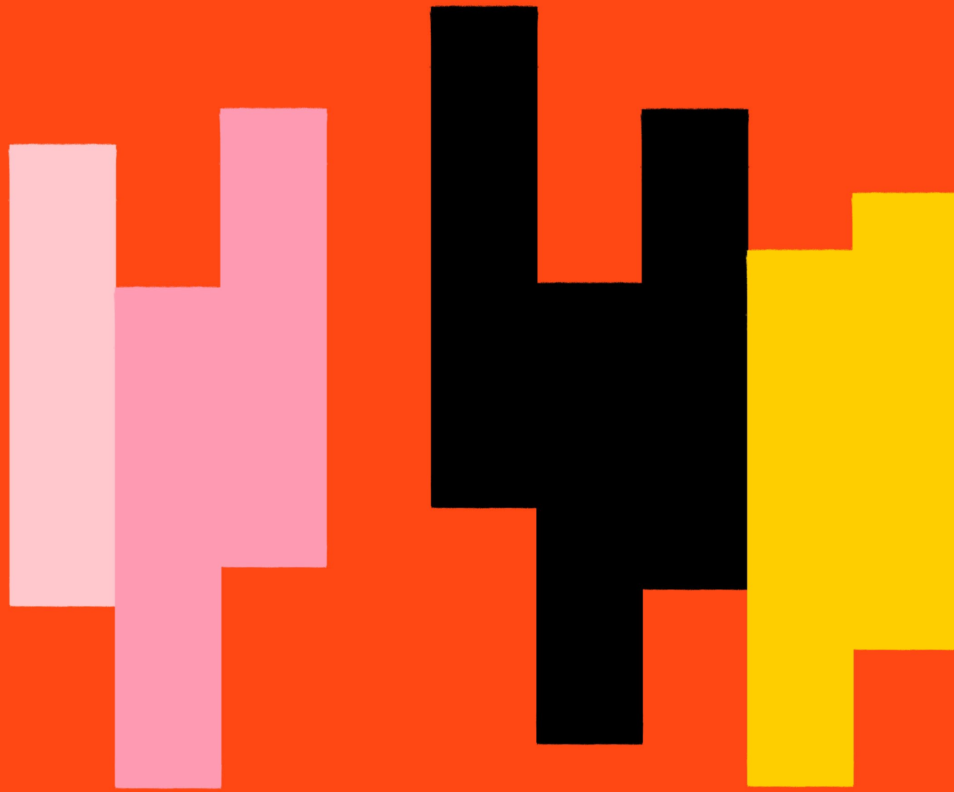

Too Much of a Good Thing? Planning for Capital Loss Carryovers

By Lincoln Fleming

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In this article, Fleming examines tax-loss harvesting and offers strategies for maximizing the benefits of capital loss carryovers.

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During periods of economic uncertainty and market volatility, capital losses generated from tax-loss harvesting (TLH) can emerge as a silver lining and provide significant tax benefits to investors. However, these benefits may be fully realized only to the extent a taxpayer has capital gains or other income to offset. When a taxpayer has capital losses that exceed capital gains and excess losses carry forward to future tax years, how should the capital loss carryover be viewed, and what actions are advisable?

Capital Loss Carryover Mechanics

For noncorporate taxpayers such as individuals and non-grantor trusts, capital losses can offset capital gains and up to $3,000 ($1,500 in the case of a married individual filing a separate return) of ordinary income on a federal income tax return.[1] Excess capital losses are carried forward indefinitely during the taxpayer's lifetime and may be used to offset capital gains and limited amounts of ordinary income in future tax years. Capital losses retain their character as short-term (ST) or long-term (LT) capital losses as they carry forward.[2]

If upon termination of a non-grantor trust a capital loss carryover exists, the capital loss will carry over to the beneficiaries succeeding to the trust property.[3] The capital loss carryover retains its character in the hands of noncorporate beneficiaries.[4]

Value of a Capital Loss Carryover

Capital loss carryovers may result in significant tax benefits given that they can offset future capital gains and limited quantities of ordinary income that a taxpayer may otherwise have to pay taxes on.

The actual benefit of a capital loss carryover will vary based on factors such as the following:

- timing of use;
- character of the income or capital gains offset;
- tax regime in effect; and
- taxpayer marginal tax rates.

Other than the $3,000 of excess capital losses eligible to offset ordinary income each year, capital loss carryover benefits are deferred until the taxpayer has capital gains to offset. The value

[1] Section 1211(b).

[2] Section 1212(b)(1); INFO 2004-0108 (Apr. 30, 2004). Noncorporate taxpayers may not carry back capital losses to prior years. The focus of this article is on the treatment of capital loss carryovers for federal tax purposes only, but planning should also factor in relevant state tax considerations. For example, some states may not allow capital losses to carry forward.

[3] Section 642(h)(1).

[4] Reg. section 1.642(h)-1(b).

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of losses diminishes as they carry forward unused to future tax years. This may be especially true in an inflationary environment.

The value of a capital loss carryover also varies based on the character of the income or gains that it offsets. For example, losses offsetting ST capital gains taxed at ordinary tax rates may provide more value than losses offsetting LT capital gains taxed at preferential rates. The limited quantity of losses that may offset ordinary income may be immaterial for high-income investors and offset income only in low tax brackets for lower-income taxpayers.

Because of the mechanics of the capital gain and loss netting rules, an ST capital loss carryover may be more valuable than an LT capital loss carryover if the taxpayer will have both ST and LT capital gains to offset in future years.[5] However, there may be no difference in value if a taxpayer will have only ST capital gains or only LT capital gains, but not both.

The value of a capital loss carryover may increase if there is a rising tax rate environment or if the taxpayer has higher marginal tax rates in the future. Conversely, the value may decrease if relevant tax rates will be lower in the future.

Capital loss carryovers that offset ST capital gains may be more valuable in years that a taxpayer isn't subject to the alternative minimum tax.[6] Capital loss carryovers may also increase in value in years when a taxpayer is subject to the net investment income tax.[7]

Importantly, taxpayers cannot pick which tax years they wish to apply their capital loss carryovers to maximize their benefit.[8] Capital losses simply carry forward to future consecutive years until fully used.

Adjusting TLH Efforts

Systematic TLH isn't necessarily an all-or-nothing portfolio strategy — the intensity of TLH may be dialed up or down to fit the needs and circumstances of the taxpayer.

Should systematic TLH efforts be paused or dialed down because a taxpayer has a capital loss carryover? There is no single correct answer. To address this question, advisers must fully understand the taxpayer's situation and the circumstances surrounding the loss carryover, considering:

- the source, quantity, and character of the excess losses;
- estimated quantity, character, and timing of future capital gains and losses;
- health, age, and marital status of the taxpayer; and
- appetite for costs, fees, and portfolio tracking error.

A taxpayer who has a temporary capital loss carryover may have reasons to continue TLH at existing levels. For example, most equity markets have historically drifted upward over time, so available losses may dissipate if they aren't harvested. Realized capital losses can be banked until the taxpayer has sufficient capital gains or other income to offset.

Thus, there should be a compelling reason to halt or ratchet down TLH efforts. On one end of the spectrum, if the capital loss carryover is a one-time event and the taxpayer is expected to soon have sufficient capital gains to fully absorb the losses, no adjustments to TLH efforts may be warranted.

On the opposite end of the spectrum, TLH may be inappropriate for taxpayers who don't anticipate ever having sufficient capital gains to fully absorb a capital loss carryover. This is because a methodical TLH approach typically isn't free — it may involve costs in the form of increased portfolio tracking error, management fees, or trading costs. For TLH to make sense, the expected benefits must exceed these costs.

Before making any adjustments, it is important to understand the life cycle of TLH and how some actions or views may affect future TLH opportunities and existing loss carryovers. For example, in a TLH portfolio, the quantity of losses harvested tends to naturally decrease as the portfolio becomes more highly appreciated. Some portfolio actions or convictions, such as having an alpha view or taking withdrawals, may affect future TLH opportunities or require some gain realization.

[5] Section 1222.

[6] Section 55(b)(1)(A).

[7] Section 1411.

[8] *See* Rev. Rul. 76-177, 1976-1 C.B. 224.

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During severe bear markets, taxpayers may feel discouraged by the collapsed values of their portfolios, and their perception of the probability of benefiting from capital losses can become easily distorted by recent events. Although estimating future capital gains can be challenging, advisers can provide valuable perspective and insights to clients during those times. For example, information about some future events, such as the sale of a business, may be available. Advisers can assist clients in estimating a realistic timeline for absorbing capital losses and determining whether changes to existing strategies are warranted.

Manufacturing or Accelerating Gains

Should taxpayers artificially manufacture or accelerate capital gains to fully use a capital loss carryover as quickly as possible? Absent a compelling reason to do so, the answer is likely no.

Capital loss carryovers don't expire until death. They are essentially an asset on the books available to offset capital gains that can't be avoided or that may be deemed necessary to accomplish an important goal, such as rebalancing a portfolio, managing risk, transitioning assets, or participating in alpha-seeking strategies.

Absorbing manufactured or accelerated capital gains that could otherwise be deferred or avoided doesn't provide any immediate tax savings. It may also mean no capital losses are available to shelter future capital gains that can't or shouldn't be avoided or deferred, which can increase a taxpayer's overall tax liability in the long run. Taxpayers may also miss out on the opportunity to offset up to $3,000 of ordinary income each year, which may be taxed at higher rates than some types of capital gains. However, this benefit may be immaterial for some taxpayers.

Artificially taking gains may be especially ill-conceived in a rising tax rate environment or if the carryover losses offset LT capital gains now instead of ST capital gains in the near future.

Tax-Rate Arbitrage Exception

Although intentionally realizing gains to absorb a capital loss carryover may not be beneficial in many situations, some scenarios may warrant a closer look. For example, opportunities for tax-rate arbitrage, or taking advantage of the differential between ST and LT capital gains tax rates, may present such a scenario.

Tax-rate arbitrage involves strategically realizing LT capital gains to elevate the cost basis of a portfolio in order to facilitate opportunities to harvest additional ST capital losses. A favorable tax-rate differential may exist between the ST capital losses offsetting capital gains taxable at ordinary income tax rates and the realized LT capital gains taxed at preferential rates.[9]

An existing capital loss carryover may help to cushion the impact of the LT capital gains realized upfront, and indirectly convert a LT capital loss carryover to more favorable ST capital losses.

For example, consider a hypothetical taxpayer who normally has a large supply of both net ST and LT capital gains. However, a very large, one-time LT capital loss was generated this year, creating a temporary LT capital loss carryover. The taxpayer isn't subject to AMT, has a long investment horizon, and one year ago cash-funded a TLH account that will eventually be liquidated.

In that case, a tax-rate arbitrage strategy may be beneficial. For example, shallow capital gains could be harvested in the TLH account, increasing the overall basis of the portfolio while minimizing the quantity of capital gains realized. The LT capital loss carryover could be used to absorb the LT capital gains realized. Increasing the basis of the portfolio may facilitate future ST capital loss-harvesting opportunities. Future ST capital losses may offset future ST capital gains otherwise taxable at ordinary income tax rates.

That strategy certainly bears risks, and it may not be appropriate for every situation.[10]

Pre- and Postmortem Planning

Capital loss carryovers lapse at death. They may be used on a decedent's final income tax return, but any remaining capital losses expire

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[9] Section 1.

[10] Lisa R. Goldberg, Taotao Cai, and Pete Hand, "Tax-Rate Arbitrage: Realization of Long-Term Gains to Enable Short-Term Loss Harvesting," 20 *J. Inv. Mgmt.* working paper, coming 2022.

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and cannot be carried over to the decedent's estate, surviving spouse, or other heirs.[11]

However, if the decedent was married and a joint tax return is filed for the year of death, the capital loss carryover may be used to absorb any capital gains generated in the year of death by either spouse, even capital gains realized by the surviving spouse after the death of the decedent.

A single taxpayer in failing health with a capital loss carryover may have few options to profit from it. Even if the taxpayer has assets with significant unrealized gains that could be harvested to absorb any carryover losses before death, there may be little economic benefit to resetting the basis because most assets will receive a step-up in basis anyway at the time of the taxpayer's death.[12]

For married taxpayers, the surviving spouse might be able to harvest sufficient capital gains to fully absorb the decedent's capital loss carryover. However, as with a single taxpayer, the surviving spouse may gain little economically by using the capital loss carryover to shelter harvested gains and reset the cost basis on assets that will receive a step-up in basis anyway at the time of the deceased spouse's death.

For example, appreciated assets may have been transferred to the decedent spouse more than a year before death and then bequeathed back to the surviving spouse, now with a stepped-up cost basis.[13] If the taxpayers reside in a community property state, any community property will typically receive a full step-up in basis at the deaths of both spouses.[14] In those cases, the surviving spouse might have insufficient unrealized gains to fully absorb the deceased spouse's capital loss carryover. However, the surviving spouse may still benefit from capital loss carryovers used to offset any postmortem appreciation realized in the year of death.

Careful Planning Is Needed

When dealing with capital loss carryovers, taxpayers must be aware of many important issues. Tax advisers can assist clients in navigating relevant considerations, strategies, and pitfalls to ensure that capital loss carryover benefits are maximized. ■

[11] *See* Rev. Rul. 74-175, 1974-1 C.B. 52.

[12] Section 1014(a)(1).

[13] Section 1014(e).

[14] Section 1014(b)(6).

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