Regions Wealth Podcast

Episode #48
Understanding Capital Gains Taxes

Whether your assets have grown $1,000 or $1,000,000 in value, having a solid understanding of how those gains are taxed is key to ensuring you're not caught off guard come Tax Day. In this episode, Regional Fiduciary Manager Mark Hammond joins us to provide a crash course in capital gains taxes. We explore what every taxpayer should know about capital gains taxes and how they apply to a variety of asset types, including real estate, stocks, cryptocurrency, retirement plans, and the sale of a business.

SME: Mark Hammond, Regional Fiduciary Manager

Sarah Fister Gale, Host:
Welcome to Regions Wealth Podcast - the podcast that tackles life's challenges with financial experience. I'm your host, Sarah Fister Gale.

Thanks to double-digit stock market gains, rapid asset price appreciation, and broadening participation in markets, household equity wealth rose 40 percent in 2021. However, with those gains came significant tax liability for many Americans. According to an analysis from the Penn Wharton Budget Model, individual taxpayers owed the IRS *$522 billion* as of April 2022 — that's an increase of roughly $200 billion compared to previous years.

While taxes shouldn't drive investment strategy, having a solid understanding of how capital gains are taxed is key to making smarter, more informed decisions. So what do you need to know to ensure you're well-prepared for tax season?

Joining me remotely is Mark Hammond. He's a Regional Fiduciary Manager at Regions Bank. Mark, thanks for joining me today.

Mark Hammond:

Absolutely. Great to be here.

Sarah:

So, Mark, in this episode we're discussing capital gains taxes. We've taken some frequently asked questions and have developed a character who needs your help. Let's listen.

Alexa:

“Hey! My name’s Alexa and I’d love your help understanding capital gains taxes. Basically, I’ve been saving like mad since I started my career as a programmer—currently, I’ve got around $370k socked away in the bank. I’ve also been maxing out my 401(k) contributions each year, so I’m in a good position financially, but now that I’m 36, I feel like I should be doing more with my money. I’ve been exploring a handful of investment options, from real estate to ETFs to cryptocurrency, but before I make any moves, I’d like to get a better grasp on the potential tax implications.

Let me preface this by saying that I know I should be working with a tax professional and a financial advisor, and I definitely plan on doing both of those things. However, I’m someone who really likes to understand things on my own first, so if you wouldn’t mind, I’d be grateful if you could walk me through the basics of capital gains taxes.”

Sarah:

So, Mark, let's start with the basics. What are capital gains taxes and how do they work?

Mark:

Sure. So capital gains taxes are part of the income tax system. It's a unique type of taxable income. A capital gain is the difference between what you purchase an asset or investment for and what you sell that investment for. So, for example, if you buy investment real estate for $100,000 and you sell it for $150,000, that $50,000 increase would be the capital gain that's subject to taxes. One difference between ordinary income and capital gains is that capital gains has the potential to have a preferential lower tax rate than your normal ordinary income would have.

Sarah:

Before we get too deep into this topic, let’s clarify: Do the tax rules we're discussing vary by state?

Mark:

That's a good question. What I've been discussing are federal taxes. Depending on the state that you reside in, there could potentially be state income tax consequences from transactions as well. So if you are in a state with an income tax or own property in a state with an income tax, you want to make sure that you're working with an advisor so you know those rules as well.

Sarah:

And what types of assets are subject to capital gains taxes?

Mark:

Anything that's a capital asset is what it's called in the tax code, which is really any type of asset you could own, so, stock, real estate, a business, art, gold, coins, anything like that would be an asset that you could buy and sell.

Sarah:

You said the tax rate could be lower on capital gains compared to those on standard income. Could you explain the difference?

Mark:

Sure. So, long term capital gains have generally speaking, a lower tax rate than ordinary income. So if you're in the lowest capital gains tax brackets it's actually zero percent and then a large portion of tax payers, up to about $450,000 in income, it's a 15% tax bracket and then over that it's 20%, which is, quite a bit lower than your ordinary income rates which are closer to 40.

Sarah:

So it sounds like Alexa is making good use of her employer-sponsored 401k plan. Are these retirement plans subject to capital gains taxes?

Mark:

That's a very good question, and the answer is no. So retirement accounts are one big category of asset type that is excluded from capital gains taxes. So the way a retirement account works, whether it's a 401k or an traditional IRA, is that you receive a tax deduction when assets go into the account. So, essentially, you don't pay taxes on funding the 401k or traditional IRA. The way a retirement account is taxed is when you take distributions from the account. That's when you would pay ordinary income tax rates on those assets. So the benefit of the retirement account is that it goes in pre-tax. It grows pre-tax and then you only pay taxes when you withdraw the funds. One alternative to that would be a Roth IRA or Roth 401k, which is a similar type of account. But in order to get funds into the Roth 401k or Roth IRA, that's post-tax money, so you pay taxes upfront. The assets grow tax free without paying any capital gains. And then, once you reach retirement age, you can start withdrawing those funds and you don't pay taxes when you withdraw. So you only pay taxes on the front end and not when you withdraw.

Sarah:

With an employee-sponsored 401k, you only pay taxes at the time of distribution, and that’s based on whatever income bracket you're in at that point, correct?

Mark:

Exactly. So that's a very good point around the tax impact on your retirement accounts. Generally speaking, if you're funding a traditional 401k, you're receiving the benefit of

essentially the tax deduction when you're in a higher marginal rate. For example, let's say, you would be taxed at 30% on that income. Later, in retirement, your income is lower, your effective tax rate might only be 10 or 15%. And that's what determines the taxability is your income in retirement.

Sarah:

Okay, so Alexa mentions that she's thinking of investing in cryptocurrency. That's a topic we've been talking about a lot in this season. Is cryptocurrency subject to capital gains taxes?

Mark:

Yes, that's a very good question, cryptocurrency is a capital asset just like any other type of investment you would hold. So if you were to purchase cryptocurrency with cash and then sell that currency and exchange that currency either for cash or another cryptocurrency, when you dispose of that cryptocurrency, you're going to have a capital gains or loss based on the difference between what you acquired it for and what you disposed of it for.

Sarah:

So even if it never turns back into cash, if you trade one cryptocurrency for another you'd still have to pay capital gains taxes?

Mark:

Correct. Even though they are referred to as currencies, as far as the IRS is concerned, they are a digital asset.

Sarah:

Now, before we dive back into Alexa's story, I'd love to ask: how important is it for investors to think about capital gains tax before making investment decisions?

Mark:

In general, thinking about the tax impact of any investment is a big component when you're thinking about your return. Because, ultimately, it's the after-tax return that really matters when you're evaluating whether an investment makes sense. The flip side of that is you can become so focused on the tax implications that you end up making bad investment decisions. I've seen, in my practice multiple times, where a client will have one investment that does phenomenally well where if they were to sell that, there would be a significant amount of income tax. The problem is, it's such a concentrated amount of risk in their portfolio that the income tax is certainly important, but it's really dwarfed by the risk that they're taking on. And I've seen it numerous times where, you know, it's not going to go down, it's not going to go down. Lo and behold, it goes down and it is too late to do anything.

Sarah:

So in other words, it's important to consider not only the tax implications, but all of the associated opportunities and risks. What would you advise someone to do if they're worried about the tax implications of selling a high-performing investment?

Mark:

Working with your financial team, which would include your financial advisor as well as your CPA or accountant, to work through the tax consequences. And a lot of times it doesn't have to be an all or nothing equation. Sometimes if someone has a large concentration in an asset we can set up a plan to reduce that concentration over time so you don't pay all the taxes all in one year. But also, so you take a more appropriate level of risk and you're not so exposed to the value of just one asset.

Sarah:
Great reminder. So let's pause here and listen to a bit more of Alexa's story.

Alexa:
"The difference between unrealized gains and realized gains seems pretty straightforward, but I'm still a bit fuzzy on things like cost basis, and the difference between short-term capital gain and long-term capital gains. Also, as both a homeowner and someone who's interested in purchasing an investment property, it would also be great to learn a little bit more about how this all applies to real estate. I purchased my condo back in 2013, and given how crazy the market has been over the last few years, the value has skyrocketed. Based on comps in my building, the value of my condo has gone up around $210k over the last decade. If I decided to sell, would those gains be taxed differently than, say, an investment property?"

Sarah:

So, Alexa mentions unrealized gains and realized gains. Let's start there. Can you define those terms for us?

Mark:

Sure. So before you have sold an asset, if that asset has gone up in value, those gains are unrealized. So, for example, if you purchase stock for $100 and it goes to $200, you have an unrealized gain or sometimes it's referred to as a built-in gain of $100. So that means if you were to dispose of that asset, that's when the gain is recognized. So, a gain goes from unrealized to realized at the moment you sell it or dispose of it.

Sarah:

Okay, so what's the difference between short-term and long-term capital gains?

Mark:

Sure. So a short-term gain is an asset that is disposed of inside of one year of when it's acquired. So, for example, if a day trader is buying and selling securities in a very short time span, they would not have the ability to get those preferential, longer term rates. Short-term capital gains are taxed the same as ordinary income. Long-term capital gains would be anything held for more than one year. And those are the gains that are subject to those potentially lower tax rates.

Sarah:

So you're saying if I bought a stock and sold it 340 days later, I'll pay the higher tax rate, but if I sell it after 370 days, I get the lower tax rate?

Mark:

The way these tax brackets work together can get a little bit complicated. But in general, yes, your ordinary income tax brackets operate independently of your long-term capital gain tax bracket.

Sarah:

Alexa also mentions cost basis. What is cost basis and how is it calculated?

Mark:

The cost basis is essentially what it costs you to acquire a property. the most simple example of buying a stock, it's what you paid for that stock. So, the way you arrive at your actual capital gain is your cost basis of, let's say it's $100, and then if you sell for $150, the $150 minus the $100 cost basis equals your $50 capital gain. So, knowing your cost basis is very important so that you can know what your capital gain is. Certain types of assets, your cost basis can get a little bit more complicated. For example, if you have real estate and you have made capital improvements to that property. So if you buy a house for $100,000 and then you put in an addition and a swimming pool for $50,000, that's a capital improvement that increases your cost basis. So it's very important that over the life of owning an asset you keep good records around what the cost basis is.

Sarah:

Alexa had a few questions about how gains on real estate might be taxed. If she were to tell her primary residence, would she be subject to capital gains taxes?

Mark:

So that's a good question and there are some special rules around that. So the general rule is that when you sell your primary residence you can exclude $250,000 of capital gain from your taxes, and that's for an individual. For a married couple, it's actually a $500,000 capital gain exclusion. There are some rules around what counts as your primary residence. In general, the property needed to be your primary home for two of the five years prior to the sale.

Sarah:

Interesting. So again, it feels like it's very important to have someone advising you on all the different aspects of how these taxes are going to play out before you make a selling decision.

Mark:

Absolutely.

Sarah:
And are capital gains on investment real estate taxed differently from capital gains on a primary residence?

Mark:

They are. So capital gains on investment real estate are generally the same as any other assets where you're not going to have that exclusion. So the difference between what you purchased a property for and what you sold it for would be a capital gain. One complicating factor with real estate is you can take depreciation deductions against real estate. Those have the impact of lowering your cost basis. So you can depreciate real estate over time, receive an income tax benefit in the year that you take those depreciation deductions. Then, when you ultimately go to dispose of the property, those deductions that you took before essentially get lumped back in with the income. So it's a little bit more complicated with investment real estate because that cost basis can be depreciated.

Sarah:

And what happens if it is a vacation property or a second home?

Mark:

So, in general the exclusion applies to your primary residence. It can get a little bit tricky with vacation homes, depending on whether it's strictly a vacation home for our own use or if it's a vacation home that you're earning investment income off of by renting out. If you do have vacation property or vacation rental property, you definitely want to be working with a tax advisor.

Sarah:

That's helpful. Alexa has a few more questions, so let's pause here and listen to the final portion of her story.

Alexa:
"Also, my current salary puts me at the high end of my income tax bracket, so I'm a little concerned about that, too. Can realized gains push me into a higher income tax bracket?

Sorry for the litany of questions. I just want to make sure that I'm well-informed and making investments in a way that's both honest and tax efficient, so if you have any best practices, I'm all ears."

Sarah:

Alexa raises an interesting question. Can realized gains push individuals into a higher income tax bracket?

Mark:

So this is a really good question and it used to be more straightforward than it is now. So, the way the interplay between ordinary income taxes and capital gains taxes work right now is that essentially capital gains are not going to push you into a higher ordinary tax bracket. But your overall level of income will potentially impact what your capital gains tax rate is. So you're taxed first on your ordinary income and then, long-term capital gains are stacked on top of that. So, your salary impacted your capital gains rate, but it would not work the other way where your capital gains put you in a higher ordinary income tax bracket.

Sarah:

Now, Alexa said she'd like to ensure she's making decisions in a way that's both honest and tax efficient. With that in mind, are there any best practices she should be aware of?

Mark:

I think one thing that we focus on at Regions is really investing for the long-term. So taxes are an important component of that. If you have a significant amount of churn in your account where you're buying and selling assets, those capital gains over years and decades are really going to drag your performance. So, I think investing with a long-term strategy, buying high-quality assets that you can hold for a significant period of time is really the long-term strategy.

Sarah:

So Mark, one thing Alexa hasn't asked about is estate planning. Do capital gains taxes come into consideration during the estate planning process?

Mark:

One thing that we deal with quite a bit in private wealth management is a concept called a step-up in basis. So there are provisions in the Federal Tax Code where the unrealized capital gains in the hands of the decedent who you inherited the assets from would be eliminated when you inherited them. So, for example, if your grandfather bought stock for five dollars and held it for 50 years and it was worth $100 when you inherited that property, had your grandfather sold it prior to his death, there would've been a significant capital gain on the difference between the five dollar cost basis and whatever it was sold for. Whereas, if you

inherited that property, you receive a cost basis equal to the fair-market value at the date of death. So many times, when we're dealing with clients who are wanting to pass assets on to the next generation, choosing which assets you hold onto, which assets you gift, there's a significant capital gains planning component to that because you can eliminate all of those gains by passing them at death rather than spending them during your lifetime or gifting them.

Sarah:

I'd love to shift the conversation to small business owners. At a high level, how do capital gains taxes come into play during the sale of a business?

Mark:

Owning a business is a capital asset itself. So if you are the owner of a corporation and you sell that corporation, there would be a capital gain that could be calculated based on your cost basis in the business and what you sold it for. Business transactions can get complicated very quickly. Part of the reason is there's multiple different tax classifications for businesses. It could be a C-corporation, it could be taxed as a partnership. It could be taxed as an S-corporation. The way a business transaction is structured, whether it's a sale of the business as a whole or if it's a sale of all of the assets of the business, are going to impact the way the capital gain is calculated. So if you are in a situation where you are thinking of selling a business or acquiring a business, you definitely want to bring your tax advisors in early to help structure that deal in the most tax-efficient way possible.

Sarah:

You talked about, with the sale of a home, keeping track of the investments you've made that add value, right? Does the same thing count for the small business?

Mark:

Absolutely. The stake that you own in your business And the cost basis of the business and of the assets in the business are definitely going to be subject to adjustments that potentially impact the cost basis. So, having very good accounting along the way is going to be very important for you knowing the tax consequences of a sale.

Sarah:

During the sale of a business, what sort of assets might be subject to capital gains taxes?

Mark:

When you sell a business, you could actually sell the entire operating business or the entity itself, whether it's a corporation or an LLC. you would calculate a capital gain based on your cost basis in the entity and the amount that was realized in the sale. Another type of business sale is where all of the assets of a business are sold. And a business that owns multiple

different types of assets, those individual assets are also going to have a cost basis and are potentially going to have capital gains on each particular asset that would be tracked and could've been depreciated. So determining the taxability of the sale of all of the businesses' assets could be quite complicated.

Sarah:

And what if you sell the business assets included? You know, all the equipment, all the real estate, in one fell swoop. Does that then have to be parceled out?

Mark:

That's a good question and this can also depend on the way the entity is set up from a tax standpoint, whether it's a C-corporation, an S-corporation, or a partnership. These rules Can get very, very complicated, so you definitely want to make sure you're working with a good CPA who can help you determine exactly what rules apply to your business.

When you're selling a business, you don't know what you don't know. So I think it's critical that if you're contemplating a sale of your business to really bring in competent tax advisors as soon as you can. Not only so that they can make you aware of what the laws are, but also to really be a part of structuring a transaction that meets your goals in a tax-efficient way. A lot of times, there are people selling a business that are charitably motivated, there are some significant tax planning opportunities where you can give a significant amount to a charity and not really impact the net proceeds of the sale. And the issue with all of these strategies, once you've already signed a deal or closed the transaction, it's too late, in most cases, to do this type of planning. So, definitely engage experts on the front end so that you know what your options are.

Sarah:

So that's a really good point. We've talked a lot about the value of talking to a tax professional or wealth planner. At what point should investors like Alexa start talking to those professionals?

Mark:

I think having someone on your financial team who has a solid understanding of tax implications is really—it's not a one-time conversation, it's part of an ongoing relationship. Taxes are getting more and more complicated each year. I don't think that trajectory is going to change. So having someone who's able to really customize advice to your specific situation is really important.

Sarah:

So, Mark, at the end of these discussions we like to ask our guests to sum up some key takeaways. What takeaways would you offer our listeners on how to think about and deal with capital gains taxes?

Mark :

Sure. I think the first would be, if you have any doubts or questions about your tax situation, I always recommend bringing an advisor in on the front end. Like I said, you don't know what you don't know, and tax impacts can make a significant difference to your financial situation. My perspective on taxes in general is obviously, you want to be taking advantage of the tax laws in such a way that you're not paying more taxes than you need to be paying. If there are opportunities for you to use the tax code to your advantage, whether that's IRA and 401k contributions or the timing of a sale, absolutely you should be mindful of the tax impact of any of those transactions.

I think the second would be, keep an appropriate perspective on taxes. They're one component of what it means to hold an investment, but they shouldn't impact everything. If you only focus on taxes you can make some very bad investment decisions. So you don't want to hold onto an asset that's a horrible investment or is an unreasonable amount of risk for your situation just because you don't want to pay taxes to sell it. Hindsight is 20/20. If your investment goes down 50% or 75%, you're wishing that you would've sold it and paid a 15 or 20% capital gains tax on it.

Sarah:

Mark, this has been such a useful and interesting conversation. Thank you so much for your time today.

Mark:

Absolutely. Thank you for having me.

Sarah:

That was Mark Hammond, Regional Fiduciary Manager at Regions Bank.
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