

Sell before probable tax increases – or hold?

Planning for a change in capital gains tax rates

Barring congressional action, capital gains tax rates will climb significantly on Jan. 1, 2011 when tax legislation enacted earlier in the decade expires. If Congress does move before then, nobody knows where tax rates will go, who will be affected, or when the change will happen.

At Laird Norton Tyee, we have been analyzing what the potential tax changes ahead could mean for you and your investments.

Conventional wisdom holds that when tax rate increases are expected, you should accelerate income into years with lower rates and defer deductions until the higher rates kick in. That would mean taking gains during 2010 to avoid paying tax in subsequent years at higher rates. But tax-aware analytics reveal that the decision isn't that clear cut. If you aren't planning to recognize or take a gain before a certain date in the future, the further off that date is, the less compelling is the benefit from paying tax now, especially if the tax rate increase isn't large.

This paper offers a set of differing tax-rate and sales-timing scenarios worth considering when making choices about whether to sell some assets to take advantage of 2010's potentially lower tax rates.

First, let's step back and review where we are today.

Congress at odds

In his budgets for both 2009 and 2010, President Obama has taken a stand supporting retention of the 2001 and 2003 tax rate cuts including the capital gain tax rate cuts - but only for the middle and lower classes, which he defines as those who "make" less than \$200,000 per year if single and less than \$250,000 if married filing jointly. The budget proposal retains capital gain tax treatment for qualified dividends for all taxpayers.¹

Congress is divided on the issues, with some legislators supporting retention of the lower rates for both ordinary income and capital gains for everyone and others favoring a return to higher rates – at least for the wealthy. It is unclear what the breadth of support is in Congress for changes in tax rates and completely uncertain that any changes in tax law

Conventional wisdom holds that selling assets and taking gains in lower-tax-rate years is recommended.

Our analysis suggests that even if you know tax rates will increase, the decision is not clear cut.

1. Office of Management and Budget, Budget of the U.S. Government, Fiscal Year 2011

will occur during 2010. In addition, with the country operating at huge deficits, support for provisions that reduce tax receipts may be tepid, especially since the relationship of tax rates to strength of financial markets is not clear cut.

If Congress fails to act during 2010, the rates increase on January 1, 2011. If Congress acts later in 2011 to reduce rates, it isn't clear that a 2011 law change would be retroactive to the beginning of the year. Historically, changes in capital gain tax rates, such as those in 2003, have often been prospective from the date the law change occurs and not retroactive to the beginning of the tax year. This means that a sale made before the lower rates were reinstated would not benefit from the reduction.

How did we get here?

Tax legislation in 2003² decreased the long-term capital gains tax rates from 10% (for taxpayers in the 10% and 15% tax brackets) and 20% (for everyone else), to 5% and 15% initially, and eventually, 0% and 15%. Subsequent legislation extended the effective date for the 0% rate through 2010.³ But by their terms, the tax acts that decreased the rates provided an automatic reinstatement of the old rates of 10% and 20% following their expiration date of December 31, 2010.⁴ (Note: the 10% and 20% rates are reduced to 8% and 18% for "qualified five-year property," which is property that has been held for more than five years before its sale.⁵)

The same legislation that decreased long-term capital gains tax rates also extended the capital gains tax rate to qualified dividends. Prior to that change, dividends were subject to tax as regular taxable income, which in 2010 is taxed at a maximum tax rate of 35%. This provision also expires on December 31, 2010.

Almost since the passage of these laws, taxpayers and their advisors have wondered whether these tax rate changes would be made permanent. As we near the end of 2010, the answer is still unclear. In the intervening years we have experienced both a boom when the stock market hit record highs and a major recession from which, as of today, the economy still hasn't fully rebounded. Tax revenue forecasts⁶ projected a big increase in capital gains taxes for this year, the final year of the lower rates as taxpayers were expected to take steps to maximize their benefits from the lower tax rates before they expired. Because of the market crash of late 2008 and early 2009 it is highly unlikely that the tax collections for 2010 will meet those original projections.

2. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) §301, PL 108-27, 5/28/2003
3. The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) §102, PL 108-222, 5/17/2006
4. JGTRRA §303
5. IRC §1(h) before amendment by PL 108-27
6. The Budget and Economic Outlook: Fiscal 2008-2017, January 2007

These uncertain conditions complicate planning because there are no clear cut rules. The answer to nearly every question about tax rates is - "it depends." Not only does a person have to determine what the increases in tax rates might be; he or she also has to weigh the likelihood of the change occurring and its timing, as well as the chance of any change actually applying to him or her. In addition, individuals with capital loss carryforwards must consider the effect of these losses in their planning.

To add to tax planning challenges, while the 2011 and subsequent years' capital gain tax rates are uncertain, it is important to remember that tax rates on capital gains **will definitely** increase for some taxpayers. This will occur because gains are subject to the 3.8% Unearned Income Medicare Contribution Tax which takes effect in 2013. This new tax applies to the unearned income (which includes capital gains) of taxpayers whose modified adjusted gross income (MAGI) exceeds \$200,000 if single and \$250,000 if married and filing a joint tax return.⁷

Are 2010's tax rates an opportunity?

For those who have unrealized gains in their investments, these rates present opportunities that include re-setting tax basis to minimize future gains or generate future losses and diversifying from concentrated positions. Re-setting tax basis refers to selling currently and immediately re-investing in the same or other securities. The sale produces a gain now and the purchase at today's prices minimizes the future gain (or may even produce a loss) at the time that the asset is finally liquidated when tax rates might be higher. This opportunity should be considered and evaluated whenever an investor's holding period can be defined, such as when a future cash need has been identified but has yet to mature.

The planned holding period is key

As noted above, the analytical process actually starts with holding period, not with the dollar amount of gain or the tax rate⁸. If a person has no intention or need to sell securities (more on "need" in a bit), then regardless of the perceived benefit of low tax rates today, there is likely not an after-tax benefit of selling securities in 2010 to recognize gains and re-set tax basis.

7. IRC §1411(c)(1)(A)(iii), effective for years beginning after December 31, 2012
 8. David M. Stein, "Do You Anticipate an Increase in Tax Rates? Deferring Capital Gains is Not Always the Best Strategy," Parametric Portfolio Associates Commentary, July 2004 and Paul Bouchey, "Pay Now, or Later? Making Investment Decisions in a Changing Tax Environment," Parametric White Paper, Spring 2008

Generally, the longer the expected holding period, the less likely it is that selling now to re-set basis will produce a greater after-tax return. In Figure 1, you can see that if a person plans to hold a security for at least 20 years, there are few circumstances in which the 2010 sale is recommended.

Future Rate 20%

Years the security will be held	What is the expected annual growth in the security's value?						
	1%	2%	4%	6%	8%	10%	12%
1	0.1%	0.3%	0.5%	0.8%	1.0%	1.3%	1.5%
2	0.3%	0.5%	1.0%	1.5%	2.1%	2.6%	3.1%
3	0.4%	0.8%	1.6%	2.4%	3.2%	4.0%	4.9%
4	0.5%	1.0%	2.1%	3.2%	4.4%	5.5%	6.7%
5	0.6%	1.3%	2.7%	4.1%	5.6%	7.1%	8.7%
6	0.8%	1.6%	3.3%	5.0%	6.9%	8.8%	10.8%
7	0.9%	1.9%	3.8%	6.0%	8.2%	10.6%	13.1%
8	1.0%	2.1%	4.5%	7.0%	9.6%	12.4%	15.4%
9	1.2%	2.4%	5.1%	8.0%	11.1%	14.4%	17.9%
10	1.3%	2.7%	5.7%	9.0%	12.6%	16.4%	20.4%
11	1.4%	3.0%	6.4%	10.1%	14.2%	18.5%	23.0%
12	1.6%	3.3%	7.0%	11.2%	15.8%	20.6%	25.7%
13	1.7%	3.6%	7.7%	12.3%	17.4%	22.9%	28.5%
14	1.9%	3.9%	8.4%	13.5%	19.1%	25.1%	31.3%
15	2.0%	4.2%	9.1%	14.7%	20.9%	27.4%	34.1%
20	2.7%	5.8%	12.9%	21.1%	30.1%	39.3%	48.0%
30	4.2%	9.2%	21.4%	35.3%	49.0%	60.5%	69.1%

Sell now and re-set basis Hold

In Figure 1, each box represents a tax rate increase over the base rate of 15%. The shading indicates that for any identified holding period and expected growth rate, it is either tax efficient (the white shading, meaning you have more on an after-tax basis) or tax inefficient (the orange cells, meaning you have less after tax) to sell in 2010 and repurchase to re-set tax basis. These outcomes apply regardless of the magnitude of the gain.

Here's an example: Alex owns Security A, which he expects will grow at the rate of 6% per year. His intention is to sell the security when his daughter starts college in 7 years. Alex believes that his tax rate then will be 20%. Figure 1 indicates that Alex will have more after-tax if he simply holds the security and sells it in 7 years rather than selling and paying tax now at a 15% rate and then reinvesting in Security A or another security that will grow at 6%.

Let's test this: Alex sells Security A for \$20,000. His gain is \$10,000 and his tax is \$1,500. After paying the tax, Alex has \$18,500 to use to repurchase Security A. After 7 years, Alex sells

Security A again and has a gain of \$9,317 after seven years growth at 6%. His tax at 20% is \$1,863. After tax, he has \$25,954. If he had done nothing in 2010, Security A would appreciate to \$30,073 at 6% per year. Selling it for that price, his gain would be \$20,073 and the tax, at 20%, would be \$4,015. After tax, he would have \$26,058, \$104 more than if he had sold and repurchased.

Sell today and reinvest

Initial investment in Security A	\$10,000
Alex sells security A	\$20,000
Gain	$\$20,000 - \$10,000 = \$10,000$
Tax @ 15%	$\$10,000 \times 15\% = \$1,500$
Amount to reinvest	$\$20,000 - \$1,500 = \$18,500$
Sells after 7 years of growth @ 6%/year	$\$18,500 \times 6\% \text{ for } 7 \text{ years} = \$27,817$
Gain from 2nd sale	$\$27,817 - \$18,500 = \$9,317$
Tax @ 20%	$\$9,317 \times 20\% = \$1,863$
Total after tax	\$25,954

Sell in seven years

Initial investment in Security A	\$10,000
Current value of Security A	\$20,000
Sells after 7 years of growth at 6%/year	$\$20,000 \times 6\% \text{ for } 7 \text{ years} = \$30,073$
Gain from sale	$\$30,073 - \$10,000 = \$20,073$
Tax @ 20%	$\$20,073 \times 20\% = \$4,015$
Total after tax	\$26,058

Another important factor to consider is how much the security will appreciate. The higher the expected rate of growth for the security, the less likely it is that selling now to re-set basis will produce a higher after-tax result, especially as the holding period increases. Figure 1 shows that as the expected rate of growth for the security increases (moving to the right on the table), the length of holding period for which there is a benefit from selling in 2010 shortens (the number of white boxes is smaller as you move to the right on the table).

The final factor to consider is the expected tax rate - the big unknown. As the expected tax rate increases, the number of circumstances in which the sale to recognize gain and re-set basis is recommended grows. Figures 2 and 3 on the next page demonstrate this point as the expected tax rates increase to 23.8% and 28%. Why 23.8% and 28%? 23.8% is the combined tax rate for capital gains that will apply in 2013 if tax rates increase as scheduled in 2011 and the gain is

subject to the additional 3.8% Unearned Income Medicare Contribution Tax mentioned earlier. Twenty-eight percent was the tax rate the last time that the maximum rates for capital gain and ordinary income were the same. You can see that in Figure 3, with a capital gain tax rate of 28%, there are many more white boxes than in either Figure 2, the 23.8% table, or Figure 1, the 20% table.

Figure 1: Future Rate 20%

Years the security will be held	What is the expected annual growth in the security's value?						
	1%	2%	3%	4%	5%	7%	10%
1	0.1%	0.3%	0.5%	0.8%	1.0%	1.3%	1.5%
2	0.3%	0.5%	1.0%	1.5%	2.1%	2.8%	3.1%
3	0.4%	0.8%	1.6%	2.4%	3.2%	4.0%	5.1%
4	0.6%	1.3%	2.7%	4.1%	5.6%	7.1%	8.7%
5	0.8%	1.6%	3.3%	5.0%	6.9%	8.8%	10.9%
7	0.9%	1.9%	3.9%	5.9%	8.2%	10.6%	13.1%
8	1.0%	2.1%	4.3%	7.0%	9.6%	12.4%	15.4%
9	1.2%	2.4%	5.1%	8.0%	11.1%	14.4%	17.9%
10	1.3%	2.7%	5.7%	9.0%	12.6%	16.4%	20.4%
11	1.4%	3.0%	6.4%	10.1%	14.2%	18.5%	23.0%
12	1.6%	3.3%	7.0%	11.2%	15.8%	20.6%	25.7%
13	1.7%	3.6%	7.7%	12.3%	17.4%	22.9%	28.5%
14	1.9%	3.9%	8.4%	13.5%	19.1%	25.1%	31.3%
15	2.0%	4.2%	9.1%	14.7%	20.9%	27.4%	34.1%
20	2.7%	5.6%	12.9%	21.1%	30.1%	39.3%	48.0%
30	4.2%	9.2%	21.4%	35.3%	49.0%	69.5%	89.1%

Figure 2: Future Rate 23.8%

Years the security will be held	What is the expected annual growth in the security's value?						
	1%	2%	4%	5%	6%	10%	15%
1	0.1%	0.3%	0.5%	0.8%	1.0%	1.3%	1.5%
2	0.3%	0.5%	1.0%	1.5%	2.1%	2.8%	3.1%
3	0.4%	0.8%	1.6%	2.4%	3.2%	4.0%	4.9%
4	0.5%	1.0%	2.1%	3.2%	4.4%	5.3%	6.7%
5	0.6%	1.3%	2.7%	4.1%	5.6%	7.1%	8.7%
6	0.8%	1.6%	3.3%	5.0%	6.9%	8.8%	10.9%
7	0.9%	1.9%	3.8%	6.0%	8.2%	10.6%	13.1%
8	1.0%	2.1%	4.3%	7.0%	9.6%	12.4%	15.4%
9	1.2%	2.4%	5.1%	8.0%	11.1%	14.4%	17.9%
10	1.3%	2.7%	5.7%	9.0%	12.6%	16.4%	20.4%
11	1.4%	3.0%	6.4%	10.1%	14.2%	18.5%	23.0%
12	1.6%	3.3%	7.0%	11.2%	15.8%	20.6%	25.7%
13	1.7%	3.6%	7.7%	12.3%	17.4%	22.9%	28.5%
14	1.9%	3.9%	8.4%	13.5%	19.1%	25.1%	31.3%
15	2.0%	4.2%	9.1%	14.7%	20.9%	27.4%	34.1%
20	2.7%	5.6%	12.9%	21.1%	30.1%	39.3%	48.0%
30	4.2%	9.2%	21.4%	35.3%	49.0%	69.5%	89.1%

Figure 3: Future Rate 28%

Years the security will be held	What is the expected annual growth in the security's value?						
	1%	2%	4%	5%	6%	10%	15%
1	0.1%	0.3%	0.5%	0.8%	1.0%	1.3%	1.5%
2	0.3%	0.5%	1.0%	1.5%	2.1%	2.8%	3.1%
3	0.4%	0.8%	1.6%	2.4%	3.2%	4.0%	4.9%
4	0.5%	1.0%	2.1%	3.2%	4.4%	5.3%	6.7%
5	0.6%	1.3%	2.7%	4.1%	5.6%	7.1%	8.7%
6	0.8%	1.6%	3.3%	5.0%	6.9%	8.8%	10.9%
7	0.9%	1.9%	3.8%	6.0%	8.2%	10.6%	13.1%
8	1.0%	2.1%	4.3%	7.0%	9.6%	12.4%	15.4%
9	1.2%	2.4%	5.1%	8.0%	11.1%	14.4%	17.9%
10	1.3%	2.7%	5.7%	9.0%	12.6%	16.4%	20.4%
11	1.4%	3.0%	6.4%	10.1%	14.2%	18.5%	23.0%
12	1.6%	3.3%	7.0%	11.2%	15.8%	20.6%	25.7%
13	1.7%	3.6%	7.7%	12.3%	17.4%	22.9%	28.5%
14	1.9%	3.9%	8.4%	13.5%	19.1%	25.1%	31.3%
15	2.0%	4.2%	9.1%	14.7%	20.9%	27.4%	34.1%
20	2.7%	5.6%	12.9%	21.1%	30.1%	39.3%	48.0%
30	4.2%	9.2%	21.4%	35.3%	49.0%	69.5%	89.1%

Sell now and re-set basis Hold

We have discussed the opportunity to sell and pay tax now to re-set basis and noted that without a current intention to sell or a need to sell securities, paying tax just to re-set basis in a security that will be held long-term is not recommended. What about other opportunities when tax rate increases are on the horizon?

Who could benefit from selling now?

Who might "need" to sell securities? Some individuals need to sell securities to raise cash for a specified purpose (e.g., a large purchase or a child's education) or simply for living expenses that exceed the cash income that the securities generate. For them, depending on when the cash need will occur, a sale in 2010 as compared to 2011 or 2012 might be tax efficient. Figure 1 can be used to help with that decision.

For others, "need" really means "should." A person who owns concentrated positions in a few securities is bearing greater investment risk than an individual whose portfolio is diversified. Most individuals who carry that risk do so for three reasons: 1) they have an emotional or sentimental attachment to the security, 2) they are precluded from selling restricted stock for a specified period of time, or 3) they want to avoid paying capital gain tax on the gain that the security's sale will produce. A sentimental attachment is purely personal and unlikely to be influenced by taxes or even by portfolio risk. A person whose stock is under restriction may be stuck with waiting

for the restriction to expire. But to reduce portfolio risk, those individuals should sell the security when the opportunity arises. And individuals who have been holding securities to avoid paying the capital gain tax should consider whether their sale time has arrived. Depending on how long the security must or would be held and the expected growth rate, Figures 1 through 3 can assist in determining when a person will be better off on an after-tax basis from selling or holding when tax rates are expected to increase.

How do capital losses impact this decision?

The big “silver lining” of the stock market declines of 2008 and 2009 was the creation of capital loss carryforwards available to shelter subsequent gains. A capital loss carryforward results when a person’s capital losses for a year exceed gains by more than \$3,000. These losses carry forward indefinitely and must be applied to offset any gains recognized in subsequent years. To the extent that an individual has no gains in a year, but has at least \$3,000 of taxable income, \$3,000 of the loss carryforward is reported and used to offset other income on the person’s tax return, generating a small but immediate tax benefit.

Taxpayers who have capital loss carryforwards may be unaffected by the changes in capital gain tax rates for a number of years simply because their loss carryforwards shelter and thus preclude taxation of the gains.

The second prong of the conventional wisdom noted above is that when rates are expected to increase, one should defer deductions to year with higher tax rates. Capital loss carryforwards are basically buckets of future deductions, available to shelter future gains - whenever they occur. The losses would appear to be more valuable after a tax rate increase since the gains they shelter would have been taxed at higher rates. In the absence of capital gains, these carryforward losses are utilized at the rate of \$3,000 per year and the most valuable losses are used-up first. Short-term losses are more valuable than long-term losses because they have priority in offsetting more highly-taxed short-term gains.

Capital loss carryforwards complicate investors’ decisions about paying tax and re-setting tax basis in 2010. In general, if a person has capital loss carryforwards to offset gains, he or she has no particular tax reason to sell securities at a gain in 2010 to re-set basis.

Example: Sandra has a security with a \$1,000,000 unrealized gain and also has a \$1,000,000 loss carryforward. If she sells the security in 2010, basis can be re-set for no tax cost. Or, she could retain the security and sell it whenever she wants for almost no tax cost. If, by 2012, the \$1,000,000 gain is \$1,100,000 and the tax rate is 20%, the net gain after taking into account the loss carryforward (which will have decreased by \$3,000 per year) is \$106,000 and the tax is \$21,200. However, in 2010 and 2011 she would also have had a tax savings from the \$3,000 per year expiration of the loss carryforward. At a 28% ordinary tax rate, the two year tax savings would have saved almost \$1,700 of tax. If basis had been re-set in 2010, the net gain in 2012 is \$100,000 and the tax is \$20,000. Those outcomes are pretty much a “push” which would mean that a 2010 utilization of the loss carryforward wouldn’t create a benefit for Sandra.

Selling now

Unrealized gain on a security	\$ 1,000,000
Loss carryforward to apply	\$ 1,000,000
Tax cost @ 15% if sold in 2010	\$ 1 M - \$1 M = \$0
Unrealized gain on reinvested security	\$ 100,000 (after two years of growth)
Tax cost @ 20% on gain	\$ 20,000

Sell in 2 years at presumably higher tax rates

Unrealized gain on a security	\$ 1,100,000 (after two years of growth)
Loss carryforward to apply	\$ 994,000 (decreased by \$3,000 per year)
Net gain	\$ 106,000
Tax cost @ 20% if sold in 2012	\$ 21,200
Tax savings on ordinary income (taxed at 28%) of \$3,000 per year	\$ 1,700 over two years
Comparable tax cost	\$ 21,200 - \$1,700 = \$19,500

Loss carryforwards are applied to offset realized gains on a mandatory basis. They can’t be “saved up” for a time when they are really valuable. In the absence of realized gains, they shelter other income on a limited annual basis until fully utilized. But they also provide flexibility for making tax free changes in investments and to take advantage of opportunities for gains at any time since loss carryforwards can shelter both short-term and long-term gains. For those with loss carryforwards, there is little incentive to sell in 2010.

What should you do in 2010?

Will capital gain tax rates go up in 2011? Perhaps we will know before the end of the year. What we expect is that the rates aren't going down. If you have loss carryforwards, you should do nothing unless a gain in excess of the carryforward loss is on the horizon. If you and your advisor are planning security liquidations in the next year or so, consider selling in 2010 to ensure you can take advantage of the 0% and 15% tax rates. The opportunity cost of paying the tax a year early (in case rates do not increase for 2011) is fairly low now because interest rates are so very low. Discuss with your advisor if 2010 is a good time to realize some gains if you have additional funds you plan to invest in the equity markets as this will alter the cost/benefit relationship.

If the status of tax rates for 2011 is clarified before the end of 2010, utilize the tables in Figures 1 through 3 to evaluate whether selling or holding is best for you after-tax. If you are holding concentrated security positions, consider whether 2010's known low capital gain tax rates present a opportunity to diversify or upgrade that you shouldn't let slip away.

About the author

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Kristi has a bachelor's degree in business administration with an accounting concentration from the University of Washington and a Juris Doctor from the University of Washington School of Law. She is a member of the Washington State and King County Bar Associations, the Washington State Society CPA and the American Institute of CPAs.

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