

Capital Gains and Losses

Deciding to sell a portfolio position should primarily be an investment decision rather than a tax decision; however, understanding the implications of that sale can help investors strategically prepare for the timing of a transaction.

Wealth Planning

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CAPITAL GAIN TAX BRACKETS

Understanding how to apply the income tax brackets will help an individual determine their capital gains tax bracket and effectively, how much they can expect to owe in taxes. Capital gains are stacked on top of ordinary income when applying the income tax brackets. In other words, the last dollar of ordinary taxable income will determine the rate at which the first dollar of net long-term capital gains (and qualified dividends) is taxed.

To determine an individual's ordinary taxable income, the amount of net long-term capital gains is subtracted from the individual's total taxable income (line 15 of 2023 Form 1040). For example, an individual with \$50,000 of taxable income and \$20,000 in net long-term capital gains would have ordinary taxable income of \$30,000 (\$50,000 minus \$20,000). Therefore, \$30,001 is the first dollar of their net long-term capital gains. For a single individual in 2024, the 0% long-term capital gains rate applies on taxable income between \$0 and \$47,025. In this case, the first dollar of long-term capital gains falls below the top of this threshold, so it is taxed at a 0% tax rate. Once total taxable income reaches \$47,025, any additional net long-term capital gains are taxed at the 15% bracket. Therefore, \$17,025 of the net long-term capital gains is taxed at a 0% rate and the remaining \$3,976 is taxed at a 15% rate. In this scenario, the individual's low income allowed him to realize a portion of his long-term capital gains tax-free. This is considered a tax gain harvesting strategy which is discussed later.

NETTING RULES

Capital gains and losses recognized in a single tax year (calendar year in the case of an individual) are aggregated together through a netting process. First, gains and losses are separated into two categories – short-term and long-term. Any short-term capital losses offset short-term capital gains, yielding a net short-term position. Any long-term capital losses offset long-term capital gains, yielding a net long-term position. If the net positions in each category are opposite (i.e. a net gain and a net loss), the loss is netted against the gain. Any excess in a category after netting the two together will retain its character (i.e. short-term vs long-term). For example, if an individual has a \$10k short-term loss and a \$6k long-term gain, the remaining \$4k loss is considered short-term. If the net positions in each category are the same (i.e. both gains or both losses), there is no further netting to be done.

The tax treatment of capital gains and losses is dependent on the net position(s) after applying the netting rules.

Net Capital Gain/Loss Position	Tax Treatment ¹
Net Short-Term Capital Gain	Ordinary Income taxed at marginal tax rate
Net Short-Term Capital Loss	Offset up to \$3,000 of ordinary income ² ; excess carried forward
Net Long-Term Capital Gain	Taxed at preferential tax rate (0%, 15% or 20%)
Net Long-Term Capital Loss	Offset up to \$3,000 of ordinary income ² ; excess carried forward

¹ Does not consider 3.8% net investment income tax

² If both net short-term capital loss and net long-term capital loss exist, short-term capital loss is applied against 3k limit before long-term capital loss

TAX LOSS HARVESTING

Tax-loss harvesting is the selling of securities at a loss with the intention of using these losses to offset current and future capital gains. Losing money on an investment, at the surface, is not ideal; however, a loss can be utilized to reduce the overall liability on other winning investments, while still putting the proceeds to good use elsewhere. For example, consider a single individual with \$150,000 of wage income, and two stocks: A with a \$10,000 long-term capital gain and B with a \$10,000 long-term capital loss. At this level of income, the sale of stock A would cause a \$1,500 tax liability (\$10,000 times 15% capital gains rate). If stock B is also sold, the tax liability on the gain from the sale of stock A would be reduced to \$0.

Now consider an identical scenario, except where the long-term capital loss on stock B is \$13,000. In this case, not only would the sale of stock B eliminate the tax on the capital gain from stock A, but up to \$3,000 of the remaining loss can offset ordinary income. For an individual with \$150,000 of wage income, this results in a tax savings of approximately \$720 (\$3,000 times the 24% ordinary marginal tax bracket). In a situation where an individual has recognized short-term capital losses but is also interested in selling their unrealized long-term capital gains, it may be best to hold off on doing so to prevent using the short-term (and more valuable) capital loss against an income type taxed at the lower 15% or 20% rate. As a reminder, any unused capital losses after applying \$3,000 to ordinary income can be carried forward to use in future years.

WASH SALE RULE

When using tax-loss harvesting strategies, it is important to be cognizant of the wash sale rule. The wash sale rule states that if a security, or substantially identical security, is purchased *30 days prior to* or *30 days after* the date the security is sold, the loss generated from the sale cannot be utilized for tax purposes. Instead, the loss is added to the basis in the newly acquired asset.

The wash sale rule can be avoided by buying a comparable asset anticipated to have similar performance. This allows the individual to benefit from the realized loss while still allowing their investment portfolio to experience similar growth. Investors should also be mindful of the type of replacement security they are considering. As a rule of thumb, avoid swapping out securities that track the same index— by their very nature, index funds are meant to replicate the same investments at approximately the same weight, and as such, they can be viewed as substantially equal. The wash sale rules also apply across different accounts and different account types. For example, if an individual sells a security at a loss in a taxable account and purchases the same security in their IRA, the loss will be disallowed. This is especially ill-advised, because the intention of repurchasing is often to capture the upside; however, when repurchased in an IRA or other qualified account, the loss is effectively gone forever.

TAX GAIN HARVESTING

Conventional tax planning suggests that deferring income, which includes delaying capital gain recognition, is the best strategy. However, in certain situations, accelerating gain recognition can help reduce the overall tax liability in the long run. As discussed earlier, when taxable income falls below a certain threshold, net long-term capital gains (and qualified dividends) are taxed at a 0% tax rate. Therefore, individuals with low taxable income might consider recognizing long-term capital gains tax-free.

Assume a married couple filing jointly has 2024 taxable income of \$68,000 which consists solely of wages. The top of the 0% long-term capital gains tax bracket for a married couple filing jointly in 2022 is \$94,045. Therefore, they can recognize up to \$26,045 (\$94,045 minus \$68,000) in long-term capital gains tax-free. Investors who have unrealized long-term gains but want to maintain their exposure can simply buy back into the position. This would reset the holding period, but it would also reset the cost-basis, thereby reducing future gain recognition. Tax gain harvesting can also be utilized when an individual has already realized capital losses in the year or has capital loss carryforwards from a previous year. These losses can offset the gains, effectively allowing the individual to recognize gains tax-free.

By understanding the mechanics and tax implications of capital gains, individuals can better plan for their recognition and do so in a tax-efficient way. Work with your tax professional and Baird Financial Advisor to determine how you can integrate capital gains planning into your portfolio.