DEALING WITH UNREALIZED CAPITAL GAINS

ADVISORS CAPITAL MANAGEMENT

Remember, 15% Was Never Yours

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Advisors Capital Management

After years of growth in the equity markets, many investors have accumulated substantial capital gains. While this typically feels good and looks great on paper, for many the thought of paying taxes (realizing the gains) is harder to deal with than the real personal economic impact. This mental challenge often prevents us from making routine and/or prudent portfolio adjustments.

We observe this issue frequently. New clients come to us with significant unrealized gains on specific positions in their portfolios and they are not sure how to address the tax issue. Or clients needing to alter or change investment strategies following a change in circumstances (retirement, for example) are paralyzed by the tax implications of doing so.

While it's unappealing for most of us to pay any taxes sooner than we feel we have to, unless you intend to die with or donate any assets that have appreciated significantly, you will ultimately have to reckon with paying taxes if you intend to make use of any appreciated assets while you are alive.

The economic benefit of continuing to defer gains is actually lower than many of us realize and strategies to avoid capital gains are similarly less effective than we realize. So we'll offer some context on this and a few strategies that may help you warm to the idea of unwinding these investments on a somewhat more regular basis.

First, if you have any assets that have appreciated significantly, then congratulations are in order. Now that we've celebrated, what do we do? The first thing is to realize what you actually have.

If you purchased an asset for $100,000 and it's worth $160,000, there's a 15% ($9,000) long term capital gain that will be due if you sold the asset. So rather than just looking at the market value on your statement each month, you should start thinking in terms of the after-tax value. The $9,000 tax obligation is already there, even if it hasn't come due yet. You have an asset worth $160,000 and a liability of $9,000, so it's really worth $151,000. That's the amount that you can take and spend on something else.

If you don't sell the asset, then you can preserve the potential growth on the $9,000 of capital gain taxes you are deferring. Assuming an interest rate of 8%, then the value of deferring taxes on this asset is worth $720 per year, or 0.48% on the net $151,000 value that would otherwise be available to reinvest or spend. Is it worth 0.48% to avoid paying taxes (hang onto the gain) when a down market could just as easily wipe that out? You could easily lose more than 0.48% on a stock or mutual fund position in one trading day.

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The larger the gain, the more potentially valuable the deferral is, but even a 100% gain might equate the annual value of the deferring taxes to maybe 1% per year, when the stock market overall averages a decline of almost 15% at least once in any given calendar year. Bottom line, the economic benefit of continuing to defer gains is actually lower than most of us realize and can easily be erased by normal market volatility.

If you wait too long, then capital gains can accumulate to the point where there is no way to liquidate without putting yourself into a higher capital gains tax bracket, which can actually reduce wealth. Five years of $50,000 gains at 15% allows you to retain more wealth than one year with a $300,000 gain where some of that gain will fall into the 18.8% capital gains tax bracket thanks to the additional 3.8% net investment income tax.

Harvesting losses on an annual basis is a prudent strategy that we employ and where we have more flexibility than other money managers because we focus on buying individual securities. But harvesting just losses and leaving only gains can create exactly the problem described above. And for some long term investors in a strong bull market, there simply may not be any losses left to harvest. We see this with some of our older clients.

In addition to harvesting losses, recognize that managing your gains is part of investing (rebalancing) and remember that the value of continuing to defer capital gains taxes is not as great as it seems. As mentioned above, the liability is already there. Don't let deferring taxes dictate your investment strategy or potentially prevent you from meeting your overall financial goals.

The goal of a capital gains harvesting strategy should be to take whatever gains can be absorbed within in your current capital gains tax bracket.

Long term Capital Gains Bracket	Single	Joint	Net Investment Income Tax (NIIT; aka Medicare surcharge)
0% tax bracket	$0-$38,600	$0-$77,200	N/A
Beginning of 15% tax bracket	$38,601	$77,201	18.8% (+3.8%) if your AGI > $200,000 single; $250,000 married
Beginning of 20% tax bracket	$425,801	$479,001	23.8% (+3.8%) if your AGI > $200,000 single; $250,000 married

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TAX BRACKET BUDGETING

Ex. Leslie and Jeff are married with a combined AGI of $170,000. They are looking to switch to a new advisor with their $1,000,000 portfolio, but are having trouble pulling the trigger due the $200,000 of long term capital gains in their portfolio.

Given that they have another $80,000 before they hit the $250,000 AGI threshold where the 3.8% Medicare tax kicks in, they set a capital gains budget of $80,000. This will allow them (or their new advisor) to go through their portfolio and transition far more than $80,000 in total value. There may be some positions that their new advisor will want to keep, part of the portfolio may not have any gains, and there may be some other losses that can be realized as well. So it's feasible that they could transition $500,000 or more of assets without triggering the 3.8% Medicare surcharge and then continue the process in the following tax year.

The strategy is obviously more effective for those in the 0% capital gains tax bracket (which could apply in a low income year) where the gains are effectively tax-free – at the federal level. State income taxes may still apply. But even at higher levels, you may be able to work through your cumulative gains with a few years of gains budgeting.

STAGED SELLING

For those with a concentrated position in a single stock, a variation on the tax bracket budgeting is staged selling. Rather than making your decision an 'all or none' proposition, you instead commit to sell in stages over time to diversify out of a large single positions. Insiders at publicly traded companies (think Bill Gates or Mark Zuckerberg) do this routinely through SEC approved 10b 5-1 plans that are pre-determined "set it and forget it" selling strategies that they can't change once they are in place.

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With a concentrated position, investors' concerns are both losing out on additional upside by selling too soon and riding the position down in a bear market. Only one in a million ever gets it perfect and, by committing to a process, you take the emotion out of the decision and you can set up a pre-determined plan within your capital gains tax bracket.

You don't have to sell all at once, and you can set price or percentage targets for what gets sold and when. A goal could be to reduce a 15% concentrated position in your portfolio to 10%, for example and rebalancing the proceeds into another asset class where you are underweight. You could sell 1% when the stock moves up 5 points, 2% when it moves up 10 points and/or set targets on the downside as well.

Or if you already have a 10% position, then sell some whenever the position gets to 12% of your portfolio to avoid allowing it to grow to 15%. Such systematic rebalancing can help prevent gains from ever becoming too big in the first place.

DONATE AND REPLACE

The final strategy is the "donate and replace" strategy. With donate and replace, you are bunching several years worth of charitable contributions by donating appreciated securities either to a charity or more likely to a donor advised fund (DAF) and then replacing the investments with outside dollars. This strategy may also be helpful for income tax purposes as it can increase the size of your itemized deductions.

Donate and replace works best for folks who regularly contribute to charity. Ex. Leslie normally gives $5,000 per year to charities. Instead, in 2018 she donates a $25,000 investment that she originally purchased for $10,000. She avoids paying capital gains taxes and the charity ultimately ends up with the entire five years worth of contributions (either all at once if donated outright or via five consecutive grants through a DAF). Instead of writing checks each year to the charities, Leslie then contributes $5,000 per year back to her own portfolio.

The caveat to this strategy is that it only works for those who are actively making charitable contributions and have the outside dollars to add back to their portfolio. If there is no charitable intent, then the above strategies for selling, paying your taxes and keeping the after tax amount are more appropriate. Also keep in mind that donate and replace only makes sense

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for those who can contribute enough to exceed their standard deduction and actually itemize in the first place. Those who take the standard deduction get no benefit for charitable contributions. Bunching several years worth of charitable contributions via DAF can be a superior strategy for this exact reason.

To summarize, start thinking about the after-tax value of your investments and not simply the market value, particularly if you plan to use these assets while you are still alive. You can only spend the after- tax amount and knowing this can make it easier emotionally to sell investments and realize capital gains on an ongoing basis. The actual value of deferring gains is less than you probably expected and can be wiped out quickly. Waiting too long to decide can potentially result in less wealth given the 3.8% net investment income tax. Instead, consider using a capital gains budget or staged selling or the donate and replace strategy while navigating your tax brackets and itemized deductions.

If that's a lot to consider, then that's because it's become more important to do tax planning throughout the current tax year rather than waiting until tax time to sort things out. If you have questions, consult your advisor and consider working with your tax preparer to have a tax projection prepared before the end of the calendar year so you have an idea of your capital gains budget for the current tax year.

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