Strategies to Deal with Potential Capital Gains Tax Increases.

President Biden's proposal to raise taxes on capital gains has many investors concerned. But before you make any rash decisions with your own portfolio, it's important to understand whether you'll be among those affected — because not everyone will be — and if so, what steps you can take to help minimize the impact.

In addition, if you own investments you're looking to leave to your heirs, you should also be aware of a possible change in estate tax treatment that could mean a higher tax bill for your loved ones that could be somewhat avoidable if you take action.

Managing Your Capital Gains Taxes

Before digging into the possible changes, it may be helpful to recap what capital gains taxes are. Capital gains taxes simply are taxes levied on profits from selling an investment. So, if you buy $10,000 in stock and sell those shares five years later for $20,000, you will likely owe taxes on your $10,000 capital gain, unless the investment is held in a tax-deferred account, such as a 401(k) or an IRA.

Under President Biden's proposal, the highest tax rate for capital gains would increase to 39.6%, up from a top rate of 20% currently. But because the higher tax rate as proposed would only impact investors earning more than $1 million a year, most people wouldn't be affected. Also, it's important to note that the proposed changes may evolve as they move through the legislative process.

Still, if you would be impacted by this change, or are just looking to reduce your potential capital gains tax exposure, consider these actions:

- **Invest in municipal bonds.** These are generally exempt from federal income tax, and they are also exempt from state income taxes if the bond issuer is from the investor's home state, making them appealing to investors in high-tax states. Still, be sure to also consider out-of-state municipal bonds, which provide portfolio diversification and can provide higher after-tax yields.
- **Max out what you contribute to your tax-deferred retirement accounts**, including your 401(k) and IRAs. Any capital gains you earn from investments in these accounts will be tax-deferred until you begin withdrawing the funds in retirement.
- **Utilize tax-loss harvesting to help lessen the tax bite from capital gains.** Under this strategy, you can sell an investment that's fallen in value and use that loss to reduce any taxable gains. If you'd like, you can then reinvest your proceeds into a similar type of investment to maintain your asset allocation but beware of the Wash Sale Rule if you reinvest within 30 days of the sale because the loss may be disallowed. Note that only $3,000 of capital losses can be used to offset ordinary income over and above offsetting any capital gains in the same tax year –any remaining losses can be carried forward to any future tax year, indefinitely, until exhausted. So, for example, if you sell a stock that's declined in value by $20,000, that loss can reduce a $10,000 capital gain to $0 and help lessen your overall tax burden. In addition, $3,000 of unused capital

losses can be used to offset your ordinary income. Finally, the remaining $7,000 in unused losses can be carried forward and used to offset future taxable gains and up to $3,000 in ordinary income.
- **Consider investing in separately managed accounts** (SMAs) as an alternative to mutual funds. Fund investors are often surprised to receive taxable gains statements at the end of the year, even when they didn't sell any shares of the funds. SMAs do not have embedded capital gains, unlike mutual funds. And because an investor who invests in an SMA owns the portfolio's securities directly, they can take advantage of tax-loss harvesting.

Managing the Potential Elimination of Step-Up in Basis for Inherited Assets

Another potentially important change to be aware of is the proposed elimination of the step-up in basis for inherited assets. Currently, the step-up provision means that the cost basis of the inherited asset is adjusted (stepped-up) to reflect the fair market value of the asset at the time of the owner's death. For example, if you inherited shares worth $100,000 from a deceased loved one and then sold those assets, you wouldn't owe capital gains on that sale, even if the stock appreciated in value from an original purchase price of say $10,000.

Under President Biden's proposal, when someone passes away, their death would trigger capital gains taxes on appreciated assets for their heirs, either at the time of death or when their heirs sell the assets. So, as with the previous example, if you inherited shares worth $100,000 that had been purchased for $10,000, you'd owe capital gains on the $90,000 worth of appreciation.

Buy-and-hold investors who own assets that have appreciated considerably in value may want to speak with an attorney or tax adviser to shrink the size of their estate. You may simply choose to realize the gains at the current lower capital gains tax rates and re-establish the basis by purchasing the same security again if the goal is to continue to hold the investments and pass them to your heirs. When repurchasing the security, be careful of the wash-sale rule, which may affect your ability to claim a deduction if you sold at a loss.

In addition, possible strategies you may want to consider include:

Annual gifting of assets to heirs. You can give up to $15,000 per person during the year without having to pay any tax, and if you are married, your spouse also can give $15,000 to the same person, for a total of $30,000 per beneficiary per year.

- Donating appreciated assets to charity.
- Placing assets into a trust.
- Purchasing a life insurance policy. The funds from a life insurance policy can help replace the loss of funds from an estate due to estate taxes or capital gains if the step-up in basis is eliminated.

Note that you should discuss your particular situation with a trusted accountant or tax adviser.

Revisit Your Plan with Your Financial Adviser

Tax laws are always evolving, and what's proposed is often not the same as what becomes law. It's important to add that these are proposals made by the administration, but also need to be passed by Congress. Regardless of what happens with taxes, consider meeting with your financial adviser. The past year has brought many developments, and it's worth revisiting your overall plan in light of any changes COVID-19, a new administration or your personal situation may mean to your financial plan.

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