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Dynamic Wealth Advisors

Leverage Capital Gains Budgets For Mindful Tax Planning

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Dynamic Portfolio Perspectives: Predictable Tax Planning Improves Investor Outcomes

Savvy investors and their advisors are always searching for opportunities to reduce unnecessary costs, improve returns and capitalize on opportunities in their financial plans. As traditional investment management becomes commoditized by "robo-advisors" and algorithms that run on autopilot, tax minimizations strategies measured by a metric known as after-tax alpha are gaining attention.

After-tax alpha describes the potential increase in investment returns received through reducing tax costs incurred, and the subsequent opportunities created to use these savings for other benefits within a meticulously crafted financial plan. For investors and their financial advisors, this proactive tax planning stance can help mitigate a potentially unwelcome byproduct of investing: a higher tax bill. As strategies advance around asset management tax planning, investors and their advisors are reaping the benefits. These approaches include tax-loss harvesting, capital gain harvesting, optimizing asset location in certain accounts and charitable giving.

One approach that can help increase after-tax alpha is capital gains budgeting, which is an oft-overlooked option to mitigate investment related tax bills. This technique involves deciding, in advance, the amount of capital gains an investor plans to realize during the year. Such planning facilitates a stronger holistic approach to an investor's overall investment related tax planning. The goal? To minimize how much an investor pays in investment related taxes in any given year, and to provide a predictable level of capital gains that are *acceptable* to be realized without derailing an investor's financial plan.

In this post, we'll review the basics of capital gains budgeting, offer insight into how a capital gains budget helps with tax-sensitive asset management, and, finally, take a look at the potential beneficial results of a proactive approach towards capital gains management.

Capital Gains Taxes Reviewed

The IRS considers a capital asset as virtually anything an investor owns personally owns and uses, from a home to government bonds to publicly-traded stocks.[1] When capital assets are sold for a profit, capital gains tax will usually apply.[2] In other words, if an asset is sold for more than its purchase price—minus any expenses to maintain the asset—a realized capital gain occurs.

Capital gains can be divided into two types:[3]

- Short-term gains: A gain on an asset held for one year or less
- Long-term gains: A gain on an asset held for longer than one year

Short-term capital gains will be taxed using marginal ordinary income levels of the tax-bracket of an investor's filing status. For example, an investor in the 32% married filing jointly tax bracket would incur a tax bill of $3,200 on a realized $10,000 short-term capital gain. Unique to capital

assets, how much you pay on long-term capital gains is determined by your taxable income—though at lower rates, fortunately, than taxes on ordinary income.

Depending on an individual investor's unique situation, it is often more advantageous to realize long-term capital gains as opposed to short-term capital gains. In the same $10,000 realized capital gain example as above, the long-term capital gains rate would be only 15%, resulting in a $1,500 tax bill–*less than half* of the short-term capital gains bill. Here's a handy overview of how long-term capital gains tax brackets work as of the 2024 tax year, which is adjusted for inflation annually by the IRS:

2024 Long-Term Capital Gains Tax Rates

	0%	15%	20%
Single	≤ $47,025	$47,026-$518,900	> $518,900
Married filing separately	≤ $47,025	$47,026-$291,850	> $291,850
Married filing jointly and qualified surviving spouse	≤ $94,050	$94,051-$583,750	> $583,750
Head of household	≤ $63,000	$63,001-$551,350	> $551,350

Source: CFP Board [4]

Capital Gains Tax Budgets

Investments operate within the universe of the markets and global economy, which means that the unexpected can occur, potentially upending the best laid plans.[5] That means that investors and their advisors should review capital gains budgets at least annually to facilitate minimizing tax bills and the knock-on effects of increasing income levels from realized gains as much as possible.[6] That's because increasing income levels can result in moving an investor into a higher tax bracket, which can increase an overall tax bill. It is also beneficial to revisit capital gains budgets when there are major life events such as an investor moving to another state with higher or lower state taxes, an investor receiving a promotion at work that upwardly adjusts compensation levels, or a change of marital status.

To engage in capital gains budgeting, investors and their advisors need to first review how much in realized capital gains they have the *capacity* to incur in a specific tax year. This process involves analyzing all facets of the investor's specific situation to determine the level of additional investment gains that could be realized each year without triggering adverse effects in other areas of their financial plan. A couple of examples where capital gains budgeting may be especially effective:

- For investors with student debt whose Income Driven Repayment (IDR) plans may be predicated on annual adjusted gross income levels;
- For retired investors enrolled in Medicare whose Income-Related Monthly Adjustment Amounts (IRMAA) premiums may sharply increase if income is $1 over the set threshold, or;
- For high-net worth investors who are at income levels subject to the additional 3.8% Net Investment Income Tax (NIIT)

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Targeting a specific capital gains budget can potentially avoid the additional taxes that are associated with a higher tax bracket. In that situation, the investor may pay more in federal taxes than would occur at a lower tax bracket.[7] There is also the potential for reduction in other deductions and credits with higher tax brackets.[8]

A capital gains budget is a necessary part of any investor's comprehensive financial plan, no matter how big or small the profits. It's based on your own individual investment goals, financial strategies and anticipated tax needs.

What's the result?

Improving investment outcomes is the result of mindful planning, strong communication and adherence to an established processes within the investor/advisor relationship. Investors and advisors who effectively deploy capital gains budgets rightly place contingencies in their plan to avoid adverse tax consequences of the ongoing management of investment portfolios. Adding value through increasing after-tax alpha to investor portfolios with careful consideration can be achieved with many tools, with capital gains budgeting being a strong compliment to an advisor's tax toolbox.

Invest with Intention.

Sources

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As always, Dynamic recommends staying balanced, diversified and invested. Despite short-term market pullbacks, it's more important than ever to focus on the long-term, improving the chances for investors to reach their goals.

As Director, Portfolio Services, Lucas Felbel, CIMA®, leads the implementation, monitoring and evaluation of trading activities at Dynamic Advisor Solutions.

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