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Contemplating an 18% long-term rate

If the Bush tax cuts expire, assets held for five years or more could benefit from a 1997 law

By Robert N. Gordon

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Few remember that there was once an 18% tax rate on “super” long-term property. The rate, which was to apply only to property purchased after Dec. 31, 2000, and held more than five years, was part of the Taxpayer Relief Act of 1997, which ushered in the 20% long-term-gains rate.

No taxpayers were ever taxed at the “preferential” 18% rate because the Bush tax cuts in 2003 lowered the long-term gains tax to 15%, rendering the 18% rate superfluous.

But if the Bush tax cuts expire and no new law is passed, we will revert to previous law, which includes the 18% rate.

The reversion may have a significant impact on the way investors deal with capital gains.

Taxpayers should take this into consideration, especially when they contemplate harvesting capital gains to take advantage of today's lower rates.

If your tax is rising to 18%, from 15%, the increase isn't as dramatic as a rise to 20%, from 15%, especially when you get to decide when to take gains.

An 18% rate 10 years from now may not be worse than a 15% tax now.

To qualify for the 18% tax rate, an investor must have purchased the stock or bond after Jan. 1, 2001 and had a “good” holding period of more than five years.

If the property was purchased before 2001, the 20% tax rate would apply.

There is one exception to all this: Taxpayers who owned property purchased before 2001 and wanted to enjoy the 18% tax rate in the future. Those investors were allowed to make what is known as a “deemed-sale” election and be taxed as if they had sold and immediately repurchased their property on Jan. 1, 2001.

This was a one-time election available on a security-by-security basis.

Deemed-sale elections triggered unrealized gains. In cases where deemed-sale elections created a loss, the loss was to be ignored; effectively, it was lost forever. (The loss could have been made more palatable had it been able to be deferred, as in a wash sale.)

Making a deemed sale could have made sense if an investor had positions with little or no gain or loss. Our firm advised those with unrealized losses to sell and repurchase — watching out for the wash sale rule, of course — after Dec. 31, 2000, to reset the holding period to one that could enjoy the 18% rate.

Taxpayers who made this election in 2001 and paid some gains tax or gave up losses may have felt foolish when the Bush tax cuts made the five-year rule moot.

But they may wind up having the last laugh.

If we revert back to pre-Bush capital gains tax law, those with five-year property, which had been purchased before 2001, will be taxed at 20%, unless they made a deemed sale in 2001. The few who made this election would pay just 18%.

None of the calculations above take into account the addition of the 3.8% Medicare tax on investment income that is scheduled to kick in Jan. 1.

There has been much debate as to the fate of that tax if the Supreme Court rules against the president's health care plan.

There are those who think that it is unlikely that the Supreme Court will repeal all the legislation. The 3.8% Medicare tax would remain unless the Patient Protection and Affordable Care Act were repealed in its entirety.

How the Supreme Court rules should be known soon. Unfortunately, I don't think that we will know the fate of the Bush tax cuts until after the presidential election.

At the moment, tax certainty is in very short supply.

Given what we know now, long-term capital gains could be taxed next year at 15%, 18%, 20%, 18.8%, 21.8% or 23.8%.

Stay tuned.

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