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**How Active & Passive Investors Can Use
Market Volatility to Pay Less Tax
By Harnessing the Power of
Tax Loss Harvesting (TLH)**

by RICHARD WARNER

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The model portfolios and ideas discussed are intended to provide general guidance for understanding key issues in personal investing. There is no guarantee that the model portfolios and/or tax strategies discussed are the best match for your individual financial situation.

Past performance of funds, benchmark indices, and models discussed do not guarantee future results. Investing involves risk. The author encourages readers to conduct their own due diligence before investing, utilizing concepts outlined in this book and other relevant sources.

Most investors see red in their portfolio as a failure; smart investors see it as a "tax-saving asset."



What is Tax Loss Harvesting (TLH)?

Tax-loss harvesting = selling investments at a loss to offset gains and reduce taxes on future short and long-term capital gains as well as ordinary income.

The Goal: Maximize After-Tax Returns

"It's not how much you make; it's about how much you keep."

- For short-term traders and long-term passive investors
- Put losing trades to good use
- Not just \$3,000 per year
- **Build a cumulative capital loss tax bank** over years that **carry over** into the future
- Offset future capital gains and ordinary income with losses from the capital loss tax bank
- Short-term and long-term capital losses combined
- Requires a consistent and rigorous tracking methodology to avoid 30-day wash sale rule violations/disallowals

View losses from a completely different perspective!

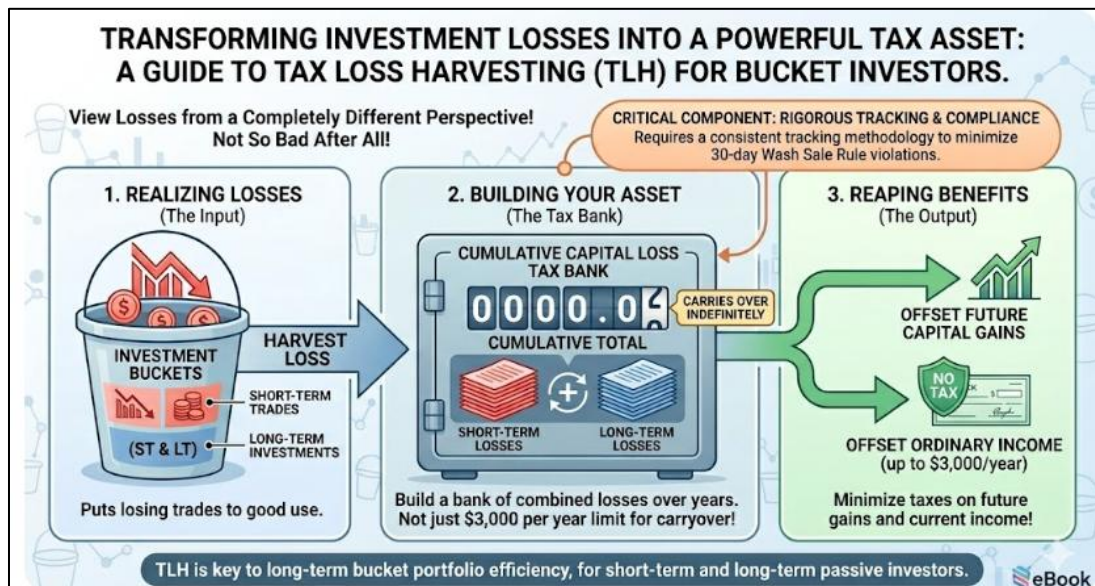
Losses are not so bad after all!

How the IRS Taxes Capital Gains

- **Short-term capital gains (<1-yr holding period)** are **taxed as ordinary income** (according to the tax bracket you're in)
- **Long-term capital gains (>1-yr holding period)** are taxed at 3 main threshold levels:
 - a) At **0%** for taxable income levels <\$50K single, <\$99K married
 - b) At **15%** for taxable income levels <\$546K single, <\$614K married
 - c) At **20%** for taxable income levels >\$546K single, >\$614K married

So, tax loss harvesting REALLY helps active traders.

- **The Netting Rule:** Short-term losses first offset short-term gains, and long-term losses offset long-term gains.
- **The \$3,000 Perk:** If losses exceed gains, you can offset up to **\$3,000** of ordinary income (salary/wages) per year.
- **The Carry-Forward:** Unused losses don't disappear—they roll over into future years indefinitely.
- **The Wash-Sale Rule (Crucial):** The **61-day window** (30 days before/after). Avoid using a "substantially identical" security—you can't sell SPY and buy VOO/IVV/SPYM during the wash sale window period.

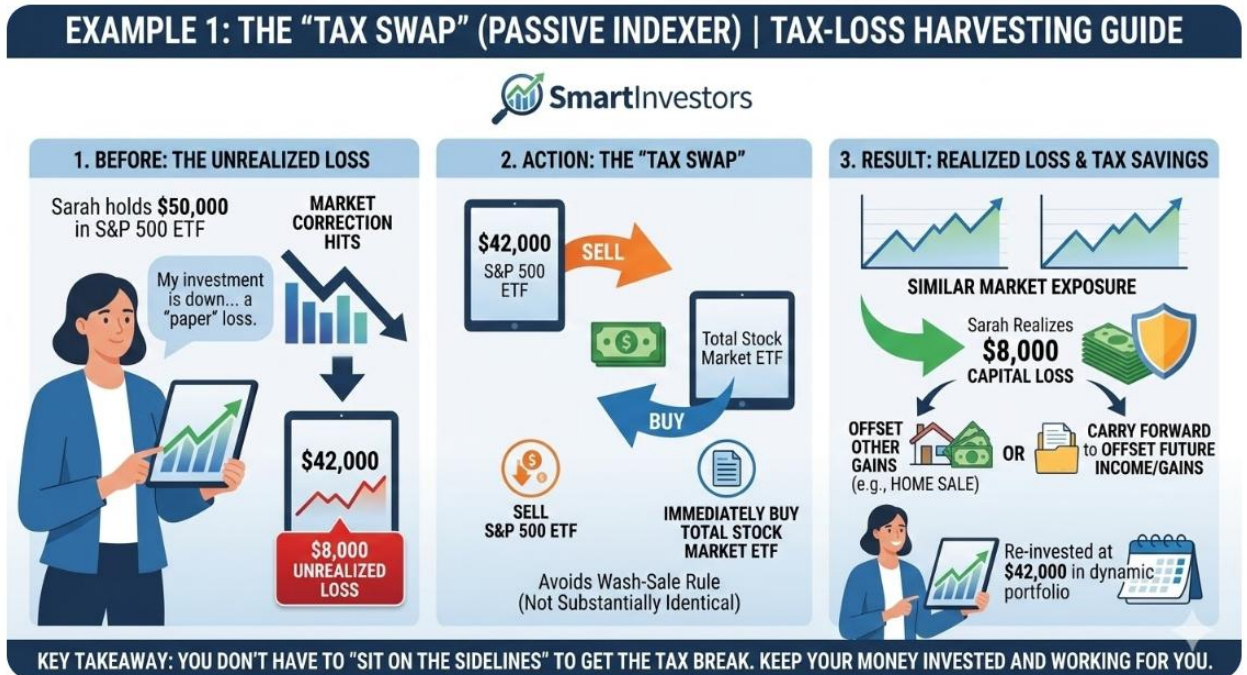


Active vs. Passive Strategy

- **For the Passive Investor:**
 - Find proxies or "**Tax Swaps**" for positions that you've realized losses in. Example: Exit an S&P 500 ETF (like VOO) and buy a Total Stock Market ETF (like VTI). You stay in the market (with a similar but not substantially similar ETF) and harvest the tax benefit.
 - TLH strategies can help when **rebalancing** portfolios in taxable accounts as well. Take advantage of severe market sell-offs to make adjustments, otherwise known as "opportunistic harvesting."
- **For Traders and Active Investors:**
 - Focus on taking **Short-Term Losses**. Active traders often face tax rates as high as 37% on gains. TLH becomes an essential means of reducing taxes on short-term capital gains.
 - If active trading is what you do for a living, you may want to opt for the **Mark-to-Market (MTM) 475f election** – please review the section at the end of this presentation.

3 Case Studies that Illustrate the Advantages of TLH

Example 1: The "Tax Swap" (Passive Indexer)



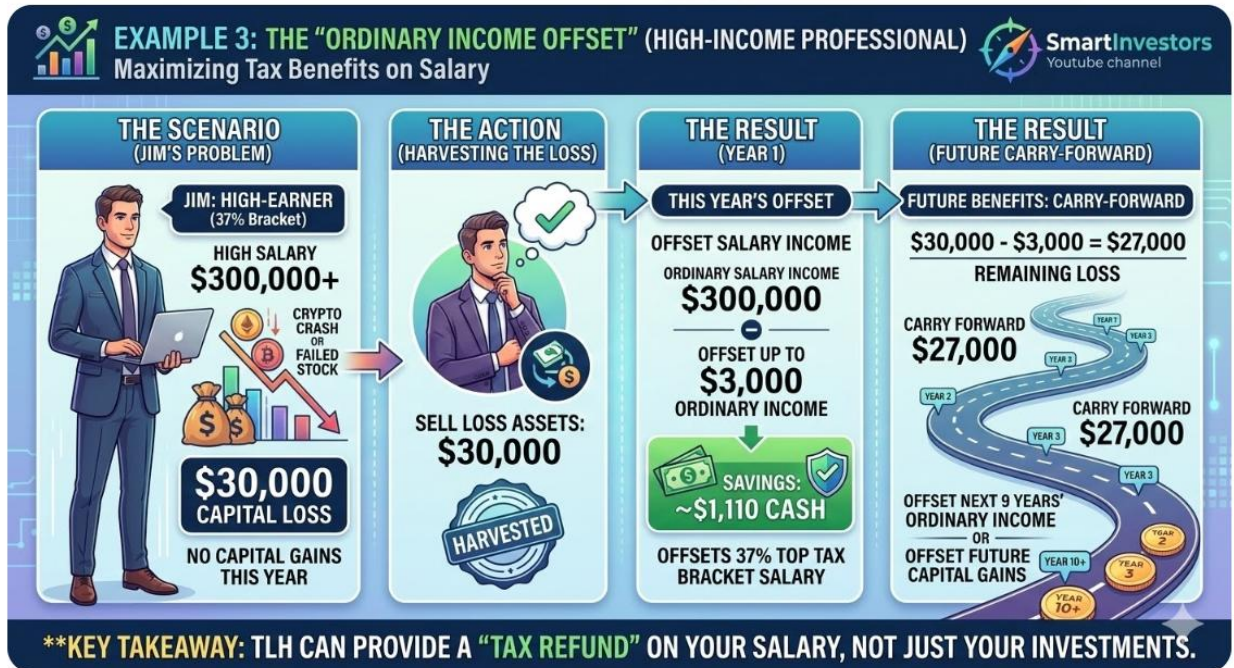
- **Scenario:** Sarah holds \$50,000 in an S&P 500 ETF. A market correction hits, and her position is now worth \$42,000 (an \$8k unrealized loss).
- **Action:** Sarah sells the S&P 500 ETF and immediately buys a Total Stock Market ETF.
- **Result:** She keeps her market exposure (they move almost identically), but she realizes an \$8,000 capital loss. She uses this to offset a gain from a home sale or carries it forward to offset future dividends.
- **Key takeaway:** You don't have to "sit on the sidelines" to get the tax break.

Example 2: The "Short-Term Shield" (Active Trader)



- **Scenario:** Mark is an active swing trader. He had a great year in Tech, netting \$20,000 in short-term gains. In his 35% tax bracket, he owes \$7,000 in taxes.
- **Action:** He has a "dog" in his portfolio—a biotech stock down \$15,000. He sells it before Dec 31st.
- **Result:** His taxable gain drops from \$20k to \$5k. His tax bill drops from \$7,000 to \$1,750.
- **Key takeaway:** Harvesting high-tax (short-term) gains is the most "profitable" use of TLH.

Example 3: The "Ordinary Income Offset" (the High-Income Professional)



- Scenario: Jim is a high-earner with no capital gains this year, but he's holding a \$30,000 loss from a crypto crash or a failed individual stock.
- Action: He harvests the full \$30,000 loss.
- Result: He offsets \$3,000 of his 37% bracket salary this year (saving ~\$1,110 in cash). He then carries forward the remaining \$27,000 to do the same for the next 9 years, or until he has a big capital gain to offset.
- Key takeaway: TLH can provide a "tax refund" on your salary, not just your investments.

Example #4: Long-Term Wealth Builder (Loss Carryforwards)



- **Scenario:** Emily has a large taxable portfolio and harvested losses during the 2022 bear market. She accumulated \$25,000 in carry-forward losses.
- **Action:** In 2026, she sells a rental property and realizes \$18,000 in capital gains.
- **Result:** Her prior harvested losses wipe out the entire \$18,000 gain. The remaining \$7,000 continues to carry forward. She pays \$0 capital gains tax on the property sale.
- **Key takeaway:** TLH can provide tax relief for physical investments as well, not just your financial investments.

Explaining the Wash Sale Rule (The 30-day Lookup and 30-day Post Sale Window)

The 30-Day Lookback Rule



When you harvest a loss, the IRS applies what's called the *30-day lookback rule*. This is where most investors get tripped up.

Here's how it works:

If you sell a stock or ETF at a loss, the IRS looks at a **61-day window**: 30 days before the sale, the day of the sale, and 30 days after (the post-sale window)

If you bought that same security — or something the IRS considers *substantially identical* — anywhere within that window, the loss is treated as a *wash sale*. And that means the loss is disallowed for tax purposes.

The key detail most people miss is the *before* window. Even if you haven't bought anything after the sale, a purchase you made 10 or 20 days *before* the sale can still trigger a wash sale.

So the cleanest way to avoid the lookback violation is to ensure you haven't bought the same security within the last 30 days. If you have, you can either sell those specific lots, or — as a last resort — exit the entire position. That guarantees safety, but it's not always the most efficient strategy.

The smarter move is usually to sell only the losing lots and then buy a **similar, but not identical**, replacement ETF so you stay fully invested while the 30-day clock runs.”

Here’s another infographic that illustrates the 61-day wash sale window:



Common Pitfalls & Professional Tips

- **Don't let the tax tail wag the investment dog:**
 - **Never sell a stock or ETF just for a tax break if you think it'll rally in the next 30 days.**
 - **Selling a stock or ETF just for a tax break may be a big mistake if it is scheduled to pay handsome dividends and the payout exceeds the amount you would save in capital gains taxes.**
 - **This advice is especially relevant if there are few, if any, similar securities (proxies) to replace the stock or ETF that you're considering for tax loss harvesting.**
 - **If there are indeed a number of proxy securities available that behave similarly (and pay a comparable dividend), then it makes more sense to tax loss harvest.**
- **Let's say you just took a small loss in a stock or ETF (for whatever reason) in a taxable account. Should you add that ticker to your Wash Sale Guard Alert list? At what threshold should a loss be considered worthy of tax loss harvesting (i.e., adding to the Alert list)?**
 - **The answer depends on the tax bracket that you're in and the size of the loss. For someone in a high tax bracket, a \$35 loss may not be worth the hassle. Generally speaking, the greater the loss, the more the reason for minding the 30-day wash sale re-entry window. But capital losses (however small) do add up quickly, especially for highly active traders. For this reason, my general rule of thumb is to track losses with a minimum \$10 to \$20 in size.**
- **Retirement Account Warning: You can't harvest losses in an IRA or 401(k). Tax loss harvesting only applies to taxable accounts.**
- **If you should realize a loss in a qualified account (IRA, 401K, etc.), these losses mean nothing to the IRS, so you could still buy the same security in a taxable account with no wash sale violation. *It's only when you realize a loss in a taxable account that you have to be on your guard.* If you buy that security back in any type of account (qualified or taxable) after realizing a loss in a taxable account, you're subject to the wash sale rule violation and will lose the ability to use that loss to offset future capital gains. For example, if you take a loss in QQQ in a taxable account, **DO NOT** buy it back inside an IRA account! And **DO NOT** buy it**

back inside a taxable account either! Use an eligible proxy during the wash sale rule window period instead!

- **Therefore, if you plan to apply harvest losses in taxable accounts, a good policy is to TURN OFF ALL DRIP (automatic dividend reinvestment programs) across ALL accounts (taxable and qualified)!**
- **The "Step-Up in Basis" Trap: If you plan to leave assets to heirs, harvesting losses now might actually be less efficient than letting them get a step-up later (advanced point).**

Trader Tax Status (TTS) 475f Eligibility – Does it Apply to You?

475f TTS is an optional accounting election that gives you:

- Trading **gains/losses are treated as ordinary income/loss** (no \$3K cap) and can offset other income (like salaries, commissions, etc.)
- **Exemption from wash sale rules** – greatly simplifies bookkeeping
- **Mark-to-market accounting** - positions treated as sold at year-end Fair Market Value (FMV)

To qualify for 475f TTS:

1. Your trading must aim to profit from **daily** market movements
2. You must be a high-frequency trader (**>720 trades per year, 4 days per week**)
3. You **must trade regularly and continuously** (no month-long breaks, etc.)
4. You **must trade significant dollar amounts**
5. Your account size should be at least \$25K
6. You have **short holding periods** (<31 days)
7. Volume of trades shows that **trading is your main business**
8. You **must devote a substantial number of hours to research and trading** (at least 4 hours per day)

If you don't meet these criteria, the IRS can reclassify your losses as capital losses and potentially hit you with penalties.

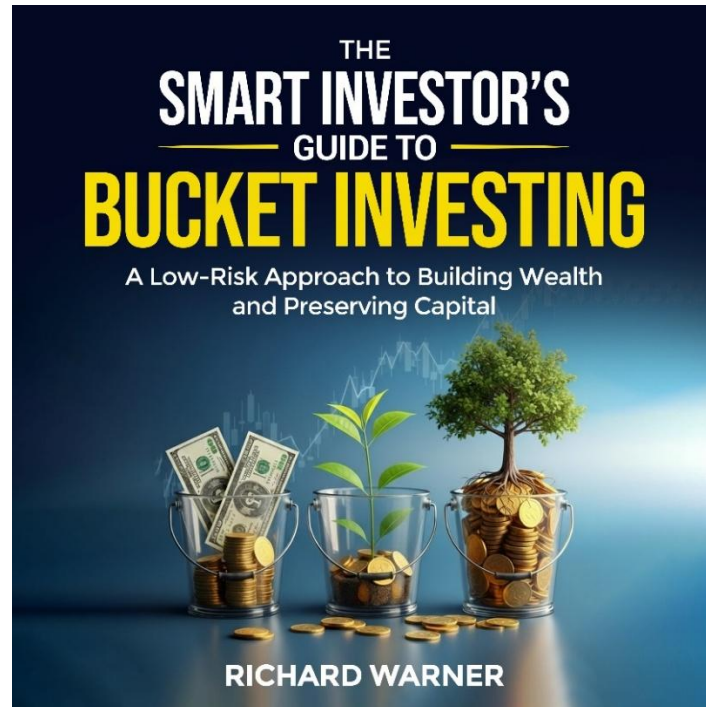
To apply for 475f TTS, you must attach a timely statement (by April 15 of the **prior year**) that includes:

- Declaration of 475f election
- Your name, address, SSN
- Description of trading accounts
- Signature and date
- In your first year, you must file **Form 3115**, to officially change your accounting method from the “realization method” to “**mark-to-market**” (MTM).

Resources & Next Steps

- **Summary:** TLH turns market volatility into a strategic advantage.
- Check out the [SmartInvestorModels Wash Sale Guard app](#)
- **Get the Book:** *[The Smart Investor's Guide to Bucket Investing](#)* (Available on Amazon in eBook, Paperback, and AudioBook formats).
- **Join the Community:** Sign up at SmartInvestorModels.com for tips and updates.
- **Watch the YouTube video on the [SmartInvestorModels YouTube channel](#).**

I hope you enjoyed reading this excerpt from Rich Warner's book *The Smart Investor's Guide to Bucket Investing: A Low-Risk Approach to Building Wealth and Preserving Capital*. If you found value in reading this PDF, consider purchasing the book in its entirety.



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With gratitude,

Rich Warner

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