HOW TO BENEFIT FROM REDUCED CAPITAL GAINS RATES

By Barry R. Marks and William Reichenstein

The Tax Relief Act of 1997 established lower capital gains tax rates for assets held for more than five years and sold sometime after 2000. Special election rules also allow individuals to reset common stock's acquisition date to January 2, 2001, without actually selling the stock and buying it back. A look at strategies that can help you benefit from the changed rates.

The Taxpayer Relief Act of 1997 established lower capital gains tax rates for assets held for more than five years and sold sometime after 2000. The maximum federal capital gains tax rate is lowered from 10% to 8% for low-income individuals and from 20% to 18% for higher-income individuals. Low-income individuals are those who are subject to the 10% or 15% federal ordinary income tax bracket. Higher-bracket individuals are those subject to the 25% or higher tax bracket. [The 2001 Tax Act slowly lowers tax brackets. In 2001, the 18% capital gains tax rate applies to individuals in the 27.5% or higher tax bracket. By 2006, it will apply to individuals in the 25% or higher brackets. Go to the on-line version of this article at www.aaii.com for a link to more information on these changes.] Different rules apply to low-income and higher-income individuals.

In addition, the Taxpayer Relief Act provides special election rules that allow someone to reset common stock's acquisition date to January 2, 2001, without actually selling the stock and buying it back. Individuals who wish to make this special election must file proper paperwork when they submit their 2001 taxes in 2002.

In this article, we will explain the lower tax rates and the special election; we will also present associated stock strategies.

THE NEW RATES

The Taxpayer Relief Act lowered the maximum federal capital gains tax rate from 10% to 8% for individuals who are subject to the 15% or lower ordinary income tax bracket. The 8% tax rate applies to assets sold after December 31, 2000, and held for at least five years. Note that the acquisition date does *not* have to be after 2000.

The maximum federal capital gains tax rate is lowered from 20% to 18% for individuals who are subject to the 25% or higher ordinary income bracket. The 18% tax rate applies only to assets *acquired after December 31, 2000,* and held for more than five years.

THE SPECIAL ELECTION

The special election allows individuals to reset a financial asset's acquisition date without actually selling the asset and buying it back in order to qualify for the lower capital gains tax rate. The reset date is January 2, 2001, for readily tradable stock, including shares in open-end mutual funds. Moreover, individuals do not have to decide whether to make this special election until they file for 2001 taxes in 2002. If they make the special election, subsequent gains, if held for more than five years, qualify for the 18% tax rate. The rules differ for business assets and common stocks not listed on an exchange, but these assets are not considered here. Henceforth, we assume the financial asset is common stock since stocks have the best potential for capital gain.

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TABLE 1. THE SPECIAL ELECTION DECISION

Special Election Exercised	Taxes Due April 2002	Taxes Due April 2007
No	$ 0	$1,240
Yes	300	846
Difference	–$300	$ 394

To illustrate the special election, suppose Jack bought $10,000 of XYZ stock on June 30, 1998. From BigCharts.com (www.bigcharts.com) or another source, he finds its value was $12,000 based upon its closing price on January 2, 2001. If he makes the special election when filing his 2001 tax returns, he recognizes the $2,000 capital gain, resets the acquisition date to January 2, 2001, and resets the cost basis to $12,000. He owes $400 in taxes on the recognized gain. But the maximum capital gains tax rate will be 18% on subsequent gains held more than five years. If he does not make the special election, the maximum tax rate remains at 20% since the asset was not acquired after 2000.

The special election can also be applied when there is a built-in capital loss on January 2, 2001. However, the taxpayer would permanently lose the tax benefit of the capital loss.

STRATEGIES FOR THE 8% RATE

In this article, we'll first take a look at scenarios and investment strategies for low-income individuals who are subject to the 8% capital gains tax rate. We'll then present scenarios and strategies that apply to the 18% tax rate.

Scenario 1: Janet acquires $10,000 of stock on December 31, 1995, and sells it for $14,000 in 2001. The 8% tax rate applies here, since the five-year holding period begins on the date she acquired the asset.

Scenario 2: Amanda, a college senior, will be in the 8% capital gains bracket in 2001 but expects to be in a higher capital gains tax bracket in 2002 and beyond. Her cost basis is $10,000, the acquisition date was more than five years earlier, and the market value on January 2, 2001, is $14,000. To lock in the 8% tax rate in 2001, she could sell the stock in 2001 and immediately buy it back. (Wash sale rules do not apply to the realization of capital gains.) Her better strategy, however, is to plan to make the special election at tax filing time. For simplicity, we assume taxes are filed in April 2002. If the stock's value in April 2002 is higher, the same, or even slightly lower than $14,000, she uses the $14,000 "selling price" on January 2, 2001. If the value subsequently falls to, say, $10,000 she would not make the special election. In essence, the special election gives her the option to lock in the January 2, 2001, selling price *if she so chooses* when she files her 2001 tax returns.

Scenario 3: Amanda's parents purchased stock more than five years ago for $10,000, it is worth $14,000, and they are in the 20% capital gains tax bracket. They want to sell the stock to finance Amanda's senior year in college. To reduce taxes, the parents could give the stock to Amanda. She would sell it and pay 8% taxes on the capital gain. Moreover, this strategy is not limited to 2001. For example, the gift and sale could occur in 2002 or 2003 or later.

18% STRATEGIES

Scenario 4: Sam acquired stock before 2001 with a cost basis of $10,000. Its market value on January 2, 2001, is $11,500. It is now April 2002, the stock's value is $12,000, and he is ready to file his income taxes. Should he make the special election? If he makes the special election, he must pay $300 in taxes in April 2002, but he is eligible for the lower tax rate on subsequent gains. As we shall see, he must weight the disadvantage of accelerating payment of the $300 tax bill against the expected advantage of a lower total tax bill.

We provide a framework that should prove useful to relatively passive investors. It assumes the individual will sell the asset in calendar year 2006 and pay taxes at 18%. This framework is not appropriate for active investors because they will likely sell the stock before attaining the five-year minimum holding period in 2006. In addition, it is not appropriate for very passive investors who expect to avoid capital gains taxes altogether. Capital gains taxes can be avoided by eventually giving the appreciated asset to charity and by holding the asset until death, at which time the cost basis is stepped-up (or increased) to the value at death.

Sam must decide in April 2002 whether to make the special election. He knows the cost basis, the January 2, 2001, value, and the current (April 2002) value. The only thing he does not know is the market value at the sale date in 2006. One rational estimate for common stocks may be that the price will appreciate about 35% to $16,200 by the sale date in 2006. If he makes the special election, he recognizes the $1,500 gain as of January 2, 2001, and must pay $300 in taxes today (April 2002). In addition, he resets the acquisition date to January 2, 2001, and the cost basis to $11,500. The 2006 sale results in a $4,700 gain, and a tax bill of $846 (18% of $4,700) to be paid in April 2007. His total tax bill is $1,146. If he does not make the special election, he sells the stock in 2006 for $16,200. He pays $1,240 in taxes (20% of $6,200, $16,200 – $10,000) in April 2007. In this case, Sam must decide in April 2002 whether to accelerate $300 in tax payments in anticipation of a $94 lower tax bill, $1,240 – $1,146.

The bottom row of Table 1 summarizes the analysis. If Sam makes the special election, he pays $300 more in taxes in April 2002 and pays $394 less in taxes in April 2007, $1,240 – $846. Assuming the stock is eventually sold at a gain, the special election results in a lower total tax bill, but an acceleration in $300 of that tax bill. This is like making a $300 "investment" in April 2002 and selling it for $394 after taxes in April 2007. This "investment" has a 5.6% aftertax rate of return. At this point, Sam must decide whether to accept this aftertax rate of return—that is, whether to make the special election.

What is an acceptable aftertax rate of return? Historically, *aftertax* stock returns have averaged perhaps 7% to 8% a year. We assume people will not want to make the special election unless it offers an aftertax annual return of at least 10%. This high hurdle rate reflects people's inertia; they would not want to bother with the special election unless it appears particularly *promising*. Doing nothing is always an option.

For each percent price appreciation (above the original cost basis) through January 2, 2001, Table 2 presents the minimum price appreciation at the sale date in 2006 and the corresponding dollar values that produce a 10% effective rate of return. In the prior example, the value on January 2, 2001, was $11,500, a 15% appreciation. Sam should make the special election if he anticipates the price in 2006 will be at least 107% above the original $10,000 cost basis, or $20,700. This is the key decision.

The last two columns are based on the assumption that the price will appreciate 35% between April 2002 and the sales date in 2006. Given this assumption, Sam should make the special election if the April 2002 price is at least 53% above the original cost basis, or $15,300. If Sam chooses to use this information, he would not make the election if the stock's value is $12,000 in April 2002; the acceleration of $300 in taxes is not worth the $94 lower total tax bill. But he would make the election if the stock's value is at least $15,300 in April 2002; the acceleration of $300 in taxes is worth the much lower anticipated total tax bill.

Table 2 indicates that the decision to make the special election is dependent upon the percent price appreciation through January 2, 2001, and the anticipated sale price in 2006. The easiest decision is when the January 2, 2001 value equals the cost basis. In this case, the election should be made since there is no acceleration in taxes and it makes future gains eligible for the reduced capital gains tax rate.

The next row indicates that it often pays to recognize a small gain through the election. Suppose 100 shares of XYZ stock is purchased for $10,000 in 1999. Its value is $10,500 on January 2, 2001, and the anticipated sale price in 2006 is at least $13,600. The individual should make the special election. The small ($100) tax paid based on the 5% built-in gain will likely be adequately rewarded in terms of a lower total tax bill.

From Table 2, if the price has appreciated 15% or more through January 2, 2001, the special election should only be made if the anticipated sale price in 2006 is at least double the original cost basis. In general, it does not make sense to accelerate taxes on a 15% or larger capital gain. The exception is if there has been a huge run up in price between January 2, 2001, and the decision date in April 2002. For example, Mary should make the special election if she buys a stock for $10,000 and its values on January 2, 2001, and April 2002 are $12,000 and $30,000, respectively. In this case, she should make the

TABLE 2. GUIDELINES FOR MAKING THE SPECIAL ELECTION DECISION

Price Apprec. Thru 1/2/01	Value of Stock on 1/2/01	Minimum Required to Produce 10% Aftertax Return: Through Sale Date in 2006		Minimum Required to Produce 10% Aftertax Return: Through April 2002	
		Min. Price Apprec.	Min. Stock Value	Min. Price Apprec.	Min. Stock Value
(%)	($)	(%)	($)	(%)	($)
0	10,000	0	10,000	0	10,000
5	10,500	36	13,600	1	10,100
10	11,000	71	17,100	27	12,700
15	11,500	107	20,700	53	15,300
20	12,000	142	24,200	79	17,900
25	12,500	178	27,800	106	20,600
30	13,000	213	31,300	132	23,200
35	13,500	249	34,900	159	25,900
40	14,000	284	38,400	184	28,400
45	14,500	320	42,000	211	31,100
50	15,000	355	45,500	237	33,700

These guidelines assume that, if the special election is made, the individual will sell the asset in 2006. Taxes are paid in April 2002 on gains through January 2, 2001, and in April 2007 on subsequent gains. The election results in an acceleration of some taxes in return for a lower total tax bill. This trade-off can be viewed as an "investment." The table presents minimum values and price appreciations that produce an acceptable 10% aftertax return on this "investment" and therefore justify making the election. The table assumes an original cost basis of $10,000, but the lessons apply equally for other cost bases. Note that the numbers in the last two columns assume that the price appreciates 35% between April 2002 and the sale date in 2006.

special election because of the anticipated substantial tax savings.

Scenario 5: Joe owns stock with a cost basis of $10,000 and it is worth $14,000 on January 2, 2001, and the anticipated sale price in 2006 is $20,000. Based on Table 2, he should not make the special election in April 2002. Suppose, however, that the stock's value later falls to, say, $10,100. At that time, he probably should recognize the trivial gain by selling and immediately buying back the stock. These transactions would not violate wash sale rules since they do not apply to the realization of gains. He would owe a trivial capital gains tax ($20) but would make future gains eligible for the 18% tax rate. The ideal situation would be to sell the stock at the cost basis so that there would be no capital gains. But paying a small tax can make sense since it makes subsequent gains eligible for the 18% tax rate.

Given stock returns since March 2000, this strategy looks particularly promising. Many individuals will own stocks that are selling at or near their pre-2000 acquisition price. By selling and buying them back, they make future gains (held more than five years) eligible for the 18% tax rate.

Scenario 6: Martha owns stock with a basis of $10,000 that was acquired in 1998. Its market value on January 2, 2001, is $9,000 and its value in April 2002 is $11,000. If she makes the special election and resets the acquisition date to January 2, 2001, the new basis is $9,000 but she *cannot* claim the $1,000 capital loss. She permanently loses the tax benefit of the $1,000 loss. Moreover, future capital gains will be higher since the new cost basis is $9,000 instead of $10,000. Normally, people *should not* make the special election for assets that have a built-in capital loss on January 2, 2001. The exception exists if there is a trivial built-in loss on January 2, 2001, and the price soars between January 2001 and April 2002. The lost benefit from a trivial capital loss may be offset by lower taxes on a large subsequent gain.

If the stock's value in April 2002 is below the cost basis, she could sell the stock in a market transaction and thus receive the benefit of the tax loss. She could later repurchase the same stock as long as the purchase does not violate wash sale rules. A wash sale occurs when the same stock (or a long position in a call option or short position in a put option on the same stock) is bought within the period of 30 days before to 30 days after the sale date.

Scenario 7: This scenario describes a situation where it makes sense to make the special election even though there is a small built-in loss. Martha owns stock with a basis of $10,000. Its market value was $9,700 on January 2, 2001, and $12,000 in April 2002. If she makes the election, she loses the tax benefit of the $300 loss but stands to benefit from the lower capital gains tax rate if the stock is sold in 2006 or beyond. A quick way to compare the trade-off is to estimate the future tax bill with and without the special election. As before, assume the stock appreciates 35% to $16,200 at the date of sale in 2006. Taxes on the gain will be $1,170 (18% of $6,500, that is, $16,200 – $9,700) with the election and $1,240 (20% of $6,200) without the election. So, the election should be made. The only way the disallowed loss on January 2, 2001, enters the analysis is to reduce the cost basis to $9,700 and thus increase the future capital gain.

CONCLUSION

The maximum federal capital gains rates have been lowered on business and capital assets held for more than five years and sold sometime after 2000. For individuals subject to the 15% or lower federal ordinary income tax bracket, the maximum capital gains tax rate has been lowered to 8% for assets held more than five years. The asset's acquisition date could be before 2001. For individuals subject to the 25% or higher ordinary income tax bracket, the maximum capital gains tax rate has been lowered to 18% for assets acquired *after 2000* and held more than five years.

In addition, a special election allows individuals to reset a financial asset's acquisition date without actually selling the asset and buying it back. This allows future gains to qualify for the 18% tax rate. The reset date is January 2, 2001, for listed common stock and shares in open-end mutual funds. Moreover, individuals do not have to decide whether to make this special election until they file for 2001 taxes in, say, April 2002. We present the proper analytic framework for making the special election decision.

It often makes sense to make the election if there is a small (5% or less) built-in capital gain on January 2, 2001. It seldom makes sense to make the election if there is a large (15% or more) built-in gain on January 2, 2001. The exception to the latter statement occurs when there is a substantial increase in value between January 2, 2001, and the decision date in April 2002. The special election results in acceleration in some taxes for a lower total tax bill. We present guidelines to help make this election decision.

Individuals cannot recognize a loss with the special election. Suppose the asset's value on January 2, 2001, is less than its original cost basis. If the election is made, the cost basis is lowered to the value on January 2, 2001, and the individual permanently loses the benefit of the built-in loss. Thus, it seldom makes sense to make the election when there is a built-in loss on January 2, 2001. ✥