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PFS Planning Update

Should you trigger capital gains at this year's low rate?

Private Company Services

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Introduction

With the threat of increased capital gain tax rates in 2013, plus additional taxes for mandated health insurance (added Medicare taxes), many high income taxpayers are wondering if it makes sense to trigger capital gains on stocks and mutual funds this year and then immediately repurchase them. The same logic might also apply to real estate and collectibles.

For this discussion, high-income taxpayers are anyone with adjusted gross income of $250,000 or more for married couples or $200,000 or more for single individuals. These are the projected income levels that will be subject to higher tax rates in 2013 and beyond.

Scheduled rate increase

The current federal long-term capital gain rate is 15%. It is scheduled to increase to 20% in 2013. The phase-out of itemized deductions also returns for 2013 and acts like an additional tax of 1.2%. Finally, a 3.8% Medicare tax will also apply to investment income beginning in 2013. The combination of these scheduled rate increases means that the 15% maximum capital gain tax rate turns into a 25% tax rate in 2013.

Assets

The first step in evaluating this potential strategy is to inventory your portfolio and determine which assets have experienced significant appreciation up to now. Then think about when you are likely to sell those assets. When considering which assets could be sold and repurchased before year end, obvious candidates include publicly traded securities such as stocks, bonds, and mutual funds. However, you should also consider appreciation in collectibles and real estate.

Basic math

The significance of these scheduled rate increases can be seen with some basic math. Assuming you trigger a $100,000 capital gain in 2012, you would pay a capital gain tax of $15,000 (15% capital gain rate). If you trigger that same gain in 2013 and your income is over the threshold, you will instead pay $25,000 in taxes (20% capital gain rate plus 1.2% phase-out plus 3.8% Medicare tax).

On the surface, it seems you should sell the stock or mutual fund today and immediately repurchase it. However, you need to factor in the out of pocket cost associated with actually paying the tax. What if you weren't planning to sell that asset for 10 years?

Let's say that it costs you $200 to sell the stock and repurchase it immediately. Overall, the sale and repurchase will cost you $15,200 ($15,000 of capital gains tax plus $200 in commissions). If you invested that $15,200 it would be worth about $22,500 in ten years (based on a 4% after tax investment rate). That is still less than the $25,000 of taxes due under the "new" tax rates. This suggests that you should think about selling any asset you might otherwise sell in the next ten years.

Certain assets held for more than 5 years are eligible for a super long-term capital gain rate of 18%. So the future tax wouldn't be $25,000, but only $23,000. This suggests that you should think about selling any asset you might otherwise sell in the next ten years, even if it qualifies for super long-term rates.

State income taxes

Triggering capital gains for federal tax savings will also trigger state income tax on that gain. Depending on the state tax rate, this could increase the current cost and change the economics. Suppose you pay a 6% state income tax on the transaction for the privilege of paying federal tax early (at a reduced rate). That means the current cost is $21,200 (rather than $15,200) and it takes about 10 years at a 4% earnings rate before those funds would equal $31,000 (the future tax cost being avoided). Note that adding state income taxes to the mix didn't change the conclusion. If your state tax deduction actually saves you federal income taxes you would have to modify the math accordingly.

Collectibles and real estate

Different math applies to collectibles, such as stamps or coins. Collectibles are taxed at a maximum capital gains rate of 28%. The special rate applicable to collectibles isn't changing. The only change for 2013 is the 1.2% phase-out tax plus the additional 3.8% Medicare surtax. So a $100,000 gain in gold bullion would produce $28,000 of tax in 2012 vs. $33,000 of tax in 2013. Remember that transaction costs associated with selling and repurchasing collectibles can be significant.

Depreciable real estate is also subject to a special capital gain tax rate. The depreciation recapture portion of any gain is taxed at a maximum rate of 25%. Again, the only new feature for 2013 would be the 1.2% phase-out tax and the 3.8% Medicare tax. Other portions of real estate gain are currently taxed at the 15% capital gain rate, so the rate differential would matter for that portion of the gain. Transaction costs on real estate can be significant so that selling and repurchase costs could easily wipe out the tax savings associated with paying early. Special calculations would apply to those with significant gains in real estate (depending on the mix of total gain and depreciation recapture gain).

Other considerations

Math isn't everything. There are a host of other factors to consider before selling and repurchasing financial assets just to capture what appears to be an attractive tax rate.

Extension of lower rates beyond 2012

What if Congress extends the lower tax rates as they did in late 2010? Such an extension is likely to take place close to year end 2012. The tax landscape for 2013 may not be known until well after the November elections. A cautious approach would be to wait until later in the year to execute transactions. This might cause unusually high trading in November and December 2012 from taxpayers cashing in at low rates. While volume might be high, there should be an equal number of buyers and sellers.

Capital loss carryovers and portfolio turnover

Existing capital loss carryovers probably make it more attractive to sell and repurchase because you are triggering less tax currently (only transaction costs). Of course you would need to forecast when you might actually pay capital gain tax in the future (when the capital loss carryover would be used up) and determine when transaction costs justify the strategy. The issue is that preserving capital loss carryovers (and adding to them) for use in later years, and against gains that may be taxed at higher rates, is a competing strategy.

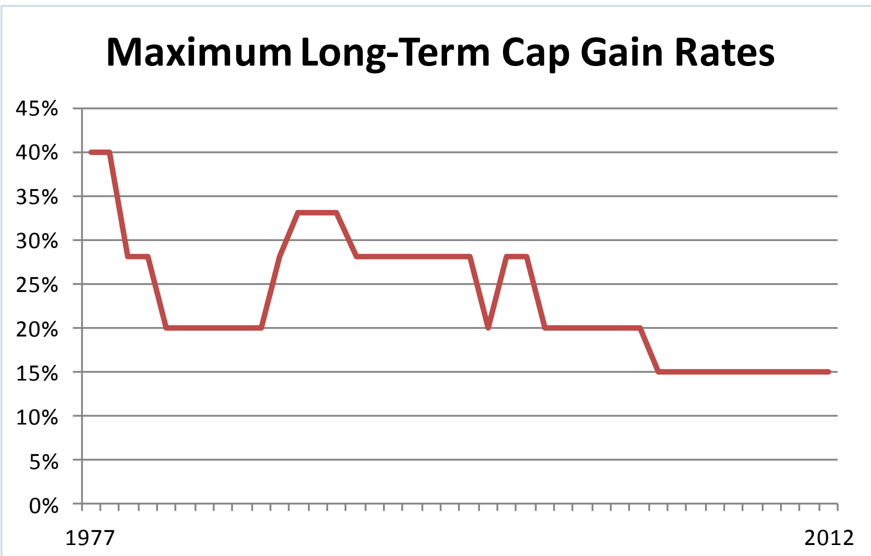
Tax efficient portfolios typically have very low turnover. However, even an index fund might have a 5% turnover rate per year. Over a 10-year period, about half of the portfolio might turn over. Depending on the current amount of gain built into the portfolio, even an index fund might be a candidate for the sale and repurchase strategy.

Mutual fund trading restrictions

Short-term trading of mutual funds attracted federal regulator scrutiny several years ago. Many mutual funds now impose special fees or restrictions on short-term trading activity. The selling and repurchase strategy may run afoul of these restrictions. Further, some mutual funds have a delay between the sale instruction and actual sale. You should check your mutual fund's rules before attempting the sale and repurchase in order to capture the lower capital gain rate. You may have to initiate the sale transaction well in advance of the repurchase. One way around this issue is to purchase similar funds in another mutual fund family. Don't attempt the sale and repurchase strategy without checking the fund's rules. Also bear in mind transaction costs, including any "load" or other fees that may be incurred on repurchase.

Historical capital gains rates

Even if rates increase in 2013, it is possible that capital gains rates will again be reduced at some time in the future. Rates shift as political power in Washington shifts. There is a reasonable chance that capital gain rates will again return to "low" levels.



Decline in Asset value

If your investment assets decline in value after 2013, you would have paid capital gain tax on a "paper gain" that you never turned into a real gain. Think how you would feel if you had paid tax based on the value of your house in the fall of 2007 at the peak of the market. Limitations on the use of capital losses could impact the math even further.

Impact on Portfolio

If you choose to sell and repurchase an asset to capture the lower rate, keep in mind that the cash to pay the tax has to come from somewhere. This may involve selling other assets or rearranging an investment portfolio to make funds available.

Conclusion

This is a complex decision. There is no single correct answer. The first step is to take an inventory of your investment assets and determine which ones have experienced significant appreciation. Consider whether those assets might be sold in the next 10 years. Then do some math. Finally, make a judgment about future tax rate changes and economic growth.