Sharing Our Thoughts on Appreciated Stock

After the last few years of outsized stock market gains, many investors are facing the need to re-balance their investment portfolios. While we all enjoy the benefits of an increasing market, the tax complexities that can arise when selling highly appreciated stock positions requires diligence and careful planning. The need to recognize long or short term capital gains may be driven by the need to fund a planned expense, a need to re-balance a broad portfolio to a target allocation, or even the need to diversify a concentrated position. As tax season is behind us and as you begin to evaluate the year ahead, we wanted to share how we approach managing long and short term capital gains in your portfolio.

1. **Pay the Tax:** The most straightforward approach toward handling long and short term capital gains is to sell the position in question and pay the tax. Profits realized when selling a stock position that you've owned for at least one year and one day are considered long term capital gains and are taxed at a preferential rate. If you've owned the stock for less than one year and one day, the profits are considered short term capital gains and are taxed at your income tax rate. An investor's income tax rate is usually much higher than their long-term capital gain tax rate, so in most cases, realizing long term capital gains over short-term capital gains is the preferred option. Bear in mind that it is always important to coordinate with your CPA if you are contemplating liquidating an investment with a significant long or short term profit, as it can impact your tax situation significantly. You may need to begin making quarterly tax payments or change your withholding in order to cover the tax owed on the gain. If using this strategy, we recommend reserving an amount of cash from the sale of stock to pay the tax, so that when tax time does come, there are no surprises.

2. **Make an Outright Gift:** Gifting shares of highly appreciated stock can often be more beneficial than liquidating the position and gifting cash. When giving to family members, such as children or grandchildren, the donor's basis (or original price paid) transfers with the stock. A child or grandchild usually has a lower tax bracket than the donor, meaning a lower tax cost overall if the child or grandchild were to recognize the long term capital gain.

Additionally, most charities can receive stock gifts, eliminating the need for the donor to recognize capital gains taxes entirely. Gifting to charity also brings the added benefit of providing a charitable gift deduction that can help lower your tax burden overall or help to offset other gains taken in the portfolio.

3. **Establish a Donor Advised Fund:** If you are philanthropically inclined, a Donor Advised Fund may also be a suitable tax planning vehicle. A donor advised fund is like a charitable savings account. The fund is established with a registered nonprofit entity, which allows any contributions to the fund to be immediately tax deductible. The donor can make contributions all at once or over time, which allows you the flexibility of consolidating your charitable deductions into years where the deductions will be most impactful, such as a year where you might be recognizing a significant capital gain. That being said, unlike an outright donation to charity, you can determine when you would like your favorite charities to receive these funds, which is likely over time rather than all at once. Donor Advised Funds can also be funded with highly appreciated positions. More information on Donor Advised Funds can be found here.

4. **Exercise Net Unrealized Appreciation:** If you happen to own highly appreciated employer stock within your 401(k) and you are over the age of 59 ½, you may be able to take advantage of a little known tax rule known as "Net Unrealized Appreciation," or NUA. Typically, income tax needs to be paid on every dollar withdrawn from a 401(k) account. The NUA strategy allows a retired employee to withdraw employer stock from their 401(k) account in kind, paying income tax only on the stock's basis, or original cost. Then, the employee can hold the stock in a traditional brokerage account. If there is a need to sell the stock in the future, the only tax paid is the long or short term capital gain tax. This can also be an effective way to reduce your Required Minimum Distributions in retirement, as reducing your retirement account assets means a lower required minimum distribution.

Like any financial decision, planning for and managing capital gains can be overwhelming. However, with proper planning and coordination with your trusted advisors, the end result doesn't have to be an unpleasant surprise. We are here to help you every step of the way and are dedicated to you and your family's success. The way to start the journey is to start a conversation.