Dorchester Advisors
Money worked harder

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Things You Control

Capital Gains Taxes on Your Investments

Will you be paying higher taxes on your capital gains?

The short answer is probably "No." But it is prudent to evaluate what may happen if the Biden tax Plan is approved.

Recently, President Biden unveiled The American Families Plan, which among other things, proposes to raise capital gains taxes on long-term capital gains for households earning more than $1 million in income. If approved, the Plan is a substantial increase in taxes for wealthy Americans.

This won't affect most people, but if the plan becomes law, I am researching tax planning strategies (as they apply to investment assets) which may help to avoid or lessen the impact.

Currently, ordinary income is taxed no higher than 37.0%. That could rise to 39.6% if the president's plan is approved. If you earn over $1 million, you may pay that 39.6% rate on the sale of assets held over one year plus the 3.8% NII (Net Investment Income) tax.

Currently, the maximum long-term rate on capital gains is 20% plus the 3.8% net investment income "NII" for high income filers. But, if you earn more than $1 million per year your rate may go much higher.

So while you have likely benefited from the strong stock market rally, the sale of an investment could create a larger tax liability, depending on your tax bracket and how long you've held the asset.

How might we lessen the impact of a big increase in the capital gains rate?

1. If a higher rate is not made retroactive, we may consider recognizing some profits in 2021, to avoid the new rate and to we step up the cost basis.

2. Another way to sidestep the tax is to simply avoid large asset sales in taxable accounts, assuming there isn't a compelling reason to do so. The only constant in tax law is change, and a future Congress and president could adjust the rates again.

   However, there is an important caveat: the time-honored tradition of passing on assets to heirs without paying taxes could be in jeopardy, which most of you know as the stepped-up basis at death. In his proposal, the president wants to trigger taxes on unrealized gains passed to heirs. This would occur after a $1 million exemption.

3. We can also strategically time the sale of assets, making sure we do not pass the $1 million limit on income. That would ensure the maximum federal rate paid would remain at 20% plus the 3.8% NII tax. It's a far cry from 43.4%.

Our Philosophy is that we do not allow taxes to drive our investment decisions. But in practice it is prudent to be aware of tax laws and tax planning. Sometimes there are benefits depending on specific client circumstances. And, we can be proactive when we have a better idea how everything will shake out.

As always, we encourage you to consult with your tax advisor before implementing any tax strategies.

Why Things You Control are Important

In Investing (as in Life) we can: hope, worry or plan.

I believe that when we hope or worry, we are largely looking at the future and are focused on things we do not control. We hope the markets will get higher and we will make money. Or we worry that markets will collapse and we may lose all our money. And yet, deep down in our hearts, we know that whether our thoughts are optimistic or pessimistic they simply do not influence future outcomes.

We can also look at the future plan-fully. When we do this we tend to focus on the things that we do control. And, by picking activities that are in our control and that are important to our future we have a far better chance of achieving our goals. Of course, life holds few guarantees! So, for example, while we all hope that our favorite stock pick will be a high performing stock, not implementing a properly diversified portfolio is plainly irresponsible to our financial well-being.

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Past performance is not a guide to future performance.

DorchesterAdvisors is a Registered Investment Advisor in NJ, NY and MI.

Our Financial Planning Principles

Without a Purpose, accumulating money can become a soul-less task. A financial plan gives your savings a purpose.

It's OK to be broke when you are young - not so when you are old: Studies show that people typically tolerate risk and uncertainty better when they are younger.

Getting down from Mount Everest mountain is as important as getting up: Pay as much attention to accumulating money before you retire as you do to consuming it after you retire.

Planning is life-stage dependent: The principles of saving and investing money in your early years are very different from the techniques that you use in retirement to generate a reliable income stream.

Financial confidence comes from being on top of your taxes, protecting yourself from risks, having a clear picture of your investments and debt, and specific targets for saving and spending.

Achieving financial independence requires a careful balancing of Income, expenses, taxes, and savings. This balancing act (planning) is not intuitive, nor can it be done well on the back of an envelope, but effective plans do give more peace of mind.

Identify your true risks (in contrast to investment volatility, labelled as risk, or uncertainty) and take action to manage them using the correct risk management tools. Pick the right tools for the job - investments won't manage the risks you face, risk products (insurance) won't deliver the growth and flexibility you need.

Taxes remain important even after you retire. However, in retirement your investments become the principal source of your income and hence drive your taxes.

In matters of health: it's your body but your doctor knows better how your body works. So it is with your money: A partnership with an advisor will help you to reach your financial goals - you save, they help your savings grow. Together you can get there faster.