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LAGOS WEALTH ADVISORS
BUILDING, PROTECTING AND PERPETUATING FAMILY WEALTH

# ADVISOR'S BULLETIN

## WHAT'S IN THIS MONTH'S NEWSLETTER

**What Every Financial Professional Needs to Know About Capital Gains Tax Management**

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## A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

Financial planning professionals often help their clients position assets properly to meet the clients' financial goals. Sometimes this means liquidating certain assets to reinvest in others. When clients decide whether to sell assets to buy others, they should take the tax consequences into account.

When assets are sold, gain or loss on the transaction is usually recognized for federal income tax purposes. Gain is measured by comparing the net proceeds the client receives against the client's income tax basis. The character of the tax result depends on the type of underlying asset. Many of the financial investments in a client's portfolio will be capital assets. Gain on the sale of most capital assets is taxed at capital gains rates.

In general, federal income tax law favors a taxpayer's investment in capital assets as opposed to ordinary income assets. The tax preference shows up with capital gains tax rates that are lower than ordinary income rates.

We wrote about the basics of how capital gains taxes work in the November 2019 issue of the Advisor's Bulletin. This article will concentrate on the techniques a client might consider in 2023 to control the gains that might be taxed in a given year. For those who own appreciated assets, properly managing the capital gains result means a client can end up being able to use more money personally rather than spending it on taxes.

Since helping our clients manage income results is an important part of a financial professional's responsibility, having a deep understanding of how capital gains taxes work is helpful. It is also helpful to understand the pros, cons, and limits of certain tax management strategies.

Please feel free to contact me to discuss further.

Regards,
Michael W. Lagos, CFP®

# What Every Financial Professional Needs to Know

# About Capital Gains Tax Management

*Capital Gains Background*

The federal Revenue Code provides a road map of how capital gains taxes work. For more detailed information, consult IRS Publication 550.

CAPITAL ASSETS

Most assets are capital assets. The IRS has carved out the following broad categories of exceptions:

- Inventory used for business
- Accounts or notes receivable
- Most kinds of intellectual property, such as patents or copyrights
- Supplies consumed in business

In addition, financial professionals are used to the idea that qualified plan accounts and nonqualified annuities are treated as *income assets* rather than capital assets.

BASIS

A capital asset's basis can increase or decrease depending on changes that occur throughout its ownership history, with those changes consolidating into the taxpayer's adjusted basis.

*Increases to Basis*

Capital improvements, such as adding a room to a rental home, increase the asset's basis. Further, government or association assessments for improvements, such as for sidewalks or roads, also increase the basis for real estate.

In a pass-through business—such as an S corporations, partnership, or proprietorship—undistributed business profit will also increase an owner's basis in the business.

*Decreases to Basis*

Cost basis is often decreased by certain activities that improve today's net cash flow. For example, depreciation deductions reduce a piece of real property's basis.

*Basis after a Nonsale Transfer*

When a capital asset is sold, a capital gain or loss is usually recognized by the asset's owner. When the asset is transferred by other means, such as gift or by testamentary transfer, there is no immediate income tax result. However, the effect on basis depends on the method of transfer.

Gifts

For capital property transferred by gift, the donee's basis is generally the same as in the hands of the donor. Thus, the basis is carried over from the donor to the donee. However, the carryover basis may not exceed the fair market value of the property at the time of gift.

Transfers at Death

Under Revenue Code Section 1014(a), all capital assets owned at death receive an adjustment to basis at the owner's date of death. The new basis is the fair market value as of the date of death. Thus, when heirs sell the capital property shortly after death, there is little or no capital gains tax on the sale.

*Federal Capital Gains Rates*

The rate at which most capital gains are taxed is based on the taxpayer's regular taxable income. Federal income tax rules differentiate between long-term capital gains rates—generally imposed when an asset is held for a year or more—and short-term rates. In general, short-term gains are taxed at ordinary income rates while long-term gains get the more favorable rates.

Here's the 2023 rate chart:

| **Long-term Capital Gains** | **2023** |
|---|---|
| Taxable income below $44,625 for single filers and married filing separate, joint filers below $89,250, head of household filers below $59,750, and estates below $3,000 | **0%** |
| Taxable income between $44,625 and $492,300 for single filers, between $44,625 and $276,900 for married filing separate, between $89,250 and $553,850 for joint filers, between $59,750 and $523,050 for head of household filers and between $3,000 and $14,650 for estates | **15%** |
| Taxable income at or above $492,300 for single filers, at or above $276,900 for married filing separate, at or above $553,850 for joint filers, at or above $523,050 for head of household filers, and at or above $14,650 for estates | **20%** |

MEDICARE SURTAX

A 3.8 percent surtax applies to the lesser of net investment income or modified adjusted gross income in excess of the following threshold amounts (dependent on filing status).

| **Filing Status** | 2022 | **2023** |
|---|---|---|
| Married individuals filing jointly | $250,000 | **$250,000** |
| Married filing separately | $125,000 | **$125,000** |
| Individual taxpayers | $200,000 | **$200,000** |

The surtax is imposed on top of the regular capital gains rates, making the effective top federal capital long-term capital gains rate 23.8 percent.

STATE INCOME TAX CONSIDERATIONS

For many taxpayers, state income tax management can play a significant role in determining how much money a seller may keep after selling a capital asset.

Most states that impose state income taxes collect capital gains taxes at the same rate they tax other income. California, for example, has a top state income tax bracket of 13.3 percent that applies to regular income and to capital gains.

Other states offer varying favorable terms to capital gains as opposed to ordinary income. In Wisconsin, a high-income earner may be in a 7.65 percent state income tax bracket, but the top capital gains rate is generally 5.36 percent.

## MANAGEMENT STRATEGIES

Our clients will often ask us about ideas to defer or to avoid capital gains tax. Here are some of the most common ones.

### *Die While Still Owning the Property*

Capital assets owned at death receive an adjustment to basis at the owner's date of death. The new basis is the fair market value as of the date of death.

There have been multiple proposals in the recent past where the federal government considered eliminating or limiting this so-called "step-up in basis at death" rule. As of the writing of this article, the rule is still intact.

Even though the step-up at death provision is favorable, most of our client are not eager to rely on it because

- They want to sell before death, or
- They think the rule will change before they die.

Such clients are candidates to consider other options.

### *Bracket Filling*

When we refer to *bracket filling* in the context of capital gains management, we are usually thinking about a relatively low-income taxpayer taking advantage of the 0 percent capital gains bracket.

Here's an example.

> Ricky and Lucy are a retired married couple with regular taxable income of $50,000 in 2023. The Ricardos also own a thousand shares of publicly traded stock they purchased years ago for $10/share which are now worth $150/share.
>
> To calculate the actual capital gains tax, the capital gains are stacked on top of regular taxable income to determine the proper capital gains rate. The table on the prior page indicates that the threshold for the 0 percent rate for a couple filing jointly is $89,250. That means the first $39,250 of capital gains would be taxed at 0 percent.
>
> That means the Ricardos would be able to sell about 280 shares of their stock in 2023 at a $140/share gain but avoid paying tax on the transaction because they would be filling the 0 percent capital gains bracket.
>
> If the Ricardos expect to have a similar amount of taxable income in 2024—and if they expect the federal income tax rules to remain stable, they can plan to employ the strategy again next year.

> On the other hand, if the Ricardos think the 15 percent capital gains bracket available today is a tax bargain, they can sell the rest of their stock position in 2023.

*Capital Loss Harvesting*

To figure how much tax a client owes on gains in a given year, realized capital losses are generally subtracted from a client's capital gains. In some cases, a client who has sold investments in significant gain positions during the year may choose to sell other assets that are in loss positions.

Through strategic timing of sales, a client may be able to minimize the overall tax liability.

*Charitable Giving*

While charitable gifts may be partly subsidized through their tax advantages, making a charitable gift nearly always involves the client's ending up with less money instead of more. Certain kinds of charitable gifts will allow a client to avoid directly paying capital gains taxes, but there is a real economic cost to the donor.

A direct charitable gift of an appreciated capital asset will allow the taxpayer to claim an itemized charitable deduction for the gift up to its full fair market value. The donor will not have to recognize capital gains tax on the gift at the time it is donated or sold. The maximum value the donor may claim as a charitable deduction in a year is 30 percent of adjusted gross income.

A client may also decide to use a charitable remainder trust (CRT) to eliminate the capital gains tax liability on the sale of an appreciated asset.

Under a CRT, the donor usually receives a regular stream of income for life or for a stated number of years, after which the remainder interest, the amount left in the trust at the donor's death, passes to the charity.

If properly implemented, a CRT creates a number of tax benefits for the donor:

- No capital gains tax is generated on the sale of appreciated assets after they have been donated to the CRT.
- The donor receives an immediate charitable income tax deduction equal to the value of the donation minus the present value of the annuity stream.
- The donor's estate receives a future estate tax deduction for the value of the charitable remainder interest.

Because of their tax characteristics—and coupled with the fact that a real charitable gift is required—CRTs work best at times when capital gains tax rates, estate tax rates, and interest rates are high. When a CRT is chosen to avoid capital gains taxes, implementation generally requires putting a professional team in place to create the needed documents and administer the trust.

*Installment Sale*

A taxpayer with an appreciated capital asset may decide to sell the property in exchange for an installment payment promise from the buyer. According to IRS Publication 537:

> An installment sale is a sale of property where you receive at least one payment after the tax year of the sale. If you realize a gain on an installment sale, you may be able to report part of your gain when you receive each payment.

An installment sale doesn't eliminate capital gain; it just spreads out the tax result over time. From the seller's perspective, spreading out the gain over a period of years may reduce the rate at which the gain portion is taxed.

On the other hand, selling an asset in exchange for installment payments puts the seller at some risk that the buyer won't be able to finish making the payments. In some cases, the exposure can be softened by giving the seller a continuing security interest in the underlying asset. In other situations, practical issues may make the default risk more significant.

The client's tax objectives and risk tolerance should be factors in deciding if and how to structure an installment sale of a capital asset.

*Deferred Sales Trust*

A deferred sales trust (DST) is a structure created for clients looking to defer capital gains taxes on the sale of a capital asset—such as real estate or closely held business interest—through an installment sale.

Advocates of the DST technique claim the taxes owed from the sale may be paid in smaller chunks every year through installment sale treatment, sometimes lowering the overall tax liability.

A DST may be set up in multiple ways. The most usual structure is for the seller to create an entity to which the capital asset will be sold in exchange for an installment note. That entity will subsequently sell the underlying asset to an all-cash buyer. The seller—arguably—would get installment sale tax treatment while keeping indirect control of the lump sum from the buyer.

The IRS identified *monetized installment sales* as an abusive strategy on its 2023 list of common tax scams and schemes. It will require those engaged in such transactions to report them to the Service.

Why is that relevant to DSTs? The IRS identified (IR-2023-139, Aug. 3, 2023) the following elements as typical of monetized installment sales:

- A seller of appreciated property, or a person acting on the seller's behalf, identifies a buyer who is willing to purchase the property in exchange for cash or other property.
- The seller enters into an agreement to sell the property to an intermediary in exchange for an installment obligation, which provides for interest payments from the intermediary to the seller.
- The seller then purportedly transfers the property to the intermediary, although the intermediary never actually takes title or takes title to the property only briefly before transferring title to the buyer in exchange for the buyer's cash or other property.
- The seller also obtains a loan with an agreement that provides for interest payments from the seller to the lender that equal the amount of interest that the intermediary pays the seller under the installment obligation.
- Both the installment agreement and the loan provide for interest due over the same periods, with principal due in a balloon payment at or near the end of the term of the installment agreement and loan.
- The sales proceeds received by the intermediary from the buyer, reduced by certain fees, are provided to the lender to fund the loan to the seller or transferred to an escrow account of which the lender is a beneficiary.
- The lender agrees to repay these amounts to the intermediary over the course of the term of the installment obligation.
- The seller then treats the sale as an installment sale under section 453 on a federal income tax return for the year of the purported sale and defers recognition of gain until the year in which the seller receives the principal balloon payment.

The Service's description of a monetized installment sale looks similar to a DST. In its proposed regulations on monetized installment sales, it includes transactions that are substantially similar to those described above as abusive tax transactions.

As a further discouragement of the DST technique, some states have begun to question whether its claimed benefits will be honored for state income tax purposes. California, for instance, has taken steps to outlaw installment sale treatment for DST transactions.

Does this mean DSTs are no longer viable? Not necessarily—although the tax risk associated with their implementation has increased significantly. Clients who wish to pursue any DST strategy will need to fully evaluate the risks and rewards with their financial advisory team.

*Section 1031 Exchange*

Section 1031 of the Revenue Code provides that the exchange of qualifying property for a new qualifying property will allow the taxpayer to defer recognition of gain on the disposition. Here is what the IRS has said about what constitutes *qualifying property*:

> Section 1031 … applies only to exchanges of real property and not to exchanges of personal or intangible property. An exchange of real property held primarily for sale … does not qualify as a like-kind exchange.

While the Service does recognize that the exchange of one commercial property for another is a legitimate way to defer capital gains taxes, it has imposed specific rules on how a valid exchange must be done:

> The simplest type of Section 1031 exchange is a simultaneous swap of one property for another.
>
> Deferred exchanges are more complex but allow flexibility. They allow you to dispose of property and subsequently acquire one or more other like-kind replacement properties….
>
> While a like-kind exchange does not have to be a simultaneous swap of properties, you must meet two time limits, or the entire gain will be taxable. These limits cannot be extended for any circumstance or hardship except in the case of presidentially declared disasters.
>
> The first limit is that you have 45 days from the date you sell the relinquished property to identify potential replacement properties. The identification must be in writing, signed by you and delivered to a person involved in the exchange like the seller of the replacement property or the qualified intermediary….
>
> The second limit is that the replacement property must be received and the exchange completed no later than 180 days after the sale of the exchanged property or the due date (with extensions) of the income tax return for the tax year in which the relinquished property was sold, whichever is earlier. The replacement property received must be substantially the same as property identified within the 45-day limit described above.

As with a Section 1035 exchange, if the taxpayer receives cash or a cash equivalent as part of the Section 1031 exchange, the amount received is considered taxable boot and is taxed gain first.

Where a taxpayer continues to own the exchanged-for Section 1031 property personally until death, it may be possible to avoid capital gains taxes entirely because of the step-up in basis at death rule.

## CONCLUSION

Our clients expect their financial professionals to help them conserve and grow wealth. Part of wealth conservation is tax management.

In this article, we discussed several strategies for managing capital gains results:

- Hang onto assets until death.
- Fill the 0 percent capital gains bracket.
- Offset gains with previously unrealized losses.
- Make charitable gifts of appreciated property.
- Sell to a buyer in installments.
- Carefully consider a deferred sales trust.
- Perform a Section 1031 exchange.

None of these techniques is right for every situation, but all should be evaluated in helping to serve clients hoping to minimize capital gains taxes.

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## IN THIS ISSUE OF ADVISOR'S BULLETIN



## *Building Protecting and Perpetuating Family Wealth*

LWA strives to develop and maintain sound financial plans designed to achieve our client's wealth accumulation, preservation and transfer objectives, with the goal of preserving their wealth for multiple generations. We provide these services in a confidential and consultative manner, building life-long relationships based upon education, trust, communication and service.

## IMPORTANT NOTICE: PLEASE READ