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Effective Planning for Realizing Capital Gains

What are capital gains taxes and what impacts can they have on your portfolio? With the strength of the recent market performance and uncertainty around future tax policies, now may be a good time to consider re-balancing your portfolio positions (and incurring some capital gains taxes in the process). In this episode of Choate's Family Office Podcast Series, Lanny Thorndike, president of ChoateIA, and Erin Kerr, a portfolio manager at ChoateIA, discuss the basics of capital gains taxes and how to think strategically about incurring these gains periodically in order to enhance longer-term performance.

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Welcome to the Choate Family Office podcast series. On this show, we explore important topics related to wealth management, investing and managing risk across generations.

Lanny Thorndike: Hello, this is Lanny Thorndike. I am the President of Choate Investment Advisors, and I am joined by my fellow portfolio manager, Erin Kerr, to talk about taxes. Now taxes aren't everyone's favorite topic, but we believe this is actually a very good time to be thinking about taxes and preparing for the future. Thank you Erin for joining.

Erin Kerr: Thank you, Lanny. We definitely feel that this is a good time to be thinking about taxes and we'll be spending this time focusing on a specific type of tax, but I also want to caution that this does not constitute tax advice and that investors should discuss their specific situation with a tax professional. Active tax management that we'll be discussing may work for some people in certain circumstances, but may not be appropriate for all investors. Our goal today I think is to provide some general background and context for investors.

LT: That sounds great. You mentioned that today's discussion will focus on a specific type of tax, and if we think of taxes as following into three primary types of taxes — income taxes, capital gains and corporate taxes — the most relevant for many investors is the capital gains tax. So, for the purposes of today, let's just table the corporate and income tax and we'll focus on the capital gains taxes. Maybe you could start by explaining what exactly are capital gains?

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EK: Absolutely. So capital gains are the profits from the sale of an asset. Until an asset is sold, any appreciation or growth is considered unrealized and no tax is due on this growth. However, as soon as an asset such as a stock is sold, any gains are considered realized and a tax liability is created based on any profits and the length of time the asset was held. Similarly, if an asset is sold for less than it was purchased, a capital loss is created which can be used to offset gains realized elsewhere. We'll come back to that later. So, it might be helpful if we could talk through an example because that's a lot of information.

If you bought a stock at $10 and it appreciated by 50%, say over five years, it would now be worth $15. The gain of $5 is considered an unrealized gain and no tax is due. However, as soon as you decide to sell and realize this gain of $5, you've generated a tax liability on the $5 of appreciation, not the total $15 in proceeds. So to summarize, you do not owe capital gains until you sell the stock and you convert the unrealized gain into actual realized gains, which are taxable and reported to the IRS. So now that you have this $5 in realized gains, you owe some percentage of that value in taxes. The exact amount will vary depending on how long you've held the asset generally differentiated by whether you have held it for a year or less. For assets held long term, that is more than one year, the tax rate is currently between 0% and 20% depending on taxable income and filing status. If the asset was held less than a year, the tax rate is equal to your ordinary income tax which is generally higher than the long-term capital gains rate. So, it is generally preferable from a tax perspective to hold a security for longer than one year. I mentioned capital losses earlier and those can be used to offset capital gains. So in this example, if you had another stock that lost $2 over the same time period and you sold it, that capital loss of $2 could be deducted from the previous gain of $5 for a net capital gain of $3 that would be taxed.

LT: Thanks Erin. Those examples are really helpful and to confirm, investors create a tax liability when they sell something that has performed well. Why would an investor want to sell an asset that has been successful?

EK: That's a great question. It does seem a little counterintuitive to sell something that's performed well, but we believe that realizing gains is an essential part of good, active portfolio management when done responsibly, and there are several good reasons why an investor might want to realize capital gains. So one reason is to help manage portfolio risk over time. An important concept in portfolio management is rebalancing or realigning a portfolio with a long-term strategic allocation that is appropriate based on an investor's goal and time horizon. Say that you determined that your allocation or your optimal allocation is 60% stocks and 40% bonds. If we have a year like 2020 where the global stock markets were up over 16% and bonds were up less than 5%, at the end of the year your allocation will have shifted to be roughly 63% stocks and 37% bonds, making your portfolio more aggressive. If stocks continue to outperform for several years in a row which is generally consistent with our outlook, this distortion will only increase. So a client that is disciplined at selling high and trimming your better performing equities periodically helps ensure that you keep a consistent amount of risk over time and that your portfolio doesn't drift and become an 80% stock portfolio ahead of a market downturn.

LT: That's a good point. If you aren't actively rebalancing, your portfolio can drift materially over time and end up looking very different from what you intended. So managing risk is actually really important, but are there other reasons?

EK: Absolutely. I think there are reasons to think about realizing gains in terms of enhancing longer-term performance as well. Another good way to think about managing gains is to envision an overgrown garden. You may love tomatoes but that doesn't mean you want them to overtake the entire garden and crowd out other plants that may have the opportunity to grow longer term. So over time an overgrown garden needs to be weeded and tended to allow room for new plants to grow and thrive, and we think investing is similar. Companies that grew and performed well in the past may not always be the best positioned for future growth and prudent adjustments should be made. The dominant companies of the past five years look very different than the fastest growing businesses ten and twenty years ago. If a company's prospects have changed or the investment thesis now deviates from your original strategy, it's time to re-evaluate whether locking in some of those gains and paying the necessary taxes is the better tradeoff to reallocate into a more promising position, and we hope that those will outperform over time.

LT: I really like your garden analogy and it sounds like realizing gains, if done well, can increase your after-tax return through a full market cycle if you can deploy to other asset classes at an appropriate time and recalibrate to match your risk in returns expectations.

EK: Exactly. We don't believe that gains should be realized unnecessarily but we do want to position our portfolios for the best long-term after-tax performance and to avoid becoming locked into positions just because of capital gains limitations. Historically we've seen that financial markets encounter a seven to ten year market cycle of expansion, followed by a slowdown and/or

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recession, and we believe it's prudent to take advantage of different points in the cycle to redeploy to better value opportunities.

LT: That makes sense. How do you think about what is the right amount of capital gains to realize? Are there ways of minimizing the impact?

EK: The right amount of capital gains will vary for each client and account, and I think what we focus on and emphasize is transparency in setting a budget with clients and communicating with them about capital gains expectations and planning. One effective tool for some clients is using appreciated securities for gifting to charitable organizations for example. That allows them to maximize their gift impact and to also transfer out the embedded capital gains so that they don't have to sell a security, pay the gains on that, and then transfer cash. This is an alternative to that for gifting purposes. There may also be good reasons to defer capital gains between different tax years and that is something we work closely with our clients and their tax professionals to plan and execute.

LT: So deferring realizing gains might make sense in some circumstances but I would argue that now is a good time to consider realizing some capital gains and the benefits of a future opportunity.

EK: Absolutely. We are now more than ten years into an economic recovery and equity markets have been strong. In addition, with interest rates in a secular decline and bond yields at historic lows, the majority of your portfolio gains over the past several years have likely come in the form of price appreciation and not income generation. So, if you owned equities, you likely have a meaningful amount of unrealized gains embedded in your portfolio. At the same time, capital gains rates remain at historically low levels.

LT: Great point. The tax rate fell to the current level in the early 1980s and has remained low really since then but future tax rates are uncertain. The U.S. government obviously operates at a structural deficit these days and it seems likely that rates may increase in the future and because of that, we think it's more prudent to be thinking about these issues now while rates are at historic lows.

EK: Yes. So to summarize, capital gains affect the profits of your investments but taxes will be paid on a portion of these gains once they are sold. While no one likes to pay taxes, having discipline around realizing some reasonable amount of gains on a regular basis is good portfolio hygiene and important to weed out holdings where the investment outlook has changed to create room for new investments. With the strength of the recent market performance and uncertainty around future tax policies, we believe now is a good time to have a discussion with your investment advisor and tax professional to think strategically about your investments.

LT: Thank you, Erin. Thank you for listening today and if you have any further questions, please feel free to reach out to your Choate representative for further details.

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