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Alerts and Updates

TAX-PLANNING STRATEGIES FOR STOCK MARKET GAINS

November 12, 2009

Few can be pleased with the stock market's performance over the last year or so. However, the market's recent rebound has raised the question of whether now is the time to capitalize on some of those newly realized gains on stocks purchased during the downturn. While taxes should not be the main factor in this decision, they should be considered, given that taxes can significantly impact the investment return.

Below are two simple, yet effective, strategies to consider as investment decisions are made on how to manage recent gains.

Timing the Sale Is Critical

Capital assets such as stock, bonds and mutual funds, must be held more than 12 months to be taxed at the lower and more favorable long term capital gain rates (LTCG). The holding period for capital assets (*e.g.*, stock, bonds and mutual funds, etc.) generally begins on the day after the purchase date and ends on (and includes) the day of disposition. For securities traded on an established securities market, the holding period is measured from trade date to trade date (the date when executed). The settlement date (the date when actually delivered) has no impact on the holding period. The gain or loss must be reported in the tax year in which the disposition (*i.e.*, trade date) falls.

Of course, the decision to hold an asset should not be driven solely by tax consequences. However, one should be aware of the rules, since missing the required holding period by even one day results in a short-term capital gain, taxed at unfavorable and likely increasing, ordinary income rates.

If the sale qualifies for LTCG treatment, it will be taxed at a maximum federal tax rate of 15 percent and in some cases not taxed at all. Otherwise, it will be taxed at ordinary income tax rates, which can be as high as 35 percent under present law. Therefore, the tax obligation will be less and more gain preserved if the stock sale qualifies for LTCG treatment. The overall tax savings depends on the taxpayer's ordinary income tax bracket.

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Evaluating the Investment Risk of Deferring a Sale

The question then becomes: Are the tax savings that would be realized by holding the security for the long-term period worth the investment risk that the security's value will fall during the same time period? If the value is expected to fall significantly or the market for the security is diminishing, liquidating quickly, regardless of tax consequences, may be the better option. Otherwise, the potential risk of holding the security should be weighed against the tax benefit of qualifying for the reduced LTCG tax rate.

For example, a taxpayer in the 35 percent ordinary income tax bracket can reduce the tax on a stock sale by 20 percent (35 percent-15 percent) by holding the security for the long-term holding period. Even if the price declines slightly during the holding period, the after-tax return may be greater if the gain is ultimately taxed at only 15 percent. A taxpayer in the 25-percent bracket can save only 10 percent by holding the asset. Thus, the taxpayer in the higher bracket can probably tolerate more risk associated with holding the security to qualify for the lower LTCG rate. However, taxpayers in the 10-percent and 15-percent ordinary income tax brackets (*i.e.*, single taxpayers with taxable income up to $33,000 and married taxpayers filing jointly with taxable income up to $65,100) can drop their tax rate on the asset sale to 0 percent for 2009 and 2010 by holding it for the required 12-month period based on current law. So, even lower income taxpayers may want to consider whether the tax savings are worth the risk of holding out for the 12-month period.

Comparing the risk of a price decline to the potential tax benefit of holding an investment for a certain time is not an exact science. However, when you consider the following you can estimate the break-even point:

- The expected ordinary income tax rate relative to the anticipated capital gains rate;
- The amount of appreciation that will eventually be taxed;
- How much longer the asset must be held to qualify for favorable capital gain rates; and
- Whether any existing capital losses could offset the gain (and the benefit of the lower rate).

If you are concerned that the value of your stocks, bonds or mutual funds will decline, the question becomes how much can the stock value decline before the decision to wait for LTCG treatment is detrimental. Computing the break-even point can help establish whether you should hold on to the stock to meet the one-year holding period or sell it and recognize a short-term capital gain. The break-even point can be computed mathematically utilizing the current price of the stock, the tax basis

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and the ordinary income (short-term capital gain) tax rate. We have created a formula for determining the break-even price and often help our clients weigh their options.

The formula computes the price to which the stock can fall and still be advantageous to hold to qualify for long-term capital gain treatment. At a price lower than the break-even amount, selling the stock at the current price and recognizing a short-term capital gain is likely to be a better decision.

Example: Computing the Stock Price Break-Even Point for Potential Sale

A taxpayer purchased 10,000 shares of Wish Corp. on December 19, 2008, for $5 a share. The stock price has soared and on October 27, 2009, it is trading at $28 a share. The taxpayer is anxious to sell the stock and realize profit because he believes it may decline in value. However, the taxpayer is concerned about the potential tax liability because a sale would result in a short-term capital gain. The taxpayer is in the 35 percent ordinary income tax bracket, and has no other capital transactions in 2009.

Should the taxpayer sell the stock now or wait until after December 19, 2009, when the sale would be eligible for LTCG treatment and based on the current value, how much can the stock price fall and LTCG treatment still be advantageous? Using our formula, we determine that the stock price break-even point is $22.59. If the taxpayer were to sell the stock at its current price, the after-tax proceeds would be $199,500 ($280,000 sales proceeds less tax of $80,500). If the price were to fall to $22.59 a share but the stock was held until the LTCG tax rates apply, the after-tax proceeds would be $199,515 ($225,900 sales proceeds less tax of $26,385). Thus, if the taxpayer believes the stock price will not fall below $22.59 per share between now and December 20, 2009, more net after-tax gain would be realized by holding the stock until at least December 20, 2009, when a sale would be treated as an LTCG.

Use the Specific ID Method to Minimize Taxes

If you are considering selling less than your entire interest in a security that you purchased at various times for various prices, there are a couple options for identifying the particular shares sold—(1) the first-in, first-out (FIFO) method and (2) the specific ID method. FIFO is used if you do not or cannot specifically identify which shares of stock are sold and pursuant to IRS regulations the oldest securities are deemed to be sold first. Thus, doing nothing generally creates the greatest capital gain.

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Alternatively, the specific ID method may be used to select the particular shares you wish to sell. This is typically the preferred method as it allows some level of control over the amount and character of the gain (or loss) realized on the sale, which can lead to tax savings opportunities.

For example, if you realized some capital losses earlier this year (or a capital loss carryover from last year exists), realizing a short-term (versus long-term) gain may be advantageous. This can be accomplished by specifically identifying the newest shares of a particular security as sold. Then, the older shares can be sold (generating a long-term gain) later, when the gain will not be offset by capital losses.

It is important to note that if the basis in the shares differs (and it usually does), the specific ID method affects the amount of the gain as well as the holding period. Sometimes, reducing the current taxable gain by selling the highest basis shares first may be more beneficial than obtaining the lower long-term capital gain rate. Additionally, if capital gain rates are expected to increase, a multi-year and multi-disposition analysis should be performed. Each case will depend on specific facts, and will require comparative calculations.

The specific ID method requires that the specific stock to be sold is adequately identified which can be accomplished by delivering the specific shares to be sold to the broker selling the stock. Alternatively, if the stock is held by the broker in street name, IRS regulations require the following: (1) provide notification to your broker regarding which shares should be sold and identify them by reference to their purchase date and per-share price; and (2) the broker must then issue a written confirmation of instructions received. The identified stock is then deemed to be sold even if the broker actually delivers to the buyer shares from another lot of stock.

However, discount and online brokers may be unwilling or unable to issue these confirmations. In this scenario, the Tax Court's 1994 *Concord Instruments Corp.* decision implied that where oral instructions are provided to the broker regarding which shares to sell, the specific ID method may still be utilized even though no confirmation is forthcoming. However, such instructions should be carefully documented by making notations on the written transaction statements received from the broker. Despite this decision, it may be prudent to follow the requirements under the IRS regulations when possible.

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Conclusion

While the foregoing capital gain planning techniques may be simple, they can be very effective when properly used and save significant dollars as the market recovers. We often work with many clients in developing a personal strategy for maximizing the benefit of one or both of the strategies discussed.

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