PORTFOLIO STRATEGIES WORKSHOP

Stocks With Gains But No Potential: Sell Now, or Hold for Your Heirs?

By Maria Crawford Scott

John Geste, 76, has lived by himself since his wife died two years ago. He gets by quite well on his own with the help of his children, who visit him often.

Mr. Geste currently has about $400,000 in total savings, including assets in IRA accounts and taxable holdings. He lives modestly off of his Social Security payments, pension payments and savings, although he really does not need to spend much from his savings. Even when his wife was alive, the couple did not need to dip very heavily into their savings, and Mr. Geste's expenses are even lower now, primarily because he does not do as much traveling. He does withdraw monies from his retirement plans each year, but that is primarily due to the minimum distribution requirements; most of the withdrawals he either gives to his children and grandchildren in gifts or puts into one of his taxable investment accounts.

Since his wife died, Mr. Geste has spent very little time on his financial concerns. First of all, he did not feel like making any major decisions right after his wife's death. In addition, he felt that major changes really were unnecessary.

Currently, Mr. Geste's tax-deferred retirement assets account for a quarter—$100,000—of his total investment portfolio, and they are invested in two different diversified stock mutual funds. Mr. Geste also has $80,000 in taxable holdings invested in a large-company stock mutual fund. These stock mutual funds add needed diversification to his investment portfolio, which includes a major holding in a single stock with a current market value of about $150,000. The remaining $70,000 in taxable holdings are invested in an intermediate-term bond fund.

The single stock holding is in the company in which Mr. Geste worked for most of his working years. Each year in which he was employed at the firm, he purchased a small amount of company stock. The Gestes never really thought of the annual purchases as a major investment, and they made other investments to build up their savings portfolio. But the company grew steadily and the couple held onto the shares for decades; the shares have since appreciated many times over.

In fact, it is that single stock holding that is the one problem currently nagging Mr. Geste. He and his wife had always refused to sell the shares, at first because the company was doing so well and Mr. Geste firmly believed in its future growth potential. As the years went by and their holdings appreciated, their basis in the company shares became an increasingly smaller percentage relative to the current market value. The couple then became loathe to sell the shares because they would have to pay capital gains taxes on virtually the entire holding. Why incur such a large tax bill, as long as the company continued to grow as fast as alternative investments? In addition, as they approached their retirement years and realized they did not need to dip into their single-stock holding, another possibility loomed—they could pass the stock on to their children, where it would receive a step-up in basis and thus not be subject to any capital gains tax if their children wanted to sell the shares when they received them.

Now, though, the capital gains tax rate has been lowered. In addition, the company itself is going through a re-adjustment—the market for its product is expanding only modestly, and the company's future growth possibilities are uncertain. Mr. Geste does not expect the share price to drop from where it is, but he really doesn't see it growing very much during the next few years, and perhaps even beyond that.

Should he bite the bullet and sell the shares now, paying capital gains taxes at the new lower rate (as well as

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Table 1.
Passing Shares to Heirs: Avoid Capital Gains or Seek Higher Returns?

Table indicates returns required by alternative investment to overcome capital gains taxes.
It assumes a 20% capital gains tax rate on shares sold now; no taxes on shares sold at end of holding period; and 1% transaction costs.

All Appreciation
(No basis)

No. Yrs.	Expected Return of Current Holding: 0%	2%	4%	6%	8%	10%	12%
	Return Required by Alternative Investment (%):						
1	25.3	27.8	30.3	32.8	35.3	37.8	40.4
3	7.8	10.0	12.1	14.3	16.4	18.6	20.8
5	4.6	6.7	8.8	10.9	13.0	15.1	17.2
10	2.3	4.3	6.4	8.4	10.5	12.5	14.6
15	1.5	3.5	5.6	7.6	9.6	11.7	13.7
20	1.1	3.2	5.2	7.2	9.2	11.2	13.3
25	0.9	2.9	4.9	7.0	9.0	11.0	13.0
30	0.8	2.8	4.8	6.8	8.8	10.8	12.8

Stock Appreciated 400%
(Basis is 20% of current market value)

No. Yrs.	Expected Return of Current Holding: 0%	2%	4%	6%	8%	10%	12%
	Return Required by Alternative Investment (%):						
1	19.3	21.7	24.0	26.4	28.8	31.2	33.6
3	6.1	8.2	10.3	12.4	14.5	16.7	18.8
5	3.6	5.7	7.7	9.8	11.9	13.9	16.0
10	1.8	3.8	5.8	7.9	9.9	12.0	14.0
15	1.2	3.2	5.2	7.3	9.3	11.3	13.3
20	0.9	2.9	4.9	6.9	9.0	11.0	13.0
25	0.7	2.7	4.7	6.8	8.8	10.8	12.8
30	0.6	2.6	4.6	6.6	8.6	10.6	12.7

Stock Appreciated 100%
(Basis is 50% of current market value)

No. Yrs.	Expected Return of Current Holding: 0%	2%	4%	6%	8%	10%	12%
	Return Required by Alternative Investment (%):						
1	11.2	13.5	15.7	17.9	20.1	22.4	24.6
3	3.6	5.7	7.8	9.8	11.9	14.0	16.0
5	2.2	4.2	6.2	8.3	10.3	12.4	14.4
10	1.1	3.1	5.1	7.1	9.2	11.2	13.2
15	0.7	2.7	4.7	6.8	8.8	10.8	12.8
20	0.5	2.5	4.6	6.6	8.6	10.6	12.6
25	0.4	2.4	4.4	6.5	8.5	10.5	12.5
30	0.4	2.4	4.4	6.4	8.4	10.4	12.4

Stock Appreciated 900%
(Basis is 10% of current market value)

No. Yrs.	Expected Return of Current Holding: 0%	2%	4%	6%	8%	10%	12%
	Return Required by Alternative Investment (%):						
1	22.2	24.7	27.1	29.6	32.0	34.4	36.9
3	6.9	9.1	11.2	13.3	15.5	17.6	19.7
5	4.1	6.2	8.3	10.3	12.4	14.5	16.6
10	2.0	4.1	6.1	8.1	10.2	12.2	14.3
15	1.3	3.4	5.4	7.4	9.5	11.5	13.5
20	1.0	3.0	5.0	7.1	9.1	11.1	13.1
25	0.8	2.8	4.8	6.9	8.9	10.9	12.9
30	0.7	2.7	4.7	6.7	8.7	10.7	12.8

Stock Appreciated 150%
(Basis is 40% of current market value)

No. Yrs.	Expected Return of Current Holding: 0%	2%	4%	6%	8%	10%	12%
	Return Required by Alternative Investment (%):						
1	13.8	16.1	18.3	20.6	22.9	25.2	27.4
3	4.4	6.5	8.6	10.7	12.8	14.8	16.9
5	2.6	4.7	6.7	8.8	10.8	12.9	14.9
10	1.3	3.3	5.4	7.4	9.4	11.4	13.5
15	0.9	2.9	4.9	6.9	8.9	11.0	13.0
20	0.6	2.7	4.7	6.7	8.7	10.7	12.7
25	0.5	2.5	4.5	6.5	8.6	10.6	12.6
30	0.4	2.4	4.4	6.5	8.5	10.5	12.5

Stock Appreciated 25%
(Basis is 80% of current market value)

No. Yrs.	Expected Return of Current Holding: 0%	2%	4%	6%	8%	10%	12%
	Return Required by Alternative Investment (%):						
1	4.2	6.3	8.4	10.5	12.5	14.6	16.7
3	1.4	3.4	5.4	7.5	9.5	11.5	13.6
5	0.8	2.8	4.9	6.9	8.9	10.9	12.9
10	0.4	2.4	4.4	6.4	8.4	10.5	12.5
15	0.3	2.3	4.3	6.3	8.3	10.3	12.3
20	0.2	2.2	4.2	6.2	8.2	10.2	12.2
25	0.2	2.2	4.2	6.2	8.2	10.2	12.2
30	0.1	2.1	4.1	6.1	8.1	10.2	12.2

transaction costs), and then reinvest in a stock mutual fund that promises a greater rate of growth as well as a more diversified portfolio?

Or should he hang on to the shares for the remainder of his life, earning a lower rate of return but avoiding a capital gains tax altogether?

The answer, of course, is a function of the rates of return Mr. Geste could receive on the alternative investment, the rate of return he expects for the stock, and the length of time invested—in this instance, his life expectancy.

Mr. Geste runs through a number of calculations. First,

he determines how much his current stock would grow to based on various growth rates and various holding periods; he also subtracts 1% from the final amount, since he assumes that his children would sell the shares once they inherited them.

Next, he determines the annual return an alternative investment would have to achieve in order to grow to the amount achieved by the single-stock inheritance. This calculation assumes that Mr. Geste sells his shares now, pays capital gains taxes on the entire amount (at a 20% rate), pays a 1% transaction fee, and then reinvests in the alternative investment. The results of these calculations are shown in the first table in Table 1, labeled "All Appreciation."

Mr. Geste currently expects that his single-stock holding will, at worst, gain 4% annually over the next few years, based on how the company has done in recent years and analysts' earnings projections. Mr. Geste feels a good growth mutual fund could probably do better if he were to pick the "right" one.

On the other hand, he doesn't expect to live much longer. Currently, he feels fine and he is able to get around quite well. But he has had a history of heart trouble, and his own family history is not one of long life expectancies. Realistically, he feels he will not live much longer than five years.

Based on his spreadsheet in Table 1, Mr. Geste realizes that he would need to find an alternative investment that would earn 8.8% annually—more than double his single-stock's expected rate of return—if he were to sell his shares now and pay the tax. If his single stock achieved a greater rate of return than he expected—say 6% annually—the alternative would need to earn 10.9% annually. On the other hand, if he were to live longer—say 10 years—and his single-stock investment achieved a 4% annual rate of return, the alternative investment would only need to earn 6.4% annually to overcome the drag of capital gains taxes.

What to do?

Mr. Geste decides to hang on to the stock and pass it on to his children free of capital gains taxes. He is relatively confident that his single stock will not do significantly worse than the overall market over his remaining lifetime. And while a growth or an aggressive growth fund may do better than the market, Mr. Geste is not confident in his ability to pick the right fund. He does not want to take the risk of picking a fund that may end up doing worse than the market. Of course, this risk must be balanced against the risk he has undertaken by having such a large portion of his portfolio in a single stock, but he decides to accept that risk. Lastly, while Mr. Geste would not allow tax considerations to push him into a bad decision, the avoidance of taxes gives him a certain amount of satisfaction that is enough to sway his decision when it's a close call.

To Pay, or Not to Pay?

Taxes and transaction costs will significantly lower your rate of return, and they should be avoided when possible. But the compounding effect of higher rates of return add up quickly and at some point will overcome the negative impact of paying taxes. In general, it is not a good idea to allow tax considerations to drive your investment decisions.

On the other hand, there are times when tax considerations loom larger—in particular, for older investors when your probable holding period becomes short and there is the possibility that you can avoid paying taxes altogether by allowing heirs to receive shares with a step-up in basis. At that point, it becomes a much tougher question, requiring a prediction of the return of one investment relative to another and an estimate of your own life expectancy. You should also keep in mind any special risks you may face in your investment decision—for instance, an undiversified portfolio.

The tables presented here may provide some guidance. They indicate the rates of return that an alternative investment would need to achieve to overcome the drag of paying capital gains taxes (and a 1% transaction fee) and provide an amount equal to a current holding that is growing at a given rate of return and in which taxes are avoided. Each table assumes a different basis level for the current holding (the basis is the amount you originally paid for the shares). For instance, a holding with a 50% basis (basis divided by current price) assumes that the current holding has already doubled in price.

Not surprisingly, the tables indicate that keeping the current holding rather than selling is more likely to be advantageous if:

- Your holding period is shorter (less than five years).
- If your basis is low relative to the current market value (in other words, your shares have appreciated greatly).
- If you expect your current holding to do only moderately worse than the alternative.

On the other hand, if you have a longer holding period, your current holding is expected to do badly, and your basis is relatively high compared to the current market value, you are probably better off simply selling now, paying Uncle Sam his dues, and reinvesting in a higher-returning asset.