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Don't Sell Me Short
Understanding the Tax Implications of Long- & Short-Term Capital Gains

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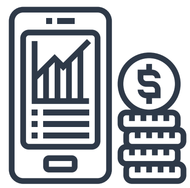

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Key Takeaways:

- The length of time you've owned an investment at the time of sale can impact your tax liability and possibly your net proceeds.
- Running different scenarios is an effective way to understand the potential implications before you sell.
- Consider working with a professional advisor who can help you evaluate the tax obligation based on your overall financial picture.

Are you thinking about selling an investment you've owned for a year or less? Wondering if it's better to wait until it becomes a long-term asset (held more than 12 months)? The answer depends on many factors, including your prediction of the security's future performance. Presumably, you feel the asset has reached or is close to its price potential; otherwise, it wouldn't be a candidate for sale. Another key factor is the potential tax liability. Short-term capital gains are taxed at a higher rate than long-term gains. So, the question becomes, "is it better to sell now and pay taxes based on your ordinary tax rate or hold the asset longer to potentially reduce your taxes, knowing the asset could decline in value while you wait?" Quantifying the numbers may help you make your decision.

Understanding the Capital Gains Tax Rates

Depending on your taxable income, the federal tax rate on long-term capital gains is either 0%, 15%, or 20%. Capital gains from the sale of a short-term asset do not enjoy any preferential treatment. They're taxed at your ordinary income-tax rate, which can be as high as 37%.

Simply illustrated, let's assume you are in the highest federal tax bracket for capital gains (37% for short-term, 20% for long-term), and the value of your asset at the time of sale remains the same:

	Sale of Short-Term Asset	Sale of Long-Term Asset
Sale Proceeds	$250,000	$250,000
Cost Basis	$150,000	$150,000
Taxable Gain	$100,000	$100,000
Taxes[1]	$37,000	$20,000
After-Tax Net Proceeds	$213,000	$230,000

Under this scenario, you would net an additional $17,000 if you waited to sell.

Capital Gains Breakeven Point

If the value of your asset decreases while you're waiting, you will end up with a smaller capital gain and lower net proceeds. Unfortunately, there is no way to know for certain if it will decline or by how much. However, you can figure out how much of a decrease you can sustain and still come out ahead. We've determined that the breakeven point is 21.25%,[2] meaning if the long-term gain is 21.25% less than the short-term gain, the after-tax proceeds will be the same for both (as illustrated below).

	Sale of Short-Term Asset	Sale of Long-Term Asset
Sale Proceeds	$250,000	$228,750
Cost Basis	$150,000	$150,000
Taxable Gain	$100,000	$78,750
Taxes[1]	$37,000	$15,750
After-Tax Net Proceeds	$213,000	$213,000

All else being equal, any capital gain decline of less than 21.25% generally makes holding an asset for the long term the better choice–assuming you don't need to sell now to address an immediate financial need. For example, even with a 10% decline in the capital gain, you would still net $9,000 more by waiting.

	Sale of Short-Term Asset	Sale of Long-Term Asset
Sale Proceeds	$250,000	$240,000
Cost Basis	$150,000	$150,000
Taxable Gain	$100,000	$90,000
Taxes[1]	$37,000	$18,000
After-Tax Net Proceeds	$213,000	$222,000

You can run a similar calculation to determine the breakeven point for sale proceeds, but the formula is slightly more complicated and beyond the scope of this article.

The bottom line is this: knowing how much of a drop in sales price or capital gain you're willing to accept while waiting for an asset to mature enables you to make a more informed decision about when to sell it.

Let Us Do the Math

If all these numbers make your head spin, don't despair. Our tax planning specialists thrive on performing these calculations. They can help you assess the best course of action based on your current financial situation, tax obligations and goals. Contact a Cerity Partners advisor to learn more.

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[1] State tax is ignored since most states don't have a preferential long-term capital gains tax rate. Also ignored for ease of presentation is the Net Investment Income Tax.
[2] STG = short-term gain; LTG = long-term gain; .63 (after-tax amount) * STG = .80(after-tax amount) * LTG; LTG =.63/.80 * STG; LTG=.7875*STG. If the LTG can be equal to 78.75% of the STG to breakeven, it means the gain can decrease by 1-.7875 or 21.25%.