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Harvest your capital gains?

Do the math when considering paying taxes now rather than later

By Robert N. Gordon

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A mantra of tax-efficient investing is to harvest capital losses and defer all gains. Does it ever make sense to take capital gains voluntarily?

As a rule of thumb, no, but there are exceptions. Both Howard Marmorstein, associate professor of marketing at the University of Miami School of Business, and David Stein, chief investment officer of Seattle-based Parametric, have explored taking gains in a portfolio context. Taking gains is easy; there are no wash sale rules for capital gains. If you sell for a profit and repurchase the same security within 30 days, the government still wants its money.

Because interest rates are so low, a gain-harvesting opportunity presents itself for investors with unrealized long-term gains on their taxable bonds.

Let's assume that an investor bought an 8% Treasury bond when it was issued at par (100) a few years ago, that there is one year to maturity and that the current one-year interest rate is 3%. In this scenario, the bond will be trade at a premium at a price of 105.

We suggest that the investor sell the bond at 105 and take a $5 long-term gain. That gain will be taxed at 15% and paid next April 15. If the 8% bond is repurchased at 105, the investor now has reset the cost basis to 105. Because the bond will mature at 100, it is preordained that the investor will lose $5.

Section 171 of the Internal Revenue Code allows the investor to offset the $5 loss against the 8% in interest income, netting only $3 of taxable interest income. If the bond is not sold and repurchased, the investor has received $8 in interest income taxed at 37%. After the sale and repurchase, there is only the $3 gain taxed at 37%, while the other $5 is taxed as a long-term gain at only 15%.

You don't need to repurchase the same bond to make sure this works; just make sure your profit is long-term. Doing this on a muni bond, however, would not make sense, because you would be turning tax-free income into long-term gains.

Measuring the value of this exercise to the investor has a lot to do with when the bond will mature. If the bond matures in 10 years, the investor is voluntarily paying a 15% tax now instead of paying tax at a 37% rate as interest is received over the years. Since those future-year dollars are worth a lot less than a dollar today, the after-tax rate of return of paying up early is more than 70% if the bond has just one year to maturity but only about 12% if the bond matures in 10 years.

The same discounting should be done when evaluating accelerating-gain recognition in anticipation of an increase in the capital gains rate.

While Republicans plan no changes in the tax on long-term gains, Democrats are anxious to roll back the Bush tax cuts, in which case the rate would rise to 20%.

Investors wondering whether they should take gains before the rate increases really are asking whether a 20% tax in 2018 is worse than a 15% tax in 2008.

What discount factor would make a client indifferent to paying the capital gains tax at the current rates, versus the higher possible capital gains rates in the future?

I've included a table that shows the discount rates to apply when making the now-or-later decision:

For example, as long an investor earns more than 2.069% annually over the next 10 years, paying a 20% tax in 2018 is preferable to the current rate. Investors with long-term horizons should also remember that capital gains tax is forgiven at death.

Much analysis needs to go into the irrevocable decision to take gains voluntarily. A similar analysis is necessary when deciding to convert a traditional individual retirement account into a Roth IRA.

Many more investors will be looking for help on this if, as planned, the income limits are lifted for conversion eligibility. In a Roth IRA conversion, the investor voluntarily chooses to pay tax today on the money in their IRA rather than pay tax in future years as the IRA is depleted. For those expecting tax rates to increase, the decision is clearer.

Thus, investors should pay tax unnecessarily only under limited circumstances.

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