InvestmentNews
The Leading News Source for Financial Advisers

Advisers wrestle with uncertainty over capital gains

End-of-year sell-off to beat the tax man may not be the best plan

By Jason Kephart

December 9, 2012

Faced with a capital gains tax rate that may rise to 20%, from 15%, next year, financial advisers are grappling with whether to take gains now or hold off in the hope that any increase will be less dramatic.

If no deal is reached in the fiscal cliff negotiations and the Bush-era tax cuts expire, the long-term capital gains rate will automatically rise to 20%. Even with a deal that keeps the rate at 15%, taxes on long-term gains are going up at least 3.8% for high-income earners as part of the Affordable Care Act.

“We know what the cards will be on Dec. 31 and that they won't be as attractive on Jan. 2, but we don't even know how unattractive,” said Clark Kendall, founder of Kendall Capital Inc.

One of his clients works in landscaping, a weather-dependent occupation with a fairly unpredictable income stream. Mr. Kendall knows that the client will require cash from his investments next year, so he is taking gains now to meet that need.

David John Marotta, president of Marotta Wealth Management Inc., is digging deeper, taking gains based on what clients will need in the next three years.

The hardest decision that advisers face in the next two weeks is what to do in situations where clients don't need money in the near future.

Mr. Marotta is using the potential rate hike as an opportunity to sell out of some high-fee mutual funds and replace them with cheaper exchange-traded funds. He figures that if you can get an extra 2% from a new position, it is worth taking the gains now.

The easiest way to boost returns is to cut expense fees, Mr. Marotta said.

John Schuman, chief planning officer at Budros Ruhlin & Roe Inc., is selling positions with sizable gains baked in, then immediately buying back the same positions at their current level, though with 15% less capital.

“We're not doing it across the board,” he said. “We're looking for the low-hanging fruit.”

Here is how it works: If you had $1,000 worth of stock with $800 in capital gains, taking the 15% hit now would cost $120 in taxes. That would leave $880 to reinvest in the stock. If that stock went up another 20% to $1,056 and you sold at the new 20% capital gains rate and 3.8% Obamacare tax, it would result in another $41 in taxes. That would give an after-tax balance of $1,014.

If you held the stock into the new rates and it appreciated 20% to $1,200 before you sold, the after-tax balance would be $962.

As long as you sold before the new position went up 77%, you would pay less overall in taxes by selling at that point, Mr. Schuman said.

Even if the position went down, you still would have the option to offset future gains at a higher tax-rate with the losses, he said.

High-yield bonds are an asset class that tax-conscious advisers should consider trimming to lock in lower rates, said Russ Koesterich, chief investment strategist at BlackRock Inc.

“We like the asset class a lot long-term, but it has run up in the past year,” he said.

For example, the $16 billion iShares iBoxx High Yield Corporate Bond ETF (HYG) is up 10% this year and has been hovering near record levels for the past few months.

But pricing isn't the only reason to think about taking a bit off the top of the high-yield position, according to Mr. Koesterich.

“It's the segment of fixed income most vulnerable if we go over the fiscal cliff,” he said.

Another complication is worrying about what overzealous clients will do, something Brent Perry, founder of Piedmont Financial Advisors, learned the hard way.

Without consulting Mr. Perry, a client sold $350,000 of his parents' stock because he thought it better to lock in rates than pay more tax next year. But the stocks were intended to be left to the client and his siblings, rather than used by the parents for income, so the capital gains would have been eliminated through inheritance.

The client paid the government $52,500 for no reason.

“It just didn't make any sense,” Mr. Perry said.

jkephart@investmentnews.com Twitter: @jasonkephart