Interactive Advisors' Tax Loss Harvesting Disclosure for Asset Allocation Portfolio Investments

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General description

Interactive Advisors ("IA") offers clients invested in the taxable Asset Allocation ("AA") portfolios the option to use tax loss harvesting ("TLH") as a value-added strategy. Tax loss harvesting is a strategy of selling securities in your portfolio that have decreased in value, to generate capital losses to potentially decrease your taxes while using the proceeds from the sales to purchase similar (but not identical) securities, to maintain the expected risk and return characteristics of the portfolio. Capital losses may be used to offset capital gains and/or up to $3,000 per year on income. Tax loss harvesting rules pertain to individual investors who are US taxpayers or US persons. They may or may not apply to other types of investors. Clients may opt in or out of TLH at any time on their IA client dashboard. There is no additional fee for activating the TLH functionality. Clients remain responsible for the annual account management fees associated with their AA Portfolio investments. Clients who are not invested in any of our AA Portfolios cannot use our TLH functionality.

TLH is conducted quarterly, during the regular quarterly rebalances for the AA Portfolios. Our TLH algorithm gives more weight to short-term losses than long-term losses since the IRS treats short-term capital gains differently than long-term ones and typically taxes them at a higher rate. The implementation of our TLH algorithm assumes you do not hold or trade the ETFs held in your AA Portfolio investments in any other account.

If the loss is deemed sufficiently large, the algorithm will direct selling of the ETF and replacing it with a different but historically correlated ETF. When determining whether to harvest a loss and replace an ETF, the TLH algorithm takes into account factors including the size of the unrealized loss and wash sale avoidance considerations. Replacement ETFs are selected based on correlation to original ETF, expense ratio, liquidity and the underlying index of the ETF.

If the weighted losses exceed a certain loss threshold and if the ETF has not been purchased over the previous 30 days, all the holdings in that ETF in the AA Portfolio investment will be sold and the proceeds will be used to buy the replacement ETF. We may revise the TLH algorithm in the future to accommodate partial replacements. **During periods of high trading volatility, IA reserves the discretion to cancel or postpone the replacement trades.**

Interested clients should carefully review this disclosure and consider their personal circumstances (e.g., tax situation) before activating TLH in their IA account(s). For additional details on the operation of TLH, including our list of replacement ETFs, you should read our white paper at: https://interactiveadvisors.com/learn-more/tax-loss-harvesting. Clients are solely responsible for determining whether to activate TLH and whether it is suitable in their circumstances.

Risks and limitations associated with the use of the functionality

IA does not represent that investing in the AA Portfolios or using the TLH functionality will achieve any particular investment or tax result. TLH does not constitute tax advice and IA assumes no responsibility for the tax consequences of any TLH-related transaction, to any client. Clients should consult their personal tax advisors regarding the tax consequences of investing in the AA Portfolios, the effects of using TLH, whether the transactions in non-IA accounts trigger wash sale restrictions, and the requirements for making appropriate reports and filings with the IRS or any other taxation authority.

The tax consequences of using a tax loss harvesting strategy generally and TLH specifically are complex and uncertain and may be challenged by the IRS or any other tax authority. In case of an inquiry or proceeding by the IRS or any other tax authority, IA will not become a party to that inquiry or proceeding on your behalf. The information with regard to TLH was not prepared to be used, and cannot be used, by any investor to avoid penalties or interest. For additional information on claiming tax losses on your tax filings, review the IRS instructions on Schedule D (Form 1040) Capital Gains and Losses or IRS Publication 550. Tax loss information associated with your use of TLH can be located on your logged-in client dashboard. Our affiliated broker Interactive Brokers LLC ("IBLLC") will provide you with a Form 1099 to be filed with your tax return.

TLH is generally valuable for investors with taxable accounts (as tax-advantaged accounts like traditional or Roth IRA accounts are already tax-free or tax-deferred) who have a long-term investment horizon (as it works through tax deferral not tax avoidance and thus it is less beneficial over a short investment horizon). Often TLH is most effective for investors who harvest losses for use against high-rate income (i.e., short term capital gains) and convert future realized gains to long-term capital gains subject to the preferentially lower rate.

The benefits of TLH and the net investment losses available for harvesting will depend on each client's particular circumstances, including but not limited to: income, state of residence, purchases and sales of assets in the client and spouse's accounts outside of IA, type of account and holding periods. **Tax loss harvesting generally and the use of our TLH functionality may not be appropriate or beneficial for all investors. Investors: (a) without taxable accounts; (b) in relatively low income tax brackets; (c) expecting higher future tax rates; (d) planning to withdraw a large portion of their investments within a year; and/or (e) trading any of the ETFs in their AA portfolio investments in non-IA accounts, including joint accounts, likely to trigger the wash sale rule, will generally benefit the least from using TLH.**

The value added from TLH will depend on a variety of factors, including but not limited to:

A. **Current tax rate versus future tax rate: Avoiding paying capital gains tax by offsetting the gains with harvested losses does not mean that you never need to write a check to the IRS. By harvesting losses now, you are simply deferring *when* you write the check to the IRS.** If your future tax rate for long- and short-term gains is lower than your current rates, you benefit by writing the check later, because that tax bill will be calculated using lower rates. Thus, the greater the differential between current and future tax rates, the higher your benefit from TLH. If future tax rates are higher than the current ones, delaying payment by opting to use TLH will work to your disadvantage.

B. **Expected return of investment portfolio:** The losses that TLH can harvest are highly dependent on the performance of the positions within your AA portfolio investment and general market conditions. In certain years, there will be large losses to harvest while in others very few.

C. **Investment horizon**: The longer you hold onto your investments, the higher the likely benefit of using TLH.

D. **Volatility of underlying holdings**: Because TLH involves selling investments that have declined in value, generally portfolios with a greater proportion of riskier securities with higher volatility and greater price fluctuations present more opportunities for tax-loss harvesting.

E. **Tracking error of replacement ETF**: After selling an ETF to harvest losses, TLH automatically invests the cash proceeds from the sale in a replacement ETF with a high *historical* correlation with the original ETF. The performance of the replacement ETF could be worse or better than that of the original ETF. **We do not represent and cannot guarantee that the replacement ETFs will ultimately perform the same or similar to the ETFs being replaced despite their similar expected risk and return characteristics.**

F. **Availability of realized gains to offset realized harvested losses:** Tax losses TLH harvests can be applied to offset both capital gains and up to $3,000 in ordinary income annually. Losses that cannot be applied in a given tax year can be carried over indefinitely to offset future income and capital gains. The benefits of TLH are higher when the offset happens earlier rather than later, and when the offset is applied to short-term gains or income rather than to long-term gains.

G. **Trading securities substantially identical to those in your AA Portfolio investments in other accounts or in the same account invested in non-AA Portfolios managed by IA, could trigger the wash sale rule.** If you buy the same or a substantially identical security within 30 days before or after the sale of such securities in any account (including other IA accounts, brokerage accounts at our affiliated broker-dealer Interactive Brokers LLC ("IBLLC") or investment accounts with other institutions), then the IRS does not allow capital losses from such sales to offset capital gains due to the "wash sale" rule. A wash sale does not completely eliminate the benefits of TLH but reduces that benefit by the amount of the wash sale itself. The wash sale rule applies across all of your accounts, including your non-taxable retirement accounts, no matter where they are held. Trading activity in any of IA's non-AA portfolios (even if in the same account where the AA Portfolio investments are held) can also result in negating our TLH algorithms, and triggering wash sale rules.

IA does not monitor transactions in clients' non-IA accounts, whether held at IBLLC or elsewhere. Clients are thus responsible for ensuring they identify and properly handle wash sales resulting from trading in their (and their spouse's) non-IA accounts. For more information on the wash sale rule and other tax-loss harvesting-related issues, please review IRS Publication 550 and the Interactive Brokers website.

Higher turnover as a result of TLH

TLH results in increased trading in the accounts of clients who activate the functionality. Such increased trading could result in increased trading expenses, executions at less favorable prices, less favorable tax treatment of some dividends, portfolio drift, and increased risk of trading errors.