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Managing Capital Gains Taxes Keeps More Money in Your Pocket

Most U.S. taxpayers are familiar with the term 'capital gains' and understand that, at some level, when they sell an asset they may have to pay tax. However, capital gains taxes don't have to eat into your cash flow. By utilizing some of the tips mentioned below, you may be able to better manage your capital gains tax exposure and keep more money in your pocket.

What is Capital Gain and Capital Gains Tax?

A capital gain is the profit you make on the sale of an asset you own, whether you bought it, inherited it, or received it as a gift. It's the difference between the asset's basis (often its initial purchase price) and selling price. This profit may be realized or unrealized. When realized, it generally means you have sold the item. When unrealized, it generally means you haven't sold the item, but you would make a profit if you did sell it.

Almost everything we own and use for our personal use or investment may generate a capital gain. This includes things such as our home, household furnishings, stocks/bonds, coin/stamp collections, gems/jewelry, and precious metals (e.g., gold).

Long-term capital gain tax rates are lower than ordinary income tax rates. Capital gains tax rates change due to the state of the economy and political considerations, but your ability to identify a capital gain situation and to plan prior to a sale may help you save a good deal of money.

Techniques for Deferring Capital Gains

Capital gains tax rates come in two forms: short-term and long-term. Higher short-term rates apply to assets held for one year or less and are taxed at ordinary income tax rates. Lower long-term capital gains rates apply to assets held for longer than one year. Accordingly, ***one of the simplest ways to manage your capital gains is to hold on to your assets for more than 12 months***. If that is not possible, there are other strategies, like the ones referenced below, that may help to defer or reduce your capital gains tax exposure.

1031 Exchange: This technique, named after Internal Revenue Code Section 1031, applies to real property (i.e. real estate) held for use in a trade or business or held for investment.[1] ***A taxpayer can exchange a piece of real estate for a new piece of real estate without incurring any capital gains tax liability.*** In essence you are rolling any gain from the sale of the original property into the new property.

To activate the "exchange," you have 45 days to find another property and 180 days to complete the transaction. The exchange is an integrated process and therefore, the transaction should go through an intermediary knowledgeable to handle these types of situations. You may repeat this strategy and defer capital gains taxes indefinitely.

Installment Sale: In some situations, you may want to sell business or investment property, but you don't want to purchase another similar property. Therefore, an installment sale may be a better option than a 1031 exchange.

With this strategy, you may still defer the recognition of capital gains when you sell the asset. The sales proceeds would be payable over a period of time, exceeding one year, evidenced by a promissory note. ***Capital gains taxes may be deferred – i.e. spread out - over the period of the installment sale.***

For example, Jen inherited an apartment building 10 years ago with a fair market value of $2 million; today it is worth $5 million. She wants to sell it and

knows she will face a large capital gain ($3 million). Let's assume she is subject to a 15% capital gains tax rate. She is flexible and doesn't have to receive the entire sale proceeds on day one. Therefore, she decides to sell the building to John for $5 million where half of the purchase price ($2.5 million) will be paid using an installment sale. John promises to repay her over a 20-year period at 4% interest ($183,954 annually).

Strategy Used	Sales Price	Capital Gain	Capital Gains Tax Due
Outright Sale	$5 million	$3 million	$450,000
Installment Sale	$2.5 M up front $2.5 M over 20 years	$1.5 M in year $75,000 annually for 20 years	$225,000 in year 1 $11,250 annually for 20 years
1031 Exchange	$5 M	$3 M	$0
CRT	$5M	$3M	$0; apx. $250,000 annual income taxable as capital gain an/or ordinary income

One of the negative tax consequences of an installment sale is the recapture of any depreciation that may have been taken on the property. The recapture is generally recognized and taxable at ordinary income tax rates in the year of the sale and cannot be deferred over the term of the note. Another negative consequence may include the buyer defaulting on the note. Since the buyer is promising to repay over time, it is important to have a buyer who can pay in installments, consistently, and who is not likely to default. Life insurance is often used to secure the repayments in the event of the death of the purchaser.

Charitable Remainder Trust (CRT): A CRT is a technique to generate a charitable income tax deduction and to ensure an income stream. You set up a CRT and transfer appreciated assets into it. The CRT then sells those assets and does not have to pay any income tax upon the sale because a charitable trust is tax exempt. Over the duration of the CRT you can receive a stream of income. At the end of the CRT the remaining assets are turned over to charity.

This technique provides you with an income and that income may be taxable as capital gain and/or ordinary income. ***The capital gain tax is thus, spread out over the period of the income stream. You may also receive a charitable income tax deduction for the gift to charity.***

Let's play this out. If Jen contributed the apartment building to a CRT she may be entitled to a charitable income tax deduction of over $1.5 million and receive an income stream of approximately $250,000 annually. At the end of 20 years approximately $5 million would go to a charity of Jen's choosing.[2]

Jen can spread out the capital gain over the term of the CRT (each payment from the CRT will constitute ordinary income and capital gain, as applicable),[3] may get a charitable income tax deduction, a consistent income stream, and benefit a charitable organization.

Integrate Capital Gains with Capital Losses: Another strategy includes integrating your capital gains with your capital losses. ***This entails selling assets at a loss to offset a capital gains tax liability.*** It requires a little bit of planning and may help to soften the blow when you know you're going to have to pay capital gains tax. Some refer to this technique as "tax loss harvesting" and it is commonly used to limit the recognition of short-term capital gains.

For example, let's assume you bought stock 7 months ago in an electric company and it has been losing value. You also just purchased stock in a real estate company that went public and its stock went through the roof. You find yourself in a situation where you need to sell the real estate stock, but you don't want a large tax bill. One option is to sell the

electric company stock at a loss to help offset the capital gains tax liability you will have by selling the stock of the real estate company.[4]

There is a limit on how much you can take as a loss. A single person and married couples filing jointly may deduct up to $3,000 of net capital losses to reduce their taxable income ($1,500 if married filing separately). Any unused losses may be carried forward on future tax returns. Note that capital losses cannot be carried over after a taxpayer's death. They are deductible only on the final income tax return filed on the decedent's behalf. Please refer to IRS Pub 544 for more information.

Conclusion

Managing capital gains takes some advanced planning and may help to defer a great deal of capital gains taxes and keep more money in your wallet. The strategies referenced above briefly outline a few techniques currently available.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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[1] Prior to the "Tax Cuts & Jobs Act of 2017," effective for tax years after December 31, 2017, 1031 exchanges were also able to be completed with respect to certain personal property held for use in a trade or business or for investment.
[2] Crescendo charitable remainder unitrust illustration run February 16, 2018: Assume 35% ordinary income tax rate; 18.80% capital gains tax rate; 5% annual unitrust interest, payable over 20 years; assets in the trust grow at 5% annually.
[3] The character of the income taxable to the income beneficiary will be determined by the rules of IRC 664(b) and will generally be determined by the character (i.e. capital gain or ordinary income) of any income generated by the sale of underlying assets.
[4] You should be careful not to buy back the electric company stock within a 30-day time frame because the IRS may consider this a "wash sale" and will disallow your deduction.

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