



Ruminations on Harvesting Capital Gains

Explanation of the strategy. Under current law the top federal tax rate for realized capital gains is 15% but is scheduled to rise to 20% next year. (The rate is currently scheduled to go even higher for many folks in future years as the tax provisions of the health care bill take effect.) For example, a stock bought for \$50,000 that is now worth \$150,000 would incur taxes of \$15,000 (15% of the \$100,000 gain) if sold this year. The same sale next year would incur taxes of \$20,000 (20% of the \$100,000 gain). Thus for investments that will be held for the long term some commentators are suggesting selling this year to lock in the gain at the lower rate and then immediately repurchasing the investment. This would mean that only future gains will be taxed at the higher rate.

Wash sale rules. To prevent taxpayers from selling investments *at a loss* to get the tax deduction and then immediately repurchasing the investment (or doing something roughly equivalent economically) there are what are known as “wash sale rules” that disallow taking the deduction until the investment is “really” sold. These rules do not apply to recognizing gains and thus do not apply to the strategy we are discussing here.

Taxable accounts. Many investors have significant amounts in IRAs and other tax-advantaged accounts. This strategy will not help in those accounts (though it may influence a Roth conversion – which is another paper). This strategy is for those with taxable investments.

Loss carryforwards. Given the market events of 2008 many people have large amounts of carryforward losses – particularly if they or their advisor was wise about harvesting those losses. The current tax code only allows the recognition of \$3,000 per year of capital losses against ordinary income. The remainder is carried forward to future years where each year \$3,000 of the losses may be used to reduce ordinary income, but an unlimited amount may be used against subsequent recognized capital gains. For taxpayers with large loss carryforwards, this strategy will not help as any gains recognized are not actually being taxed at 15%, but rather simply using up some of the accumulated losses.

When the strategy doesn't make sense. Suppose we have the investment mentioned previously with a basis of \$50,000 and a current value of \$150,000 and we expect to sell the investment in ten years to fund some goal. We sell and repurchase, paying \$15,000 today to avoid taxes of \$20,000 in ten years. (Our basis is increased by \$100,000 when we pay the taxes on the gain today, thus reducing our taxable gain in the future. Subsequent appreciation in the investment does not impact this analysis.) Thus we essentially give up (invest) \$15,000 today to get \$20,000 in ten years. That is a rate of return of 2.92% annualized. Most folks would do better to invest the \$15,000 for ten years, earning enough to pay the \$20,000 in taxes with money left over. (This simplistic analysis ignores transaction costs from the “extra” trades, so the return is ever-so-slightly overstated.)

When the strategy *does* make sense. Take the same scenario as in the previous paragraph but assume we will need the funds in two years rather than ten so we anticipate selling at that time. The rate of return on that situation is 15.47% (annualized). That is compelling. To recap, this strategy is recommended for investors who:

- 1) Have investments with substantial embedded capital gains,
- 2) Where these investments are held in a taxable account, and
- 3) The investor does not have offsetting recognized losses or loss carryforwards, and
- 4) The investment will be sold anyway in a relatively short period of time.

Notes:

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