

CAPITAL GAINS TAXES (PART 2)

Understanding the mechanics of calculating taxes due
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Yesterday we looked at capital gains taxes broadly. We saw what they are, why they have historically received preferential treatment, and how the current rates relate to ordinary income tax rates. As we saw, the often quoted 15% rate on capital gains is a bit of a misnomer. In reality, this is a graduated tax similar to marginal rates on ordinary income and there are effectively four rates currently in play. However, the application of this graduated scale is commonly misunderstood – while understanding it is critical to good tax planning and to understanding the current proposal to raise the capital gains rate “on incomes over \$1 million to 39.6%.” **Even if you are far away from the 39.6% rate potentially applying to you, we encourage you to keep reading**, as this will present some important concepts and planning opportunities for investors at any income level. *Before we continue, we will remind you that this material has been prepared for informational purposes only, and is not intended to provide, and should not be relied on for, tax, legal or accounting advice. You should consult your own tax, legal and accounting advisors before engaging in any transaction.* With that in mind, let’s now look at a couple of examples of how these graduated rates work. Our first example will look at a retired married couple with no earned income living a modest lifestyle off of Social Security and investments. The second will look at a young, high earning married couple with a combination of earned income and capital gains. As you might expect, we’ve simplified these illustrations a bit as a means of more clearly communicating key concepts.

Example 1

We’ll look at two scenarios for this couple to help illustrate two important points. Here are our assumptions in these scenarios:

- Married couple, age 67
- No earned income
- \$50,000 of capital gains (long-term) (**Scenario 1**) | \$100,000 of capital gains (long-term) (**Scenario 2**)
- \$5,000 of capital gains (short-term)
- \$45,000 of taxable Social Security
- Utilizing ‘Standard Deduction’

Income		Tax rate
Single	Married/Filing jointly/Qualifying Widow(er)	
\$0–\$40,400	\$0–\$80,800	0%
Over \$40,400 but not over \$445,850	Over \$80,800 but not over \$501,600	15%
Over \$445,850	Over \$501,600	20%

Additional 3.8% federal net investment income (NII) tax applies to individuals on the lesser of NII or modified AGI in excess of \$200,000 (single) or \$250,000 (married/filing jointly and qualifying widow(ers)). Also applies to any trust or estate on the lesser of undistributed NII or AGI in excess of the dollar amount at which the estate/trust pays income taxes at the highest rate (\$13,050).

Let’s look at the calcs, and then we’ll examine a few lessons from them.



What is "Net taxable income?"

Net taxable income is arrived at by subtracting your deductions (standard or itemized) from your Adjusted Gross Income (AGI). While many items in the tax code are driven from your AGI, it is NTI that actually determines how much tax is owed. But as we will see, even NTI gets broken down further into two components - ordinary income and preferred income (capital gains + qualifying dividends).

EXAMPLE 1 - SCENARIO #1

a Earned income	-
b Social Security (taxable)	45,000
c Capital gains (short-term)	5,000
d Capital gains (long-term)	50,000
e Adjusted Gross Income (a + b + c + d)	100,000
f Standard deduction	(27,800)
g Net taxable income (e - f)	72,200
h Income subject to ordinary income tax rates (b + c - f)	22,200
i Ordinary income tax	\$ 2,266
j Income subject to long-term capital gains rates (d)	50,000
k Applicable <i>marginal</i> long-term gains rate	0%
l Capital gains tax due	\$ -
Total tax due	\$ 2,266
Tax due if everything was treated as ordinary income	\$ 8,266
Savings generated by preferential tax rates	\$ (6,000)

Note that this couple pays 0% on long-term capital gains, and could in fact harvest an additional \$8,600 without paying one penny in additional taxes.

In *Scenario 1*, this couple's total net taxable income is \$72,200 - well below the threshold of \$80,800 where the 15% capital gains tax rate begins to apply. As a result, they pay 0% on long-term capital gains, and in fact could harvest another \$8,600 of these gains without triggering an additional penny in taxes. This is a concept called "*tax-gain harvesting*" - in contrast to the more talked about tax-loss harvesting that tends to garner attention at the end of each year. With gain harvesting, you sell your existing positions, realize a gain, and then immediately repurchase them (assuming you like them), thus resetting the cost basis and reducing future tax liability. You pay 0% taxes on those additional harvested gains, so long as you remain below the applicable threshold. Effectively implementing this strategy each year can yield very meaningful tax savings over time and is a strategy we often employ for clients.

EXAMPLE 1 - SCENARIO #2

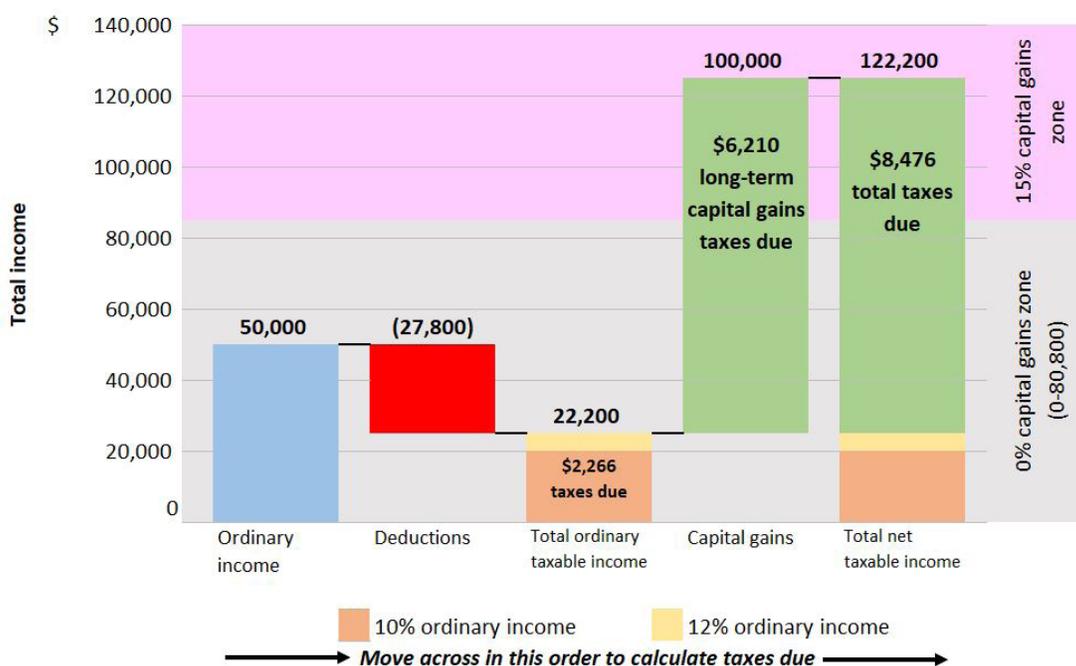
a Earned income	-
b Social Security (taxable)	45,000
c Capital gains (short-term)	5,000
d Capital gains (long-term)	100,000
e Adjusted Gross Income (a + b + c + d)	150,000
f Standard deduction	(27,800)
g Net taxable income (e - f)	122,200
h Income subject to ordinary income tax rates (b + c - f)	22,200
i Ordinary income tax	\$ 2,266
j Income subject to long-term capital gains rates (d)	100,000
k Applicable <i>marginal</i> long-term gains rate	15%
l Capital gains tax due	\$ 6,210
Total tax due	\$ 8,476
Tax due if everything was treated as ordinary income	\$ 18,381
Savings generated by preferential tax rates	\$ (9,905)

Note doubling of long-term gains from scenario above

Note that 15% only applies to the portion of gains exceeding \$80,800 of net taxable income, making the effective rate only 6.21%.

In **Scenario 2**, the only thing that has changed for this couple from an income standpoint is that they doubled their long-term capital gains to \$100,000 (line d). Here we see that their net taxable income grew to \$122,200, well above the \$80,800 threshold. In doing so, some (but not all) of their long-term capital gains are subject to the 15% rate. Important point here are the words “but not all.” This is an example of where the graduated rate comes into play. In this case, the first \$58,600 of gains (\$80,800 - \$22,200 net ordinary income) still gets the 0% rate applied, leaving just a fraction (\$41,400) that is taxed at 15% (yielding an “effective capital gains rate” of 6.21%).

You may be wondering why I said \$22,200 of ordinary income, rather than \$50,000 (Social Security + short-term gains). If you aren’t wondering this, you either know way more than the average taxpayer or you should be wondering it. As you can see in the calcs above, \$22,200 is simply the \$50,000 of incomes minus the \$27,800 standard deduction. This leads us to the concept of **“stacking.”** To understand the interaction between ordinary income and capital gains, you have to understand this idea of stacking. Simply put, it means that different types of income and deductions are ordered very specifically when calculating your tax bill. Earned income always comes first, followed by your deductions, and finally comes capital gains. Let’s see if we can make sense of this graphically, using this “Scenario #2” example.



Note how only a portion of the capital gains (green) falls in the pink(ish) section (15% rate). The majority falls in the 0% area (grey). If you took the time to re-order this and instead have deduction stack atop capital gains, you would quickly see how the total tax bill would increase, as more of the overall income would be subject to ordinary income tax rates. Sparing you the math, the increase would be \$3,336, an increase of 39%.

In both scenarios, we have shown just how meaningful these preferred rates are by showing the actual total tax bill next to the hypothetical tax bill if all income was taxed as ordinary income.

So what did we learn here?

- Preferential rates can make a significant difference.
- Understanding the concept of “stacking” is critical to proper capital gains tax planning.
- Tax planning around the combination of ordinary income and capital gains can yield meaningful tax savings (e.g. tax gain harvesting opportunities)

Example 2

Now let's turn our attention to our second example. In this example, we have a very high earning young couple who enjoy a mix of ordinary income and capital gains and itemize their deductions. Again, we'll use two scenarios for the purpose of comparative illustration, but here the difference in Scenario 2 is that we will apply the PROPOSED 39.6% top marginal rate on long-term gains. Here are our assumptions:

- Married couple, age 50
- \$950,000 combined earned income
- \$500,000 of capital gains (long-term)
- \$25,000 of capital gains (short-term)
- Utilizing 'Itemized Deductions' (\$100,000 per year)

This couple, with an income well above the \$1,000,000 threshold, is currently subject to a marginal capital gains rate of 23.8%, resulting in a capital gains tax bill of \$71,400 in this example. As you will see, when the proposed 39.6% (+3.8% NII) marginal rate is applied, their tax bill increases by \$73,500, an increase of 62%. In fact, not only does their capital gains bill increase, but their total tax bill also increases slightly (\$7,500) in comparison to when all income was simply ordinary income!

EXAMPLE 2 - SCENARIO #1 (Current tax rates)

a Earned income	950,000
b Capital gains (short-term)	25,000
c Capital gains (long-term)	500,000
d Adjusted Gross Income (a + b + c)	1,475,000
e Itemized deductions	(100,000)
f Net taxable income (d - e)	1,375,000
g Income subject to ordinary income tax rates (b + c - e)	875,000
h Ordinary income tax	\$ 260,273
i Income subject to long-term capital gains rates (d)	500,000
j Applicable <i>marginal</i> long-term gains rate	23.8%
k Capital gains tax due	\$ 119,000
Total tax due (h + k)	\$ 379,273
Tax due if everything was treated as ordinary income	\$ 445,273
Savings generated by preferential tax rates	\$ (66,000)

Rate is equal to 20% plus the 3.8% federal net investment income tax

EXAMPLE 2 - SCENARIO #2 (Proposed tax rates)

a Earned income	950,000
b Capital gains (short-term)	25,000
c Capital gains (long-term)	500,000
d Adjusted Gross Income (a + b + c)	1,475,000
<hr/>	
e Itemized deductions	(100,000)
f Net taxable income (d - e)	1,375,000
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g Income subject to ordinary income tax rates (b + c - e)	875,000
h Ordinary income tax	\$ 260,273
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i Income subject to long-term capital gains rates (d)	500,000
j Applicable <i>marginal</i> long-term gains rate	43.4%
k Capital gains tax due	\$ 192,500
% increase resulting from rate change	62%
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Total tax due (h + k)	\$ 452,773
Tax due if everything was treated as ordinary income	\$ 445,273
Savings generated by preferential tax rates	\$ 7,500

Note that we have changed **NOTHING** regarding their income in this second scenario.

Rate is equal to the **PROPOSED 39.6%** plus the **3.8% federal net investment income tax**

Note this is actually an increase rather than savings!

As you can see from this example and the one we looked at yesterday regarding a business sale, this *proposed* change is meaningful. But again, good planning can help mitigate its impact – and we encourage you to reach out to us and your tax professional to look at ways to do so. That said, we also want to remember that this is still just a proposal! There is no need to act quite yet, in our opinion, but instead to simply start planning. With good planning, you can avoid moves between now and when the ink dries on the final version that might hurt you in the long-run, and you can prepare for moves that need to take place after that ink is dry.

Let's wrap it up!

Now that our ink is running out, we'll shut up and simply invite your questions. Tune in on Monday for our final installment in this series as we look at the recently passed (and already challenged) capital gains tax here in Washington...because, you know, what we've looked at so far isn't complicated enough, we should add one more layer to the tax planning mix! Until then, we wish you a wonderful weekend.

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