TAX-LOSS HARVESTING

First Trust

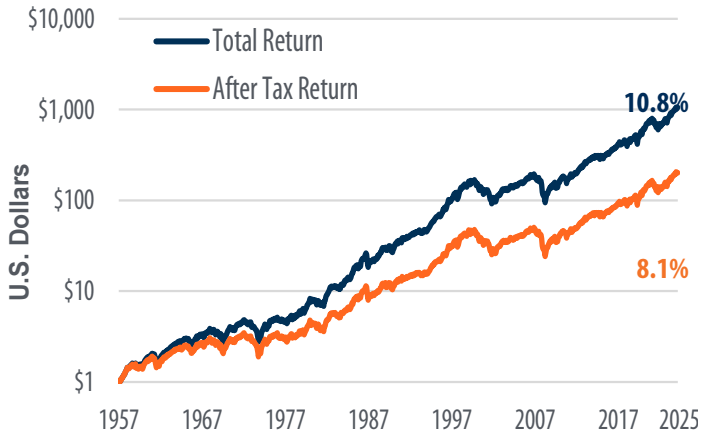
A proactive strategy that aims to maximize tax efficiency

Investing in the capital markets is one of the best ways to build wealth over time, but paying taxes on investment gains can significantly reduce overall portfolio return. To understand the impact of taxes, investors should focus on after-tax returns, the returns that are based on how much money they ultimately keep after paying taxes.

Since 1957, the S&P 500 Index has had a compound annual total return of **10.8%**, before taxes. Over that same time, however, that return would have been just **8.1%** after taxes. By utilizing tax-loss harvesting, a strategy that may help reduce "tax drag" (the negative impact of taxes), the tax burden might have been lower, potentially improving the overall growth of the portfolio.

When investments experience a drawdown, tax-loss harvesting allows investors to capture and use losses to their advantage by offsetting capital gains realized elsewhere in a taxable portfolio. Additionally, market volatility can present trading opportunities in both up and down markets to help offset taxes owed on investments, making tax-loss harvesting a year-round strategy that seeks to maximize tax efficiency.

S&P 500® Index Pre-Tax and After-Tax Returns[1]
1957-2025 | U.S. Dollars



Past performance is not a guarantee of future results.

How Tax-Loss Harvesting Works

Offsetting Gains with Losses

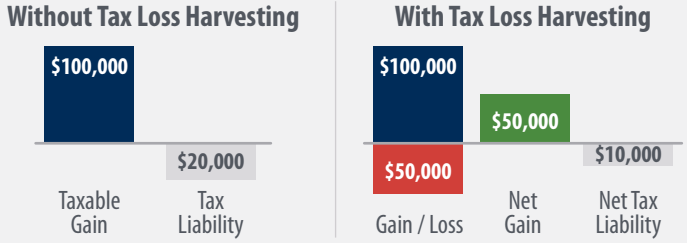
Tax-loss harvesting can be used in taxable accounts to seek to minimize tax liabilities by strategically selling assets that have experienced a capital loss. By realizing these losses, investors can offset capital gains and potentially reduce their overall taxable income.



- Offset capital gains
- Offset up to $3,000 of ordinary taxable income in one year
- **Unused losses can be carried forward to future tax years**

For example, assume an investor sold **Investment A** and incurred a $100,000 long-term capital gain. At the 20% capital gain tax rate, the tax liability would be $20,000.

Now assume the same investor implements a tax-loss harvesting strategy and sold **Investment B**, realizing a loss of $50,000. The result would be a net capital gain of $50,000 and the net tax liability would be reduced to $10,000.



[1]Sources: S&P and Bloomberg. The S&P 500® Index monthly dataset uses data beginning in 1957 and represents yearly total returns and yields of large-cap stocks, small-cap stocks, corporate bonds, government bonds of several maturities, and inflation. Hypothetical value of $1 invested since 1957, with taxes paid monthly. Annual income tax and capital gains tax rates assume a Consumer Price Index (CPI) equivalent income increase every year to the maximum social security tax income ($160,200 in 2023). Historical tax rates are calculated using historical income tax, capital gains tax, and qualified dividend income tax rates since 2003, assuming a maximum qualified dividend tax rate of 15%. Dividends prior to 2003 were taxed as ordinary income. The tax rates used in this illustration may not reflect the actual tax rates in effect throughout the entire historical period shown. Applying the tax rates in effect during each respective period could result in returns that differ from those presented. For illustrative purposes only and not indicative of any direct indexing account. An investment cannot be made directly in an index. This should not be construed as a representation that any account will, or is likely to, achieve profits, losses or tax savings similar to those reflected in this example.

[2]Source: IRS.gov.

Tax-Advantaged Solutions with Direct Indexing

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Direct indexing allows investors to seek to improve their after-tax returns through an enhanced ability to maximize tax management strategies and to align personal values with their investment goals. Investors own individual securities in a portfolio via a separately managed account (SMA). By holding individual securities rather than a single fund, investors can customize their exposure to the initial index according to their needs while allowing for greater tax efficiency.

Features of Tax-Loss Harvesting

Tax deductions

If capital losses exceed capital gains, up to $3,000 of net capital losses can be deducted against ordinary taxable income in a given tax year.[2]

Future tax savings

Any remaining losses can be carried forward to future tax years indefinitely, helping to offset future capital gains or income. Carrying losses forward can result in substantial tax savings over the long term, especially if investors have a high-income tax bracket or anticipate significant capital gains in the future.

Flexibility in timing

Tax-loss harvesting allows investors to strategically time the realization of losses, depending on their tax situation. Tax swapping may also be an effective tool for managing taxes during periods when markets are up. For example, investors may choose to offset capital gains in a high-income year or accelerate the recognition of losses to offset a large capital gain.

Rebalancing opportunities

Tax-loss harvesting may provide an opportunity to rebalance an investment portfolio. By selling assets that have experienced losses, the proceeds can be reinvested in securities that are not substantially identical. This practice allows an investor to maintain their desired asset allocation while potentially capturing tax benefits.

Long-term growth potential

By minimizing tax liabilities through tax-loss harvesting, investors can potentially reinvest the tax savings into their portfolios. Over time, this additional investment has the potential to compound and contribute to long-term growth.

Beware of the Wash Sale Rule

It is important to pay close attention to the wash sale rule, a regulation imposed by the IRS. If a security is sold at a loss and a substantially identical security is purchased within a 30-day period (before or after the sale), the loss cannot be deducted for tax purposes. By disallowing the deduction, the IRS aims to ensure that losses are legitimate and not used solely for tax avoidance.[2]



[2]Source IRS.gov.

A loss on the sale of a security is generally disallowed if the investor acquires, or enters into a contract or option to acquire, substantially identical securities within 30 days before or after the sale. The disallowed loss is generally added to the basis of the replacement security, which defers the loss rather than eliminating it, and the holding period of the original security may carry over. These rules apply to securities within this account and any account the investor or certain related persons own, including but not limited to, other taxable accounts, qualified accounts, certain trusts, and partnership interests that allocate security transactions to you. First Trust does not have visibility into these accounts, and the investor is responsible for identifying transactions outside this strategy.

It is important to note that tax rules and regulations can be complex and subject to change. Refer to IRS guidelines for specific, up-to-date information on the wash sale rule and its implications.

This summary is not intended to be tax or legal advice. This summary cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. This summary is being used to support the promotion or marketing of the transactions herein. The taxpayer should consult an independent tax advisor.

Investors or financial professionals should consult with a tax professional regarding the potential application of loss deferral regimes, such as wash sales and straddles, to the securities and potential transactions in this strategy, along with all the other securities and transactions in the investor's broader portfolio.

On September 28, 2026, the U.S. Treasury Department and the IRS issued Notice 2026-62, which warns about certain "tax-aware" strategies that the government views as using technical differences among similar financial products, or timing and identification rules, to produce capital gains and ordinary losses, and as appearing primarily tax-motivated rather than aimed at a genuine investment return. The Notice describes specific strategies and does not by itself address every tax-aware strategy, but investors and advisors should not assume this strategy falls outside the government's concerns. The Notice states that further guidance may follow, which may apply retroactively to transactions already completed, and that the IRS may challenge these strategies on examination under existing law, including the economic substance and substance-over-form doctrines, without waiting for new guidance. The Notice also contemplates designating certain transactions as reportable transactions, which could require special disclosure to the IRS and carry additional penalties. Any such guidance, designation or challenge could reduce or eliminate the tax benefits sought, increase compliance obligations, or result in additional tax, interest and penalties. Investors should consult an independent tax advisor about the Notice and any later guidance.

The information presented is not intended to constitute an investment recommendation for, or advice to, any specific person. By providing this information, First Trust is not undertaking to give advice in any fiduciary capacity within the meaning of ERISA, the Internal Revenue Code or any other regulatory framework. Financial professionals are responsible for evaluating investment risks independently and for exercising independent judgment in determining whether investments are appropriate for their clients.