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Strategies to Consider For Securities With Large Capital Gains

By Clark M. Blackman II and Thomas C. Myers

This is the first of two articles dealing with tax concerns and investment strategies relating to appreciated securities. There are many opportunities to reduce the tax burden, although the applicability of most of these strategies will vary widely from case to case.

One time-worn adage known to tax advisers and financial planners is "don't let the 'tax' tail wag the 'investment' dog." It applied in the days of "5-to-1 tax write-offs" for limited partnership investments and it still applies today. Every serious investor should heed its warning. As important as tax considerations can be, sound investment judgment should always be applied first.

Regardless of what Congress might do to lower capital gains taxes, investors will likely struggle with the dilemma of whether to sell an investment and realize a capital gain (thus paying tax) or hold on to a stock they aren't particularly enamored with anymore. And this concern is justified. Investment costs must be carefully managed to protect your investment return.

First, let's deal with the simplest strategy—waiting until tax rates are reduced before selling. This can be particularly appropriate to consider when Congress begins to talk seriously about lowering the capital gains rate. It also applies when you determine that it would be to your benefit to defer the tax to a later tax year. Finally, it is a strategy used by older investors who will receive a "stepped-up basis" at death. In this instance, securities included in the deceased investor's estate are exempt from income tax on the appreciation in the security as of the date of death (or six months later if the alternate valuation date is chosen).

[This issue can get a little cloudier when you consider that estate taxes may be higher by having to include the full before-tax value in the estate tax calculation. Estate tax rates can be as high as 60% and reach 55% for an estate that is as little as $3 million. However, this gets into the realm of estate planning, and a further discussion of this issue is beyond the scope of this article.]

Does it make sense to wait for tax relief?

It depends. What do you expect the security to earn between now and then? If the stock price drops, the advantage of the lower capital gains rate could be wiped out. The formula in Table 1, taken from an *AAII Journal* article that appeared the last time this was an issue in 1990 ["Capital Gains: Sell Now, or Wait for Legislative Relief?" by Clark Blackman, August 1990) is still applicable today. You can use this formula to determine how much the security price has to drop before you eliminate the benefit of the lower tax rate.

To fine-tune the results, you should decrease the "calculated" downside swing rate of return by the aftertax risk-free rate of return; this is the return you could have received with no risk if you had sold the security and paid the tax. This rate should be further adjusted for the pro-rata amount of the investment lost due to taxes. For example, if the risk-free rate (typically defined as the 30-day Treasury bill rate, but arguably could be the Treasury rate for the time period you intend to hold the security) is 4% for one year and you are in a 40% tax bracket, your aftertax risk-free rate of return for one year is 2.4% (4% × (1 – 0.40)). Furthermore, assume your tax basis is 50% of the current market value of the security. If you were to sell the security, you would retain 86% of the current market value of the stock (28% tax rate × 50% of the total value = 14%; 100% – 14% = 86%). Therefore, you would earn 2.4% on 86% of the current market price, or roughly 2.1%. Subtract this annual rate from the return by which your security would have to change in price before you reach a breakeven point with taxes paid. (Table 1 shows the fine-tuning formula).

Remember, the downside swing formula indicates the percentage drop in current stock value that will eliminate the benefit of any capital gains tax rate differential; by subtracting the risk-free rate you could have earned on the "sold" securities, you are reducing the

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Table 1.
Determining the Downside Swing

The Formula: Determining the percentage drop in current stock value that will eliminate the benefit of any capital gains tax rate differential.

$$\left[\frac{\text{Investment's Taxable Gain}}{\text{Investment's Current Value}}\right] \times \left[1 - \frac{1 - \text{Current Tax Rate}}{1 - \text{New Tax Rate}}\right] = \text{Downside Swing (\%)}$$

Applying the Formula: An Example
(Assuming a current capital gains tax rate of 28% and a potential future rate of 20%)

Stock A:	Current value	$ 1,000
	Original cost	–500
	Taxable gain	$ 500

$$\left(\frac{500}{1{,}000}\right) \times \left(1 - \frac{1 - 0.28}{1 - 0.20}\right) = 0.05 = 5.0\%$$

A 5.0% drop in stock value would eliminate the advantage of a drop in tax rates. This applies regardless of the time period the stock is held—i.e., it is not *an annnualized rate.*

Fine-Tuning the Formula

$$\text{Downside Swing (\%)} - \left[\text{Risk-Free Rate*} \times (1 - \text{Marginal Rate}) \times \left[1 - \left(\frac{\text{Taxable Gain}}{\text{Current Value}} \times \text{Capital Gains Tax Rate}\right)\right]\right]$$

An Example for Stock A
(Assuming an annual risk-free rate of 4% and a marginal tax bracket of 40% and a capital gain rate of 28%)

$$\begin{aligned}\text{Downside Swing} &= 0.05 - \left[0.04^{**} \times (1 - 0.40) \times \left[1 - \left(\frac{500}{1{,}000} \times 0.28\right)\right]\right]\\ &= 0.05 - (0.024 \times 0.86)\\ &= 0.05 - 0.02064\\ &= 0.02936 \text{ or } 2.9\%\end{aligned}$$

A 2.9% drop in stock value would eliminate the advantage of a drop in capital gain tax rates.

**This rate represents the return over the entire holding period. Therefore, if you will hold the stock for six months, use a rate representative of six months (½ the annual rate); if for five years, compound the annual rate for five years.*
***Assumes you will hold the security for one year before sale.*

amount of a drop that would result in breaking even and losing the benefit of the lower tax rate.

Basic Rules for Realizing Gains

Before going further, let's review some basic rules on recognizing realized capital gains for income tax purposes:

1. A gain is realized whenever a security is disposed of in a "taxable" transaction. Generally, tax rules define a taxable transaction as any disposition that is not specifically excluded as a non-taxable exchange. Common non-taxable exchanges include:
   - Gifts
   - Transfers to charities
   - Qualifying like-kind exchanges
   - Certain dispositions of principal residences

- Certain contributions to corporations and partnerships

2. Capital losses during the same tax year, or carried forward from previous tax years, can be used to offset capital gains in the current year.
3. Long-term capitals gains, at the time of this writing, are taxed at the lower of your marginal regular income tax rate or 28%.
4. Short-term gains (on assets held less than one year) are taxed as other ordinary income at your top marginal tax rate.

Now we can address some of the more common tax dilemmas and popular tax strategies used to delay and/or avoid capital gains tax.

When the highly appreciated security is "employer stock" in a qualified retirement plan.

In this situation, it may be wise to take the distribution in stock and pay tax only on the original value of the stock when it was purchased. Consequently, the stock would be carried until it is sold and taxed using capital gains rates in effect at that time. This strategy allows you to avoid the ordinary income tax that would otherwise be due when the qualified plan distributes your assets—either during retirement or at your death.

When you have capital losses in your portfolio.

Since capital losses can reduce capital gains, it may be beneficial to realize these losses before year-end. However, you must consider the transaction costs of this strategy if your goal is to buy back this security in the near future. If you do buy back the security be aware of the "wash sale" loss rules. These rules require you wait at least 30 days before buying back a security (or a substantially equivalent security).

When making gifts to family members in a lower tax bracket.

As mentioned earlier, gifts are not a taxable disposition. Therefore, consider gifting appreciated stock. By gifting stock, you do not pay capital gains tax. You have passed along the gain to the benefactor of your generosity. The recipient receives a "carryover" tax basis. On disposition, they will pay whatever tax rate is applicable to them at that time. The downside to this strategy is that you will be using up part of your $10,000 annual gift exclusion to transfer a tax liability to the recipient.

When making charitable contributions to qualifying charities, community foundations, and private foundations.

If you are charitably inclined and wish to make a contribution to charities directly or via community or private foundations, consider donating appreciated stock. This approach generally allows you to avoid capital gains tax while taking a deduction for the full fair market value of the stock. The charity may then sell the stock with no tax consequences.

Be wary of using private foundations however, because they can have significant ongoing costs and potential liability to the donor. Furthermore, the ability to deduct the full appreciated value of the security continues to come and go at the whim of Congress.

Charitable Remainder Trusts

These vehicles can be designed to provide significant benefit to individuals. They are complex and a discussion of when these particular strategies are appropriate is beyond the scope of this article. Due to the cost, complexity, and on-going maintenance involved, this strategy is generally not recommended unless the gain you wish to defer is substantial.

Advanced Risk Management

The "short-against-the-box" strategy is one of today's best known tax-deferral strategies for individuals with large capital gain buildup, in no small part due to recent proposed legislation that would ban or severely restrict its use.

The short-against-the-box strategy isn't for everybody, and it is unlikely to survive the current round of tax law changes. In its simplest form, an individual would lock in a gain for a relatively short period of time to defer a gain to the next tax year. It works because a "short" position in a stock exactly offsets the long position (your original investment) in your stock. When the stock moves down two points, the value of the short position goes up two points, exactly offsetting the loss. The opposite is true as well, effectively eliminating any future gain on the stock. The cost of this strategy is not inconsequential. There are brokerage commissions relating to the transaction, a loss of dividends, and the proceeds from the short sale are locked up as collateral with no interest being paid. You wouldn't want to hold this position open for extended periods of time.

However, in its more sophisticated form, the short-the-box strategy could be used to "monetize" a large holding in an appreciated stock. For large holdings—of, say, $5 million or more—an investor may be able to find a brokerage firm to help structure a strategy that makes sense to the investor. It is this strategy that the Estee Lauder family used to avoid capital gains tax altogether when the originally-held long position passed through the estate and received a full step-up in basis. The short and long positions were then closed with minimal income tax effect.

Here's how it can work: Once the short position is in place, the investor agrees to leverage the long position that the broker holds against the short position. The broker can lend up to 95% of the long position, but to help avoid margin calls, this is generally limited to 90%. So, for a $5.0 million holding, the investor has pulled out $4.5 million. The investor pays margin interest on the "loan." However, the investor receives interest, albeit at a lower rate, on the $5 million proceeds from the short sale. Depending on where interrest rates go, the investor can lose money, or make money, on the two pools of funds. The investor further agrees to invest the borrowed $4.5 million with the broker, so the broker makes money on the new transactions being generated. Everyone wins . . . except for Uncle Sam, especially if the investor dies before the positions are closed and receives a step-up in basis on the long position. In effect, no capital gains tax is ever paid.

Other Strategies

Here are some other risk-management strategies that will be dealt with in greater detail in our next article:

Equity Swaps: This is a strategy used to defer large amounts of capital gain. It involves the use of a large third-party financial institution who will swap a return on an agreed upon index (e.g., Standard & Poor's 500) in return for the return on your stock.

Writing Calls: Selling "out-of-the-money" calls is one way to enhance your return on an inactive stock if you refuse to sell for tax reasons. It is a dangerous strategy if you guess wrong and the stock price exceeds the option strike price. You could be forced to deliver stock or cash to the exercising call holder.

Selling "deep-in-the-money" calls is a complex strategy of selling calls on your stock using European style calls which can only be exercised on the call date. You can pull a substantial amount of the value from your low basis stock by setting up this strategy with a third-party institution.

Equity Collar: The "equity collar" is one way to manage your risk on a low- or no-cost basis using calls and puts. This strategy, however, has its own risks. It should only be considered if you believe your risk of loss on your stock in the near term is substantial and there is little likelihood of the stock appreciating in value. This entails the selling of a call option several points above the current trading price of the security that you own. These proceeds should be more than enough to allow you to buy a put option on your stock that is some price below the current market value. Examine brokerage costs carefully, as they could easily exceed the excess proceeds from the sale of the call.

Exchange Funds: This is another complex strategy whereby you contribute your highly appreciated publicly traded stock to a partnership, which in turn gives you a limited partnership interest in the pool of diversified investments. There are many caveats and pitfalls to this strategy, which will be discussed in greater detail in Part II. Some exchange funds utilized a short-against-the-box strategy to provide additional diversification. Unfortunately, they may no longer be able to do this if the proposed tax law changes are passed. In addition, other limitations and restrictions being proposed may curtail the use of this strategy as well.

In the next follow-up column, in the October issue, we will discuss these risk management strategies in greater detail. At that time, tax law changes being considered may be in final form and, if so, we will include an update on their import.