Tax Law Changes & Capital Gains Tax Strategy

November 5, 2020

Joe Biden has proposed a capital gains tax increase from 23.8% to 39.6% for individuals earning over $1 million, the largest real increase in capital gains rates in history. Research conducted by senior economists at the U.S. Congress Joint Committee on Taxation and the Urban Brookings Tax Policy Center found that two previous hikes in capital gains taxes (the 1986 Reagan tax plan and as part of the 2012 fiscal cliff negotiations) led to 60% and 40% stock sales in the months before the increase as investors acted to capture temporarily low rates.[1]

Over the intermediate to long term, however, broader macroeconomic factors such as interest rates, economic growth and corporate earnings are more important determinants of individual stock and overall market performance than a tax hike. For example, in 1986, the market continued to rise even as investors cashed in on the temporary low rates. According to Goldman Sachs research, in the three months leading up to the 2013 tax increase, the wealthiest 1% of households sold 1% of their starting equity, worth about $100 billion today. Then, in the months following the rate hike, they bought back more stocks than they had sold.[2] The current political and economic uncertainty could offer a similar opportunity to write up low cost-basis, high-quality long-term investments and possibly buy them back at a reduced price.

There are alternative long-term estate planning strategies that investors can use to help hedge, monetize, mitigate, or defer capital gains impact. We discuss and consider these strategies with careful planning alongside a client's tax and legal advisors to maximize their long-term after-tax returns. Here are the most common approaches:

1. Step-up. "Step-up" in basis has been a high-net-worth capital gains tax-planning tool and strategy for many decades. Upon death, a surviving spouse inherits the investment free of estate tax (unlimited spousal exemption). Additionally, there is a reset of cost basis upward to market price at date of death or six months later. This leaves the surviving spouse free to sell some or all the shares and pay zero capital gains tax. Upon the death of the surviving spouse, there is a reset of cost basis for the estate beneficiaries after estate tax. A Biden administration-proposed repeal of the step-up involves difficult tradeoffs that policymakers will need to assess. Please refer to this research report from the Tax Foundation by Scott Eastman for more information.

2. Tax loss harvesting. Realized gains can also be offset by a capital loss in the same investment portfolio or elsewhere (ex: property or private investments). These losses can even be "banked" for use against capital gains in future years to sell or trim winners at a gain and pay no tax.

3. Charitable giving. If an investor is inclined to support a charitable cause, low cost basis stock can be gifted at the full market value. The donor pays no capital gains tax and receives an income tax deduction on the full value that year or held over to future years. Another option is the use of a Charitable Remainder Unitrust (CRUT). This trust can convert low-basis assets into an income annuity stream anywhere between 5 to 50% of the trust's market value. However, upon your death, the remaining assets are passed along to a designated charity and not your family.

4. Margin loans. Our clients also make regular use of margin loans, often as bridge loans during real estate transactions. Without any lender pre-approval required, they borrow against the stock in their account to make a "cash offer" and later pay it off when the older property is sold. No stocks need be sold but are utilized as collateral for liquidity.

5. Exchange Fund. Other more sophisticated strategies exist. One such example is an "exchange fund," popular with founders of tech companies with highly concentrated and highly appreciated securities. They pool their stock holdings into a comingled fund with other founders facing a similar circumstance. It locks them into the fund for seven years during which time they receive a stock index return, but at the end of seven years, they receive shares of 30 different companies with no capital gain realized. There is a cost associated with this structure, however, and you are locking into a period of illiquidity.

If one knows of or anticipates a liquidity event in the foreseeable future that will require the sale of a low-cost stock, then writing up the cost basis of that asset in advance of a capital gains tax increase could be a financially sound strategy. If taxation can be deferred for a long enough period by using one of the strategies outlined above, then capital gains tax may never be paid, and permanent loss of capital is avoided. We always recommend consulting with tax and estate professionals in advance of a write up of cost basis or use of any other tax deferral strategy.

Sources:

[1] Robert Frank CNBC Wealth 9/21/20

[2] Goldman Sachs 10/18/20 History and Joe Biden’s planned capital-gains tax