#2: Capital Gain Harvesting

Gain harvesting is a great year-end strategy that could potentially save the taxpayer substantial amounts of capital gains tax. The strategy applies to taxpayers who expect to be in a higher tax bracket in the future than in the current year. If this is the case, the taxpayer will sell the assets this year, pay tax on the gains at the lower current tax rate and step-up the basis of the assets to the sale price. Then the taxpayer will immediately repurchase the assets and sell them whenever he or she would have sold them if the gain harvesting strategy had not been used.[3] By doing so, the taxpayer shifts recognition of part of the capital gain from the higher bracket future tax year to the lower bracket current tax year.

The first consideration in deciding whether to use this strategy is determining what the taxpayer's expected tax brackets are over the coming years. In 2024, for married taxpayers filing jointly, the long-term capital gains rates are as follows:[4]

Amount of Income	Capital Gains Tax Rate
Less than or equal to $94,050	0%
$89,251 to $583,750	15%
Greater than $583,750	20%

In addition, consider the net investment income tax (NIIT). The 3.8% NIIT applies to the lesser of (1) net investment income, or (2) the excess of a taxpayer's modified adjusted gross income (MAGI) over the applicable threshold amount. In most cases, unless the capital gain is from the sale of active business assets, it will be treated as net investment income. Since the applicable threshold amount for married taxpayers filing jointly is $250,000, any married taxpayers with capital gains and a MAGI of over $250,000 will usually be subject to the 3.8% NIIT on top of the capital gains tax rate. Thus, including the NIIT, the tax rates for most capital gains of married taxpayers filing jointly are as follows:[5]

Amount of Income	Capital Gains Tax Rate
Less than or equal to $94,050	0%
$94,050 to $250,000	15%
$250,001 to $583,750	18.8%
Greater than $583,750	23.8%

[3] Note that if gain harvesting is used, the taxpayer must hold the asset for an additional year and one day to avoid being subject to short-term capital gains rates on subsequent sales.

[4] In 2024, for single taxpayers, the long-term capital gains rates are as follows:

Amount of Income	Capital Gains Rate
Less than or equal to $47,025	0%
$47,026 to $518,900	15%
Greater than $518,900	20%

[5] The applicable threshold amount for single taxpayers is $200,000; therefore, any single taxpayers with capital gains and a MAGI of over $200,000 will usually be subject to the 3.8% NIIT on top of the capital gains tax rate.

It may be advantageous for taxpayers in a lower tax bracket to harvest gains in the current year if they expect to fall into a higher tax bracket in later years.

Seems simple enough, but it's not. The difficulty in deciding on whether or not to harvest gains comes when the taxpayer was not planning on selling the asset for two, three, or more years. It becomes a battle between two competing benefits: paying tax at a reduced rate and loss of tax deferral. The best way to analyze these competing benefits is to think about gain harvesting as an investment in the current year to buy tax savings in a later year. This allows for a calculation of the rate of return on this investment. Below are two scenarios. In order to hold the investment consequences constant, let's assume that the taxpayer sells his publicly traded stock in the current year, immediately repurchases the same stock with the after-tax proceeds and sells it again in the year in which he or she would have sold it originally, had there not been any gain harvesting.

Example 1. Taxpayer (T) owns ABC company growth stock with a basis of $50,000 and an FMV of $150,000. If T sells the stock in 2024 his capital gains tax rate will be 18.8%. If T waits until 2025 to sell the stock, he expects his capital gains rate to be 23.8%. Shown below are the economic consequences of two scenarios: 1) T decides not to harvest gains and sells the stock next year; or 2) T harvests the gains from the stock by selling the stock this year.

Scenario 1: No Gain Harvesting

	December 31, 2024	January 1, 2025
Stock Value	$ 150,000	$ 150,000
Less Basis		$ 50,000
Gain		$ 100,000
Tax @ 23.8%		$ 23,800
After-Tax Gain		$ 76,200
Total Value (gain + basis)	$ 150,000	$ 126,200

Scenario 2: Gain Harvesting

	December 31, 2024	January 1, 2025
Stock Value	$ 150,000	$ 0
Less Basis	$ 50,000	
Gain	$ 100,000	
Tax @ 18.8%	$ 18,800	
After-Tax Gain	$ 81,200	
Total Value (gain + basis)	$ 131,200	

Taxpayer ends up with $5,000 more in the gain harvesting scenario ($131,200 - $126,200). Thus, T's rate of return on the tax paid in the current year is 26.60% ($5,000/$18,800). Since this is presumably far above T's opportunity cost of capital, T should harvest his gains.[6]

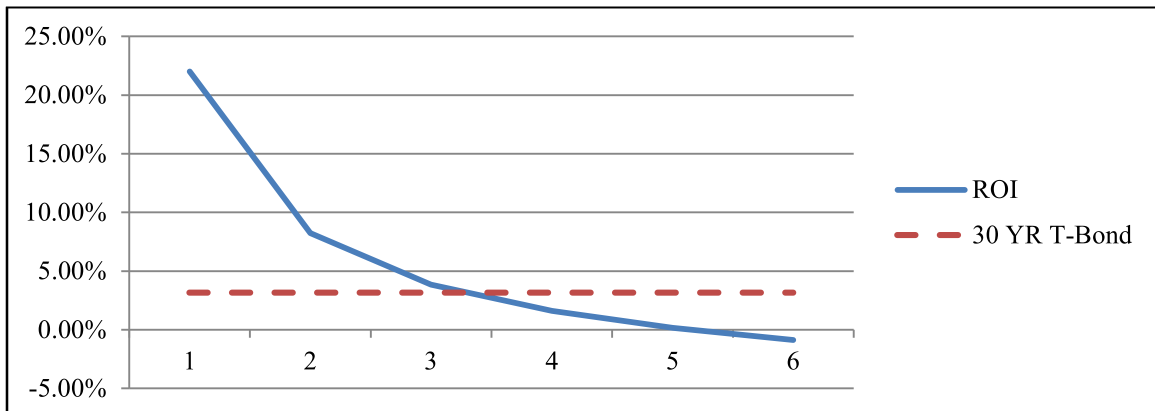
[6] Note that although there is only a one-day delay in selling the stock, the $18,800 of tax paid in the gain harvesting scenario is really invested for one year (April 15, 2024 to April 15, 2025, assuming no extension).

Usually if the taxpayers originally planned on selling the assets in the following year and they are in a lower tax bracket this year than they will be in next year, gain harvesting can be very beneficial. If the planned sale was farther in the future, however, loss harvesting may or may not be beneficial. The key variables to consider in deciding whether to harvest gains are:

- The time period between the gain harvesting sale and the sale of the repurchased assets (i.e., the period of time between the sale in the current year and the sale in the originally planned year);
- The difference in the taxpayer's tax rates between the two sales;
- The growth rate of the stock; and
- The taxpayer's opportunity cost of capital.

As stated above, the shorter the time period between the gain harvesting sale and the originally planned sale, the more favorable gain harvesting will be. The decision of whether to harvest gains will be based on the taxpayer's return on investment compared with his or her opportunity cost of capital (the return he or she could have earned on the best alternative investment of comparable risk). To illustrate, assume the same facts as in Example 2 above except that the time period between the sales will increase and the stock grows in value by 6% per year.

Time Period (Years)	Return on Investment
1	22.02%
2	8.25%
3	3.86%
4	1.61%
5	0.16%
6	-0.90%

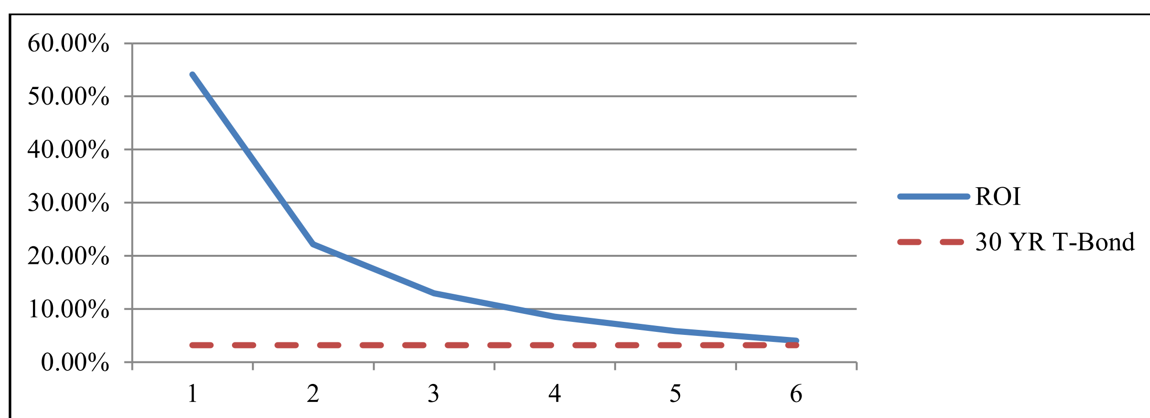


As the above data shows, the advantages of gain harvesting quickly decline as the time period between the two sales increases.

Another important variable is the difference in tax rates for the two stock sales—the greater the differential in tax rates, the more favorable gain harvesting will be. In the above example, the tax

differential was only 5%, below is a table with the return on investment for a tax differential of 8.8%; i.e., the taxpayers are in the 15% capital gains tax bracket in the current year and when they plan on selling the asset they will be in the 23.8% tax bracket.

Time Period (Years)	Return on Investment
1	54.09%
2	22.17%
3	12.95%
4	8.52%
5	5.85%
6	4.03%



Additionally, the higher the growth rate of the asset, the lower the return on investment will be. The last variable to consider is the taxpayer's opportunity cost of capital.[7] If the return on investment is higher than their opportunity cost of capital, then gain harvesting makes sense, if it is not, then it doesn't make sense to harvest gains.

Bloomwood developed a Gain Harvesting Return on Investment calculator that allows practitioners to quickly see what the return on investment of gain harvesting will be depending on the combination of the various variables mentioned above:

- The time period between the gain harvesting and the subsequent sale;
- The tax rate in the current year versus the tax rate in the year the asset will be sold;
- The asset's growth rate; and
- Any state tax rate.

Shown below is a sample screen shot of the results produced by the calculator.

[7] A taxpayer's opportunity cost of capital is the return that could be earned on the next best use of the money invested. In other words, it is the expected return foregone by investing in the gain harvesting strategy.

Gain Harvesting Return on Investment (after-tax)

		2024	Future	2025	2026	2027	2028	2029	2030	2031
Growth Rate	4.0%	0.0%	15.0%	371.76%	116.42%	66.90%	46.55%	35.54%	28.66%	23.95%
State Tax	4.0%	0.0%	18.8%	466.91%	137.42%	77.62%	53.62%	40.80%	32.84%	27.43%
		0.0%	20.0%	496.96%	143.68%	80.75%	55.66%	42.30%	34.03%	28.42%
		0.0%	23.8%	592.11%	162.51%	90.01%	61.65%	46.70%	37.50%	31.28%
		15.0%	18.8%	16.91%	6.63%	3.34%	1.68%	0.65%	-0.08%	-0.64%
		15.0%	20.0%	23.28%	9.60%	5.32%	3.20%	1.90%	1.00%	0.33%
		15.0%	23.8%	43.43%	18.50%	11.15%	7.60%	5.50%	4.09%	3.06%

		2024	Future	2025	2026	2027	2028	2029	2030	2031
Growth Rate	8.0%	0.0%	15.0%	368.52%	114.83%	65.58%	45.31%	34.31%	27.39%	22.64%
State Tax	4.0%	0.0%	18.8%	448.78%	132.82%	74.88%	51.51%	38.98%	31.17%	25.83%
		0.0%	20.0%	493.92%	142.35%	79.70%	54.69%	41.35%	33.08%	27.43%
		0.0%	23.8%	589.22%	161.34%	89.10%	60.82%	45.90%	36.70%	30.47%
		15.0%	18.8%	13.82%	3.52%	-0.02%	-2.02%	-3.48%	-4.75%	-5.99%
		15.0%	20.0%	20.24%	6.62%	2.15%	-0.27%	-1.94%	-3.31%	-4.57%
		15.0%	23.8%	40.54%	15.89%	8.45%	4.73%	2.37%	0.65%	-0.76%

Most importantly, if the taxpayer is currently in the 0% capital gains tax bracket, gain harvesting will always be favorable because it gives the taxpayer a free basis step-up. Thus, always make sure to fill up the 0% capital gains tax bracket. Furthermore, if the taxpayer is nearing death and plans on keeping the asset until death to pass it on to his or her heirs, then there is no reason to harvest gains now because the taxpayer (or his heirs) will get a free stepped-up basis at the time of the taxpayer's death.

Lastly, before engaging in gain harvesting, be sure to take a look at the economic substance doctrine. IRC § 6662(b)(6) imposes a 20% penalty on any underpayment of tax due to a transaction that lacks economic substance. That penalty increases to 40% if the transaction is not adequately disclosed on the return. IRC § 7701(o) provides that a transaction has economic substance only if: (1) it changes the taxpayer's economic position in a meaningful way; and (2) the taxpayer has a substantial non-tax reason for entering into the transaction.[8]

From an investment perspective, the taxpayer would like to repurchase the asset as soon as possible after the gain harvesting sale to minimize the risk of the price increasing between the time of sale and the time of repurchase. When harvesting gains, it is difficult to see how either requirement above would be met if the sale and repurchase occurred on the same day or perhaps within a very short time period. If the time between the sale and repurchase is very short the IRS might take the position that the sale lacks substance. The seller has claimed a basis increase without really cashing out his or her investment or changing his or her economic position. However, gain harvesting would present a rather unusual situation for applying the economic substance doctrine. This is because there would be no understatement in the year the gain was harvested and you could not speculate in the current year how much might be saved later. Nevertheless, if the investor's tax rate was higher when the repurchased asset was later sold, the IRS might take the position that the penalty applied in the year of the second sale.

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[8] IRC § 7701(o)(1).

> ***Example 3.*** Ken and Julie, married taxpayers filing jointly, own X Corporation stock with a basis of $5,000 and a fair market value of $35,000. In Year 1, when their other income is $40,000, they sell the stock, recognizing a gain of $30,000 and immediately repurchase the same stock. Because their total income for the year is less than $94,050, they are in the 0% capital gain bracket and they obtain a basis step-up without paying any capital gains tax. In Year 3, Ken and Julie's income has increased to $110,000 and the value of the X Corporation stock has increased to $45,000. They sell the stock, recognize a gain of $10,000 and pay capital gains tax of $1,500 (.15 x $10,000). It is not clear whether the IRS could (1) take the position that the Year 1 sale lacked substance, (2) deny the $30,000 basis increase, (3) claim an underpayment of $4,500 in Year 3 (.15 x $30,000), and (4) impose penalties on the understatement under IRC §§ 6662(b)(6) and 7701(o).

To be safe, taxpayers who harvest gains might wish to build substance into their sales. One way to do this would be to lengthen the time between the gain harvesting sale and the repurchase. For tax purposes, the longer the delay, the more likely it would be that the transaction would be treated as having economic substance because the taxpayer is subject to market risk during the intervening period. A longer time period would also make it easier for a taxpayer to show a non-tax motivation for the sale. If it turns out that the economic substance doctrine applies, taxpayers will want to make the delay as short as possible without taking a significant risk that IRC § 7701(o)(1) will apply. How long this period is will depend on all the facts and circumstances of the case and is difficult to determine. Another way to build substance into the transaction would be to repurchase assets that are similar, but not identical to the assets harvested.

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