Year-End Investment Decisions

What are year-end investment decisions?

Year-end investment decisions may sometimes result in substantial tax savings. Tax planning may allow you to control the timing and method by which you report your income and claim your deductions and credits. The basic strategy for year-end planning is both to time your income so that it will be taxed at a lower rate, and to time your deductible expenses so that they may be claimed in years when you are in a higher tax bracket. In terms of investment planning, investing in capital assets may increase your ability to time the recognition of some of your income and may help you to take advantage of tax rates that are lower than the ordinary income tax rates. You have the flexibility to control when you recognize the income or loss on many types of investment assets. In most cases, you determine when to sell your capital assets. In some cases, however, shifting potential capital gain income to other taxpayers through gifting may be an appropriate strategy.

How do you use the capital gains tax to lower your taxes?

Capital gains and losses are accorded special tax treatment. Currently, the top long-term capital gains tax rate is 20% (for most types of assets), while the top ordinary income tax rate is 37% — that's a difference of 17%. As a consequence, by converting some of your ordinary income to long-term capital gain income, it may be possible for you to reduce your federal income tax liability.

Tip: *Long-term capital gains are generally taxed at special capital gains tax rates of 0%, 15%, and 20% depending on your taxable income. The actual process of calculating tax on long-term capital gains and qualified dividends is extremely complicated and depends on the amount of your net capital gains and qualified dividends and your taxable income.*

In addition, the 3.8% net investment income tax applies to some or all of your net investment income (including capital gains) if your modified adjusted gross income exceeds $200,000 for single or head of household taxpayers, $250,000 for married filing jointly, or $125,000 for married filing separately.

Timing your capital gain recognition

Careful timing of when you sell capital assets may help you to reduce your federal income tax liability. For example, if it's late in the year and you want to sell a capital asset, you can wait until January to sell it so that you realize your capital gain or loss next year (assuming that you have a calendar tax year). This strategy is particularly useful if you are in a higher marginal tax bracket in the current year and expect to be in a lower one in the following year. Timing can also be important because capital gain income increases your adjusted gross income (AGI). The amount and availability of certain tax benefits may depend on the amount of your AGI. For example, the itemized deduction for medical expenses is available only to the extent medical expenses exceed 7.5% of AGI.

Plan your year-end capital gain and loss status

Planning the time when you recognize capital losses may also be important. If you expect to recognize a capital gain this year, you should review your portfolio for possible capital losses that can be used to offset the gains. If you have any capital loss carryforwards, you should review your portfolio for capital gain opportunities to make use of such carryforwards. In general, net capital losses are deductible dollar-for-dollar against net capital gains. Excess losses are allowed to offset up to $3,000 ($1,500 for individuals filing married filing separate tax returns) of ordinary income per year. Losses over and above the limit may be carried forward indefinitely.

The following strategies may be appropriate:

- Sell capital gain property before the end of the year if you have already realized capital losses for the year that exceed the sum of any capital gains you have realized plus $3,000 ($1,500 for individuals filing married filing separate tax returns).
- If you have gains for the year that exceed your losses, sell property with built-in losses to offset the excess gains.
- If your other allowable deductions for the year exceed your income, you should, to the extent possible, avoid realizing any further capital losses for the year.
- If you've held a capital asset for close to 12 months and want to sell it, wait awhile (if possible). You can take advantage of the lower long-term capital gains rates if you hold the asset for over 12 months before selling it.

How do you select investments to control income?

You can select investments likely to produce ordinary income such as interest, or income that is taxed at reduced rates (certain qualifying dividends or long-term capital gains). You can also select investments likely to produce ordinary or capital losses. You can control when your investment earnings are taxed, bearing in mind that income distributions are generally not taxed until you receive them (assuming that you use the cash method of accounting). By knowing the tax rules, you can lower your taxes.

What about shifting income?

It may be possible to shift potential capital gains to other taxpayers through gifts. If you are in a higher tax bracket, you might transfer appreciated assets to relatives in lower tax brackets.

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