

A CHAPTER FROM THE WATERFALL STRATEGY

The Loss Bank

*Tax-Loss Harvesting and Installment Gain: Capital Losses on
the Same Calendar*



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Read This First

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FROM THE WATERFALL STRATEGY

Capital Losses on the Same Calendar

\$126,672. That is what one couple's capital losses were worth against the gain from their installment sale, over ten years, in the federal example below. The same losses against the same gain, sold for cash, were worth \$94,668 (simple example). Same losses. Same gain. A different calendar.

The Waterfall Strategy is mostly about passive losses, the coupons behind the dam: mostly paper losses from depreciation, which a rental can show even while it pays you cash, and which can't reach your wages above \$150,000 of income unless you are a real estate professional. This chapter is about the second bank: **capital losses**. It is a condensed version of the companion guide, *The Loss Bank*. The full guide, with every worksheet and the state-by-state appendix, is free at thewaterfallstrategy.com/loss-bank.

What this chapter covers, and what it doesn't. It explains how the tax law treats a capital loss **once it is on your return**. It does not cover how to create losses, what to own, or who should manage your money. That is between you and your investment adviser. Every loss amount below is a given number on a return, not a projection of what any account will produce.

Two ledgers, one return

Every seller with a brokerage account keeps two ledgers, whether they know it or not.

Ledger one: the sale. Gain from selling a building or a business. You control when it is recognized, within the rules. Take cash and it all lands in one year. Get paid over time and it lands as you are paid (\$453).

Ledger two: the capital losses. A carryforward from past years, on Schedule D, lines 6 and 14. Losses that land on your return this year. Losses that may land in future years.

They meet on the same form every year: Schedule D. A capital loss offsets capital gain dollar for dollar, without limit. Against anything else, like wages, pensions or interest, it is worth only \$3,000 a year (\$1,500 married filing separately). The rest carries forward, keeping its short- or long-term label, with no expiration during your life (§§1211(b), 1212(b)).

So a capital loss is a coupon with one store that takes it at full value: capital gain. **Your building sale is that store.** Gain from selling a rental held more than a year is §1231 gain, and a net §1231 gain for the year is treated as long-term capital gain.

Your rental gain wears two hats. The same gain is passive income, which frees your passive losses (The Waterfall), and capital gain, which your capital losses meet on Schedule D. The two banks work at different stages of the return, and a stock loss doesn't use up the passive income the gain supplies. Your CPA confirms how it lands on your return.

The calendar is the lever

Sell for cash and the gain arrives in one year. Every coupon in the bank that year gets cashed. But coupons that land on your return in later years have no gain to meet. They trickle out at \$3,000 a year until you sell something else or die.

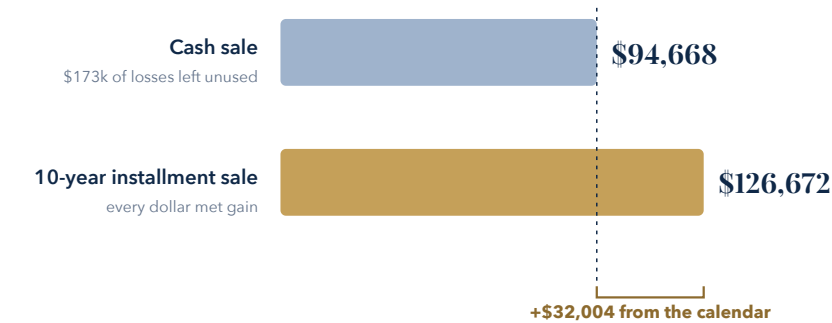
Sell on the installment method and a slice of gain lands every year, on a schedule you know before closing. A loss that lands on your return in year three meets year three's gain.

Dan and Priya (an illustrative composite) file jointly with \$300,000 of other income. They sell a rental with a **\$2,000,000 gain**, \$400,000 of it unrecaptured §1250 gain. Their loss bank, as given: a **\$300,000 long-term carryforward**, plus **\$50,000 of new long-term capital loss** landing on their return in each of years two through five. \$500,000 of losses in all.

TEN-YEAR TAX ON THE GAIN, FEDERAL (SIMPLE EXAMPLE)	CASH SALE	TEN-YEAR INSTALLMENT SALE
With no capital losses	\$515,135	\$413,286
With the \$500,000 loss bank	\$420,467	\$286,614
What the losses were worth	\$94,668	\$126,672
Losses still unused after year ten	\$173,000	\$0

The same losses are worth \$32,004 more on the installment calendar (simple example). In California, where every loss dollar also saves the full state rate, the gap is \$36,093. Part of the installment plan's edge has nothing to do with losses: spreading the gain alone saves \$101,849 here, by keeping more gain in lower brackets. The \$32,004 is the loss increment on top.

FIGURE
Same \$500,000 of losses. Same \$2,000,000 gain. Two calendars.



Federal tax saved by the losses over ten years, Dan and Priya. Illustrative; 2026 tables held constant; engine.js.

Illustrative only. Federal tax on the gain with the 3.8%; 2026 tables held constant; note interest, time value and reinvestment left out. Computed with the same engine as the cases (engine.js).

BOTTOM LINE

A cash sale cashes the coupons you hold on sale day. An installment sale also gives the coupons that arrive later a gain to meet.

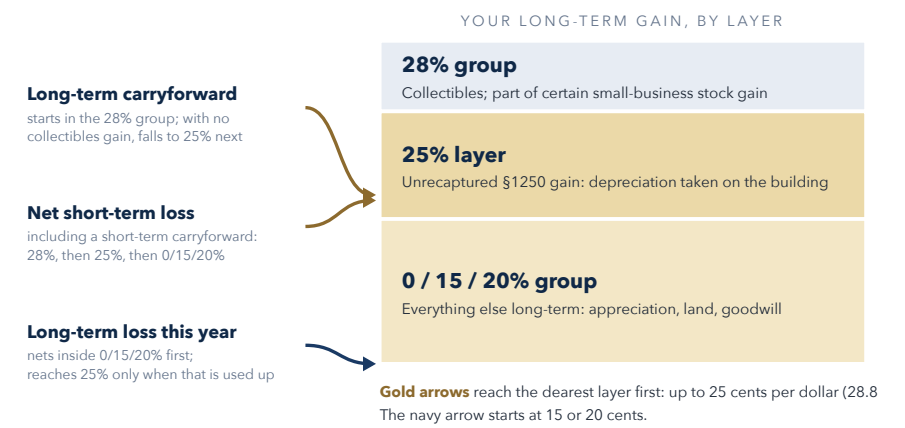
Which layer a loss hits first

Your long-term gain isn't taxed at one rate. It is sorted into layers: unrecaptured \$1250 gain (the depreciation you took on the building) at up to 25%, then everything else at 0%, 15% or 20% (The Five Layers of Tax). A capital loss comes off one layer first, then the next.

The IRS set the order in Notice 97-59. For a seller with no 28% gain that year (collectibles and certain small-business stock; most sellers of real estate have none):

THE LOSS	LANDS FIRST ON
Long-term carryforward	25% layer
Short-term carryforward	25% layer
Net short-term loss realized this year	25% layer
Long-term loss realized this year	0/15/20% layer (reaches the 25% layer only after that gain is used up)

FIGURE
Which layer a loss hits first



Notice 97-59; §1(h)(4), (h)(6). Inside each group, gains and losses net first. Simplified: see the full order in the text.

Why an installment sale lines this up. On the installment method, the 25% layer comes out first: each payment's gain is unrecaptured §1250 gain until that layer is used up. So the early payments carry the depreciation layer, and your carryforward is in the bank on day one. The dearest layer of gain and the losses that reach it first arrive on the same return: year one.

A SIMPLE EXAMPLE

Married filing jointly, 2026, \$450,000 of wages. One year's installment brings \$150,000 of gain: \$40,000 in the 25% layer and \$110,000 in the 15% layer. The couple holds a \$20,000 long-term carryforward, and \$30,000 of capital loss lands on this year's return. If the \$30,000 is long-term, the losses save \$11,400 of federal tax. If it is short-term, they save \$13,400: same \$50,000 of losses, \$2,000 more, because every dollar reaches the 25% layer first (simple example). In California, both versions save another \$4,650. California has no layers.

The netting order is a fact to plan around, not a reason to trade. Whether a loss is short- or long-term depends on when the asset was bought and sold. Those are investment decisions, with consequences far beyond this one rule.

One scoop a year

A **scoop** is the loss your return uses against one year's installment gain. **One scoop a year, sized to that year's payment.** You can't pick when a loss lands on your return. You can pick when your gain does.

The Chens (an illustrative composite) file jointly with \$250,000 of other income. They sell a building with a **\$1,000,000 gain**, \$200,000 of it in the 25% layer. Their loss bank, as given by their CPA: a **\$100,000 carryforward**, plus **\$40,000 of new capital loss** landing on the return in each of the next ten years. Same gain, same losses, three calendars:

SCHEDULE (SIMPLE EXAMPLE)	LOSSES USED AGAINST GAIN, 10 YEARS	LOSSES STILL UNUSED AFTER YEAR 10	WHAT THE LOSSES WERE WORTH, FEDERAL
5 years, level	\$300,000	\$185,000	\$72,743
10 years, level	\$497,000	\$0	\$110,086
10 years, back-loaded (\$50,000 a year for 5 years, then \$150,000)	\$485,000	\$0	\$112,780

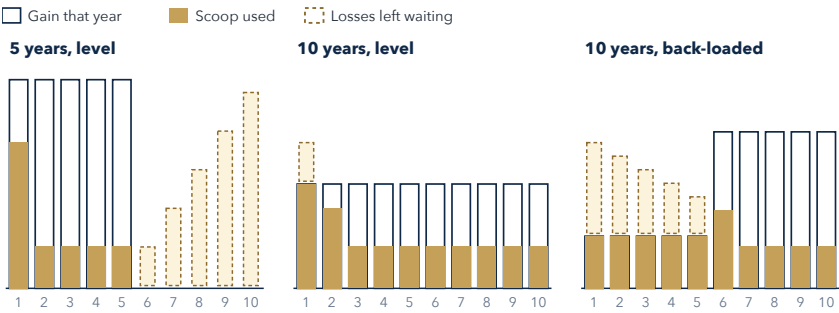
FIGURE

Same gain, same losses, three calendars

WHAT THE LOSSES WERE WORTH, FEDERAL



THE SCOOP SCHEDULE, YEAR BY YEAR



The Chens: \$1,000,000 gain; \$100,000 carryforward plus \$40,000 of new losses a year for ten years. On the five-year schedule, years 6 to 10 bring no gain, so losses pile up unused (dashed). Illustrative; engine.js (E8).

The five-year schedule runs out of gain before the losses stop arriving. In years six through ten, \$40,000 a year lands with nothing to meet but the \$3,000 allowance. On either ten-year calendar, every year's scoop has a payment to meet (simple example; same engine and assumptions as above).

What a longer schedule costs. A seller-financed note must carry interest at least at the applicable federal rate, or part of the principal is treated as interest (§§483, 1274). A longer schedule means more interest, and interest is ordinary income: capital losses reach only \$3,000 of it a year, and passive losses can't touch it. You also wait longer for your principal. And for a sale priced above \$150,000, if more than \$5 million of installment obligations that arose during the year remain outstanding at year end, §453A charges interest on the deferred tax attributable to the excess.

Whether losses land on your return at all, and how many, is between you and your investment adviser. Shape the schedule to the scoops your adviser's low case supports, not the high case. Future losses are uncertain. Published re-

search finds that new contributions refresh the chance to realize losses and withdrawals reduce it (Berkin and Ye 2003), and none of it is about your account. A carryforward is certain. It is on the return. Plan the early years around it.

The scoop worksheet

Fill it in with your CPA, from your own return. Not from a brokerage statement.

YEAR	INSTALLMENT GAIN THAT YEAR (FROM THE SCHEDULE)	25%-LAYER PORTION	LOSSES AVAILABLE (CARRYFORWARD + CURRENT, FROM YOUR CPA)	SCOOP NEEDED TO ZERO THE GAIN	GAIN STILL TAXED	LEFT IN THE BANK
Sale year						
1						
2						
3						
4						
5						

A year where the scoop needed beats the losses available is a year some gain stays taxed. A year where it is smaller leaves something in the bank. **If the bank is bigger than the whole gain**, the installment method buys nothing on the loss side. Ask your CPA to compare electing out (§453(d)), because a capital loss carryforward can be used only on the owner's final return. It does not pass to the estate or the heirs (IRS Pub. 559). An installment note does pass to the heirs, with its tax attached.

Every kind of loss that can meet your gain

Because the gain wears two hats, two families of losses can meet it, and a third kind of deduction lowers the tax around it. This is a map of the tax treatment, not a list of things to buy.

FAMILY	EXAMPLES, BY HOW THE TAX LAW CLASSIFIES THEM	HOW THEY MEET THE GAIN
Passive losses	Suspended losses on the building you sold; your other rentals; K-1s from businesses you don't materially participate in; equipment and other personal-property rentals; short-term rentals averaging 7 days or less, without material participation	Allowed against passive income, and the gain is passive income (\$469)
Capital losses	Stocks, funds, bonds and bond funds sold below basis; your carryforward; land held for investment; worthless securities; nonbusiness bad debts (short-term); §1256 contracts (60% long-term, 40% short-term)	Net against the gain on Schedule D, layer by layer; \$3,000 a year against other income
Deductions that lower the brackets	Net operating loss carryforwards (up to 80% of taxable income); losses from a business you actively run (above \$256,000, or \$512,000 joint, for 2026, the excess becomes a carryforward); a qualifying real estate professional's rental losses; retirement plan contributions; charitable gifts	Leave the gain alone; lower the income stacked under it, so more of the gain lands in a lower bracket

Look alike, but follow their own paths: a publicly traded partnership's losses offset only that partnership's income. Oil and gas royalties are portfolio income, not passive, and a working interest held directly is not passive at all. Section 1244 small business stock produces an **ordinary** loss (up to \$50,000 a year, \$100,000 joint). A net §1231 loss is ordinary. Before any of it reaches the passive bank, a loss must clear your basis and the at-risk rules.

WHAT DOESN'T WORK

A loss on surrendering a nonqualified annuity. The IRS treats it as an ordinary loss, deductible only as a miscellaneous itemized deduction, and those are no longer allowed (§67(h), made permanent by the 2025 law). It never reaches the capital loss bank. And interest income is never a loss bucket: passive losses can't offset it, and capital losses reach only \$3,000 of it a year. A bond **sold** below its basis is a capital loss; the interest it paid is still ordinary income.

Your state

Where you live decides whether your losses count at all. A resident nets capital losses against the gain on the state return, under that state's rules. California taxes all capital gain as ordinary income, so every loss dollar that meets gain saves the full California rate, whichever federal layer it hits.

Where the property sits taxes the gain. If that is not where you live, the general rule is that your portfolio losses belong to your home state and don't reduce the property state's tax. California says it plainly: for nonresidents, "the computation of California taxable income, capital loss carryovers, and capital loss limitations are determined based upon California source income and loss items only" (FTB Schedule D (540NR) instructions). Move out of California after the sale, and your future losses still help federally, but not against the California-source installment gain.

A few states don't allow a capital loss carryforward at all, so only a loss in the same year as a payment counts there. *The Loss Bank* has the state-by-state table. Ask your CPA how both states treat your losses before the schedule is set.

§ FOR YOUR CPA

§§1211(b), 1212(b); §1(h)(1)(E), (h)(4)(B), (h)(6)(A) and Notice 97-59, 1997-45 I.R.B. 7 (netting order); Reg. §1.453-12(a) (unrecaptured §1250 gain taken into account first on the installment method); §453(d) (election out); Pub. 559 (capital loss carryovers deductible only on the decedent's final return); §§483, 1274; §453A(b)(1)-(2), (c) (sales price over \$150,000; interest charge above \$5,000,000 of obligations arising in the year); Temp. Reg. §1.469-2T(c)(2)(i)(A) (disposition gain is passive activity gross income). Full citations in the Practitioner's Edition and in *The Loss Bank*.

Timing and bracket spreading, not magic. Have your CPA run your numbers.

YOUR NEXT STEP

Write your Schedule D carryforward here: short-term \$ _____, long-term \$ _____. Then get the full guide, free at thewaterfallstrategy.com/loss-bank, or call or text 213-414-2808 to model an installment schedule against your loss bank. I work only from numbers on your tax return or numbers your CPA gives you, never your brokerage statements. *Hans Goldstein, a licensed insurance agent (CA Insurance License #4273294), will contact you and may discuss insurance products, including annuities.*

Important Disclosures

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ILLUSTRATIONS

Every person in this chapter is an illustrative composite. Every example uses given numbers, 2026 tax tables held constant, and leaves out interest, time value and reinvestment unless stated. No result is typical or promised. Research findings are described for education only and are not a prediction of results in any account.

YOUR PROFESSIONALS

Confirm every figure with your own CPA or tax attorney before acting. Discuss any investment decision with a registered investment adviser or broker-dealer of your choosing.

WHO THE AUTHOR IS

Hans Goldstein is a California-licensed life and annuity insurance agent and an Enrolled Agent (EA), admitted to practice before the Internal Revenue Service. He is not a CPA, attorney, registered investment adviser, broker-dealer representative or financial planner, and he does not prepare tax returns. Tax education is provided by Hans Goldstein individually, as Hans Goldstein: Tax & Exit Planning. Insurance products are offered through Goldstein & Co. LLC dba Goldstein Insurance Services, which offers insurance only.

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LAWS CHANGE

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