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The Capital Gains Dilemma

Why investors should start thinking strategically about capital gains and taxes

The current bull market, almost a decade long, has left many investors with appreciated assets in their portfolios. While clearly a benefit, this can also have a downside: Investors may be averse to selling stock because they do not want to trigger taxes on capital gains, or the profits from a sale. Yet, by not selling, and basically "kicking the proverbial tax can down the road," investors may limit their ability to rebalance a portfolio in a timely manner, setting the scene for a rise in the level of risk they face.

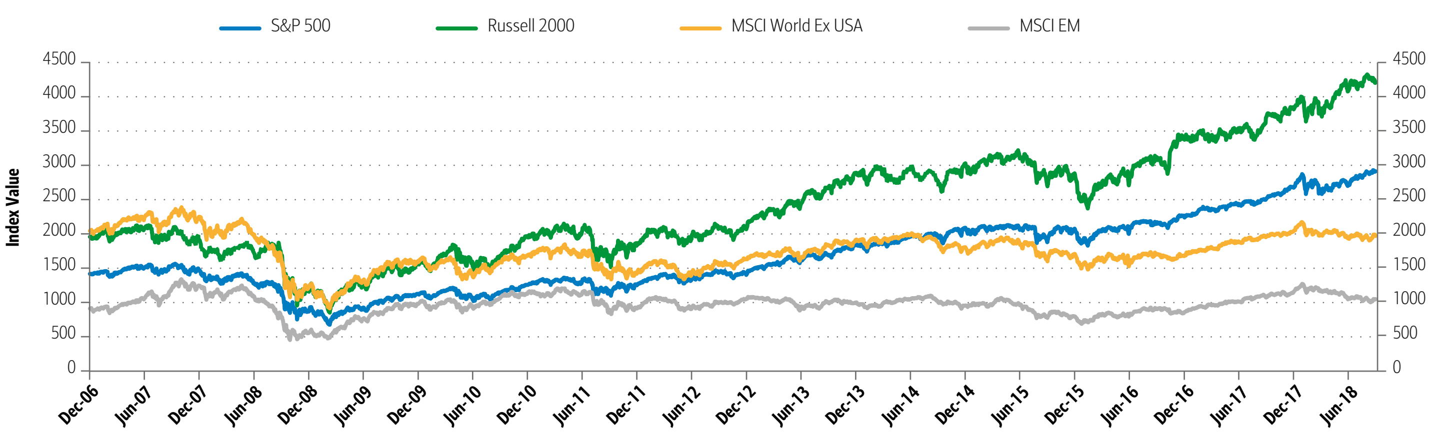
There is an important question here: What might prompt the reluctant seller and the proverbial can-kicker to view taxes in a different light, so that they can sell when appropriate and rebalance a portfolio in a prudent manner? Here are some compelling points.

TAXES CAN BE EASY TO MANAGE BUT DIFFICULT TO AVOID

Capital gains, and the tax consequences they may generate, are simply a normal part of investing. In fact, income taxes are usually a result of successful and healthy active portfolio management, rather than something to delay, or avoid. Indeed, taxes can be managed but rarely avoided entirely. That being the case, essentially all investors—and especially the reluctant sellers among them—should consider a more strategic approach to capital gains and taxes.

Thinking strategically—or planning ahead in ways that can potentially benefit a portfolio—is essential at any point in a market cycle. But it is especially important in a mid- to late-market cycle (which is where we are now), and in a period in which an economic recession is developing.

Exhibit 1: Equity Market Appreciation



Source: Investment Solutions Group, CIO Office. Data December 31, 2006 through September 30, 2018.

Past performance is no guarantee of future results.
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MANAGING CAPITAL GAIN RECOGNITION

One important step investors can take is to mitigate the amount of taxes that are recognized. To take advantage of some available opportunities to mitigate tax recognition, it is important for clients to understand their overall tax situation.

1. **Tax Rate.** Understand your effective capital gain rate. Not all individuals are in the highest capital gain tax bracket. Retirees may be surprised to find that they dip into lower income brackets and possibly lower capital gain brackets once employment income ends.

2018 Long-term Gains Bracket	Income Thresholds (Married Filing Jointly)
23.8%	$479,001 and up
18.8%	$250,001 to $479,000
15.0%	$77,201 to $250,000
0.0%	Up to $77,200*

* Gains may be taxable on the state level.
Long-term capital gains will be subject to an additional 3.8% surtax when income exceeds $250,000.

2018 Long-term Gains Bracket	Income Thresholds (Single Filers)
23.8%	$425,801 and up
18.8%	$200,001 to $425,800
15.0%	$38,601 to $200,000
0.0%	Up to $38,600*

* Gains may be taxable on the state level.
Long-term capital gains will be subject to an additional 3.8% surtax when income exceeds $200,000.

2. **Carryforwards.** Consider utilizing any carryforward capital losses from prior tax years to offset any potential capital gains.

3. **Harvesting capital losses.** Harvest any unrealized capital losses to offset recognized capital gains, and do so every calendar year. Note, however, that tax loss harvesting is only effective if "wash sale" rules don't apply. A wash sale occurs if a security is sold at a loss and the same or a substantially similar security is purchased within a 61 day window (30 days before the day of purchase, the day of purchase, and 30 days after the day of purchase).

   Always evaluate prior purchases and do not buy the same or a similar security within the window period. Note that wash sales apply to all of an individual's accounts. For example, if a security is sold in one account to capture a loss, and the same or a similar security is purchased in another account within the window period, the loss cannot be recognized. Be sure to consult a tax advisor for the application of the rules to your particular circumstances.

4. **Utilize a portfolio view** versus an account view to effectuate rebalancing. Oftentimes, we find investors hold sizeable retirement assets that can be used to start rebalancing decisions without triggering immediate taxes on recognized capital gains.

5. **Consider spreading the tax cost** over multiple tax years.

6. **Manage holding periods.** A recognized capital gain can be taxed at preferential rates if the security has been held for greater than one year.

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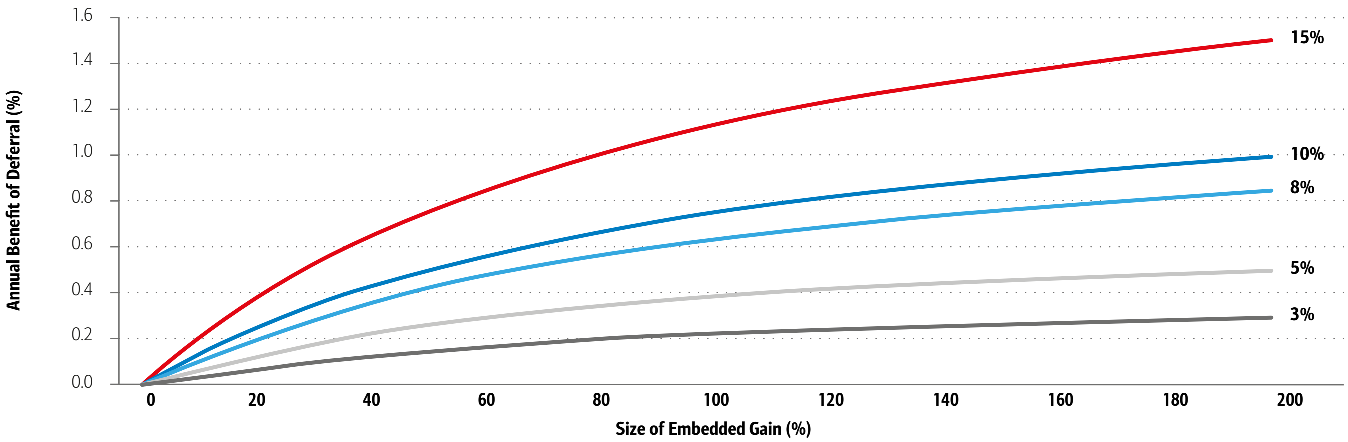
ELIMINATE CAPITAL GAINS OR FIND A WAY TO DEFER?

There are a few ways to eliminate or defer paying taxes on capital gains. Holding appreciated assets until death or donating appreciated assets to qualified charities may be some of the only ways to eliminate the capital gains tax. However, deferring capital gains temporarily is possible and it allows the assets to grow tax deferred. The benefit of deferring capital gains will vary by the size of the gain, the expected investment return and an investor's capital gains tax rate. The annual overall benefit of deferring capital gains is generally smaller than most taxpayers think.

Exhibit 2: Small Benefits to Deferring Capital Gains

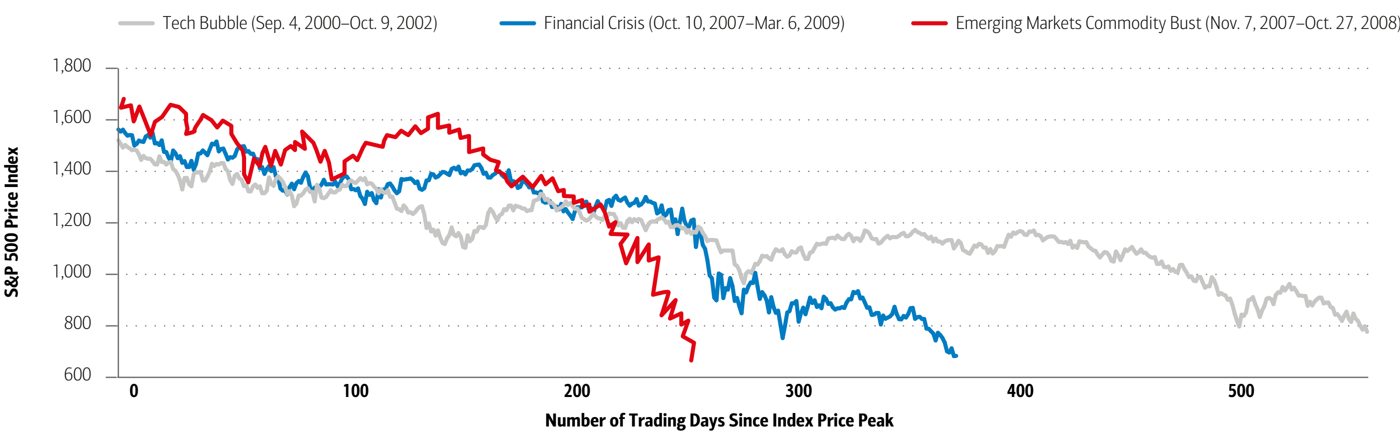


Source: Michael Kitces.

The Y axis is the annual benefit of deferral in terms of a percentage of the net value of the investment (net of capital gains tax). The X axis is the percentage of appreciation of the investment (for instance, an investment purchased at $100,000 that is now worth $160,000 has an embedded gain of 60%). Assumes a capital gain tax of 15%.

For example a $1 million gain on an initial investment is a 33% gain. The tax liability is $150,000 (at a 15% rate). That liability exists perpetually unless the gain is lost. By deferring the gain, the investment grows by the rate of earnings going forward. In this case let's say 8%, or $12,000. That equates to 0.3% of saving by deferring the gain. The savings is relatively low and can easily be eaten up by volatile markets or future tax increases.

Exhibit 3: Maximum Drawdown Periods of the S&P 500 Index & MSCI Emerging Markets Index



Source: Investment Solutions Group, CIO Office. Data as of June 19, 2018.

MANAGE THE TAX BRACKET

Deferring capital gains can actually reduce wealth by pushing a taxpayer into a higher capital gains tax bracket when that deferred gain is recognized all at once. If you monitor your annual tax situation, you may recognize enough capital gain each year to avoid bunching up the gain and pushing you into a higher tax bracket. In a similar vein, whether a taxpayer is in the 23.8% capital gain bracket will also depend on other income, so controlling that other income might allow the capital gain to remain in the 15% bracket.

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OTHER METHODS TO CONSIDER

Consider rebalancing by leveraging gifting, charitable donations and wealth structuring, using appreciated holdings. Investors should talk to their tax advisor about the following strategies as these are general strategies and may not be applicable to everyone.

Donate-and-Replace Strategy: Rather than giving cash to a charitable recipient, investors could consider transferring appreciated stock to a charity and then use the funds that otherwise would have been used for gifting. This strategy only makes sense if you normally make charitable gifts.

Gift-and-Replace Strategy: Rather than giving cash to a child or other individual recipient, investors may transfer appreciated stock to that person and then use the funds that otherwise would have been used for gifting for redeploying or towards rebalancing the investment portfolio. This strategy only makes sense if you normally make gifts to family members or others. Keep this in mind: If the gift recipient is a young child, he or she may be subject to the so-called kiddie tax, which could subject the child's capital gain, or a portion of the capital gain, to the rates applicable to trusts, which reach the maximum rate of 20% capital gain rate when taxable income exceeds $12,700 (for 2018).

Charitable Remainder Trust (CRT): A taxpayer can defer long-term capital gains by contributing appreciated property to a CRT. Gains realized by the CRT may be attributable to the taxpayer when payments are made from the CRT to the taxpayer.

Look at the portfolio level to facilitate rebalancing: For instance rebalancing in a tax advantaged account can reduce the tax burden in the taxable account.

Offset Gains with Losses: Taxpayers can harvest capital losses to offset gains, being mindful of wash-sale rules.

Opportunity Zones: A taxpayer can defer (and possibly reduce) short- and long-term capital gains by timely reinvesting an amount up to the capital-gain that would otherwise be recognized in a qualified opportunity fund. In order to take advantage of the tax benefits of the program, a taxpayer can reinvest an amount up to the capital gain in a qualified opportunity fund within 180 days from the date of the sale or exchange of a capital asset. The deferred gain, with potential for reduction up to 15%, would be recognized on the earlier of December 31, 2026 or when the opportunity fund investment is sold.

OUR PERSPECTIVE: BULL MARKETS AND PORTFOLIO POSITIONING

The Chief Investment Office typically positions portfolios for classic late-market cycles (where we are now) by favoring equities over fixed income. Here are our main reasons. Basically, as interest rates and inflation normalize, equities tend to do well, bolstered in large part by rising dividends and equity share prices. Closer to a peak in the equity markets, this balance typically shifts, with yields and hedging characteristics from fixed income becoming more attractive.

We do not believe we are at the point in this market cycle where we would position towards a peak, but we are watching closely to determine when we would make that shift and start adjusting our overweight in equities. We think that any transition from a late cycle peak would include a gradual, rather than abrupt, move toward de-risking portfolios.

CONCLUSION

As the cliché goes, "don't let the tax tail lead the investment dog". Given the assumed success investors have had in both the equity and fixed income markets, especially since March 2009, recognizing gains should be viewed as a result of successful active management.

In order to keep any gains and not lose appreciated value, investors should consider aligning to a strategic asset allocation, such as that offered by the Chief Investment Office. To the extent that the cost of rebalancing is large, spreading the tax burden over multiple years, and/or using other tax-mitigation strategies, might help other strategies.

KEY TAKEAWAYS

- Don't let past success lead to potential future failure
- Deferring gains may not be as big of a benefit as believed
- If you don't align portfolios at the back half of a market cycle, you may have a harder time when the market cycle is over
- Not rebalancing near the top of the cycle may have a steep cost when the cycle turns over
- Consider budgeting and spreading larger tax implications over multiple years.

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