DFIC) >
	International Sustainability Core 1 ETF (DFSI) >
	International High Profitability ETF (DIHP) >
	World ex US Core Equity 2 ETF (DFAX) >
Foreign Large Value	International Value ETF (DFIV) >
Foreign Small/Mid Blend	International Small Cap ETF (DFIS) >
Foreign Small/Mid Value	International Vector Equity ETF (DXIV) >
	International Small Cap Value ETF (DISV) >
Diversified Emerging Markets	Emerging Core Equity Market ETF (DFAE) >
	Emerging Markets Core Equity 2 ETF (DFEM) >
	Emerging Markets Sustainability Core 1 ETF (DFSE) >
	Emerging Markets Value ETF (DFEV) >
	Emerging Markets High Profitability ETF (DEHP) >
Global Large-Stock Blend	World Equity ETF (DFAW) >
Global Real Estate	Global Real Estate ETF (DFGR) >

2. Comparison against funds in Morningstar peer categories as of September 30, 2024.

3. Prior to September 13, 2024, the US Equity Market ETF was the US Equity ETF.

Morningstar Category	Dimensional ETF
Ultrashort Bond	Ultrashort Fixed Income ETF (DUSB) >
Short-Term Bond	Short Duration Fixed Income ETF (DFSD) >
Intermediate Core Bond	Core Fixed Income ETF (DFCF) >
Global Bond-USD Hedged	Global Core Plus Fixed Income ETF (DFGP) > Global ex US Core Fixed Income ETF (DFGX) > Global Credit ETF (DGCB) > Global Sustainability Fixed Income ETF (DFSB) >
Inflation-Protected Bond	Inflation Protected Securities ETF (DFIP) >
Muni National Short	National Municipal Bond ETF (DFNM) >
Muni California Intermediate	California Municipal Bond ETF (DFCA) >

Using unified managed account (UMA) solutions to go beyond tax loss harvesting

For investors who want to go beyond tax loss harvesting, a Dimensional unified managed account (UMA) can allow investors increased customization and tax management options. Dimensional UMAs offer integrated portfolio management of both ETF allocations and customizable, direct equity SMA strategies designed to pursue higher expected returns and apply an ongoing process whereby the tax position of the account is monitored systematically for tax loss harvesting opportunities and more. UMAs go beyond tax loss harvesting and incorporate tax management from account onboarding to portfolio design and day-to-day management.

Onboarding

Dimensional's UMA solutions recognize that clients may currently have concentrated stock positions that they want to transition to a broadly diversified portfolio with a systematic focus on higher expected returns. However, transitioning such concentrated portfolios could trigger undesirable realizations of capital gains. To evaluate the tradeoffs among diversification, exposure to premiums, and expected capital gains, Dimensional offers a thorough and transparent tax transition analysis to help investors assess the implications of alternative actions.

Portfolio design

Dimensional's direct equity starting SMA strategies and Dimensional ETFs integrate tax efficiency into portfolio design by:

- Excluding real estate investment trusts (REITs) and passive foreign investment companies (PFICs) that tend to generate nonqualified dividend income (NQDI), which is generally taxed at higher rates.
- Systematically focusing on higher expected returns in a low-turnover manner.
- Providing broad diversification to increase opportunities for tax loss harvesting and enable flexibility in implementation.

Portfolio management

Tax considerations are incorporated into an ongoing account management process that aims to:

- Harvest meaningful losses throughout the year.
- Minimize realized gains while considering returns premiums, diversification, and trading costs.
- Avoid wash sales within and across linked accounts.
- Monitor for gifting opportunities throughout the year.
- Manage qualified dividend income (QDI) to emphasize income taxed at a lower rate.
- Seek to rebalance into the investor's target asset allocation, which may include a mix of ETFs and direct equity allocations, over time as tax-advantageous opportunities arise.

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Investors should consult with a financial professional regarding their individual circumstances before making investment decisions. It is essential that investors discuss the tax implications of their investments with a tax professional, particularly when considering tax loss harvesting transactions. Among the considerations that should be discussed are "wash-sale" rule restrictions, which dictate that an investor cannot buy a "substantially identical" security for 30 days before or after the sale of the funds or securities sold at a loss. Investors and their tax professionals may consider a number of criteria when evaluating similarity of securities, which may include whether the two investments are distinct securities with different identifiers, whether two funds have the same benchmark, and how similar or dissimilar two funds' characteristics and returns have been over time.

Dimensional Fund Advisors LP is an investment advisor registered with the Securities and Exchange Commission. **Consider the investment objectives, risks, and charges and expenses of the Dimensional funds carefully before investing. For this and other information about the Dimensional funds, please read the prospectus carefully before investing. Prospectuses are available by calling Dimensional Fund Advisors collect at (512) 306-7400 or at dimensional.com.** Dimensional funds are distributed by DFA Securities LLC. Risks include loss of principal and fluctuating value. Investment value will fluctuate, and shares, when redeemed, may be worth more or less than original cost.

Dimensional may be directed to manage separate accounts in a predetermined tax-sensitive manner by utilizing certain measures, including, but not limited to, tax loss harvesting, seeking to minimize short-term capital gains, maximizing the qualified portion of dividend income, applying a tax-efficient lot selection methodology, and considering tradeoffs among premiums, costs, diversification, wash-sale rules, and capital gains in daily portfolio management. Additionally, certain events (including, but not limited to, client requests to update custodians, strategies, or client-directed restrictions; ongoing client activities like contributions, redemptions, and gifts; incorrect custodian account settings; and advisor direction) may limit Dimensional's ability to engage in tax loss harvesting and to evaluate the tradeoffs outlined above. While Dimensional will regularly monitor accounts for tax loss harvesting opportunities, Dimensional might not engage in daily tax loss harvesting.

In accounts where Dimensional has been directed to incorporate tax management, Dimensional will generally seek to limit potential wash sales. "Wash sales" relate to a tax regulation that seeks to prevent investors from selling securities at a loss and then repurchasing the same or a substantially identical security in a span of 30 days before or after the sale. Dimensional may be unable to avoid wash sales or other tax consequences, particularly around client cash flows, corporate actions, or when clients hold substantially identical securities in accounts that are not managed by Dimensional or in accounts that are not linked to the separate accounts Dimensional manages (external accounts).

Dimensional is solely reliant on accurate, thorough, and timely tax lot reporting from custodians. Should custodians fail to provide accurate, thorough, and timely tax lot data, Dimensional may be unable to transact in those accounts. The tax consequences of tax loss harvesting, including wash-sale rules, are complex and uncertain and subject to rulings by tax authorities. Dimensional does not provide tax advice, and each client should consult their own tax advisor or accountant. As such, Dimensional will not be responsible for any tax consequences of such transactions. Dimensional does not guarantee any particular tax outcome.

Dimensional is not a tax advisor and does not know the effective tax position of any individual client. Tax management is limited to managing the account's investment approach in a tax-sensitive manner.