PRACTICAL PLANNING:

Capital Gains Taxes

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One of the biggest challenges in a bull market is knowing when to sell successful investments. With markets touching new highs, we set out to help investors assess their capital gains situation by answering the following questions: how does where you live and how much you earn affect your capital gains tax?

Investments that are held in taxable accounts incur capital gains, and understanding how much you will owe is an important part of the decision equation. This decision point has been taking on urgency with some taxpayers lately, as we have just passed the one-year mark since the market bottom. Gains in portfolios that were rebalanced at the bottom have now turned from short-term into long-term gains, thereby lowering the applicable tax rate for many taxpayers.

For example: If I invested $100,000 in the S&P 500 a year ago, my investment has appreciated about 50%. If I sell that investment now (realizing the long-term capital gain in the process), then I will owe tax on the $50,000 gain. The long-term capital gains tax rate that I pay will be determined by how much I earn and by whether the state I live in assesses income tax on capital gains. If I am an Oregonian filing a married return and showing an adjusted gross income of $250,000, then my capital gains rate is 24.9% (15% federal, 9.9% Oregon). I can lower that tax rate by earning less or moving to Washington (or to any state without an income tax and, therefore, no capital gains tax), and I can increase my applicable tax rate by earning more money (the federal tax jumps to 20% on adjusted gross incomes above about $475,000). Please note: the Washington legislature recently passed a bill that will create a 7% state capital gains tax on the sale of some investments. Opponents of the bill have promised to fight the tax through the courts. We will provide updates to this space as they develop.

The following table is a look at how much embedded gains are hiding inside of hypothetical investments and gives the reader some perspective on how much an investment would have to decline in value to offset the embedded long-term capital gains tax due. The after-tax impact of where you live and how much you earn are substantial factors in determining your gain rate and should be part of the conversation when deciding whether it is worth it to lock in profits and pay the tax. This is especially true for taxpayers who may retire in different states than the ones in which they work.

The individual paying a combined 15% rate should be far more willing to lock in gains in taxable investments (and therefore willing to rebalance more regularly), than the high earner in a state that taxes these gains, as you can see below. The higher the applicable gain tax rate, the more an investor should be willing to bear downside risk before paying the tax:

HOW MUCH OF YOUR INVESTMENT VALUE GOES TO PAYING THE GAINS DUE ON SALE?

	Capital Gain Rate				
Unrealized gain %	**15%**	**20%**	**25%**	**30%**	**35%**
25%	3.00%	4.00%	5.00%	6.00%	7.00%
50%	5.00%	6.67%	8.33%	10.00%	11.67%
75%	6.43%	8.57%	10.71%	12.86	15.00%
100%	7.50%	10.00%	12.50%	15.00%	17.50%

Applicable capital gain rates should never be the driving force when deciding whether to sell an investment — but it should be part of the conversation. The analysis should be a holistic one that includes a look at macro and micro economic factors, a review of alternate options, a calculation of potential tax ramifications, and analysis of the overall allocation and risk profile of the portfolio. Please contact our team if you have questions about the embedded gains in your portfolio.