CHIEF INVESTMENT OFFICE

Educational Series

The Capital Gains Dilemma

Why investors should start thinking strategically about capital gains and taxes

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The past decade of equity market appreciation, has left many investors with appreciated assets in their portfolios. While this is a benefit, this can also have a downside: Investors may be averse to selling stock because they do not want to trigger taxes on capital gains, or the profits from a sale. Yet, by not selling, and basically "kicking the proverbial tax can down the road," investors may limit their ability to rebalance a portfolio in a timely manner, setting the scene for a rise in the level of risk they face.

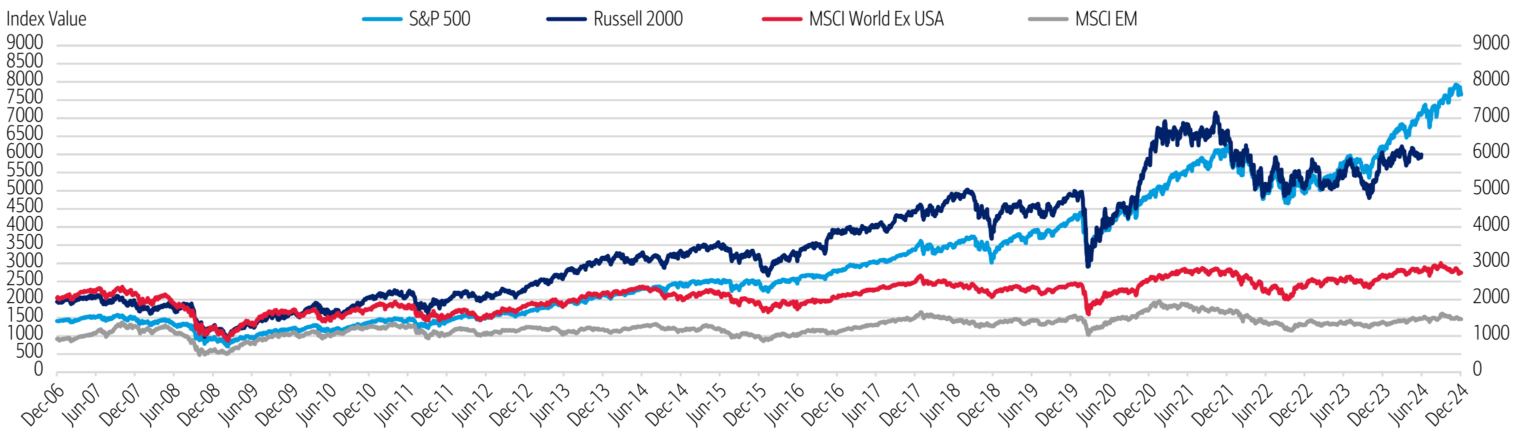
There is an important question here: What might prompt the reluctant seller and the proverbial can-kicker to view taxes in a different light, so that they can sell when appropriate and rebalance a portfolio in a prudent manner? Here are some compelling points.

TAXES CAN BE EASY TO MANAGE BUT DIFFICULT TO AVOID

Capital gains, and the tax consequences they may generate, are simply a normal part of investing. In fact, income taxes are usually a result of successful and healthy active portfolio management, rather than something to delay, or avoid. Indeed, taxes can be managed but rarely avoided entirely. That being the case, essentially all investors—and especially the reluctant sellers among them—should consider a more strategic approach to capital gains and taxes.

Thinking strategically—or planning ahead in ways that can potentially benefit a portfolio—is essential at any point in a market cycle. But it is especially important as new cycles develop that may change the existing trend in interest rates, the U.S. dollar, valuation multiples, and, of course, the level of economic growth.

Exhibit 1: Equity Market Appreciation



Source: Chief Investment Office. Data December 28, 2006 through December 2024. **It is not possible to invest directly in an index. Please refer to index definitions at the end of this report. Past performance is no guarantee of future results.**

MANAGING CAPITAL GAIN RECOGNITION

One important step investors can take is to mitigate the amount of taxes that are recognized. To take advantage of some available opportunities to mitigate tax recognition, it is important for individuals to understand their overall tax situation.

1. **Tax Rate.** Understand your effective capital gain rate. Not all individuals are in the highest capital gain tax bracket. Retirees may be surprised to find that they dip into lower income brackets and possibly lower capital gain brackets once employment income ends.

2025 Long-term Gains Bracket	Income Thresholds (Married Filing Jointly)
23.8%	Over $600,050
18.8%	Over $250,000 to $600,050
15.0%	Over $96,700 to $250,000
0.0%	Up to $96,700*

* Gains may be taxable on the state level.

The above long-term capital gains rates include an additional 3.8% surtax when income exceeds $250,000.

2025 Long-term Gains Bracket	Income Thresholds (Single Filers)
23.8%	Over $533,400
18.8%	Over $200,000 to $533,400
15.0%	Over $48,350 to $200,000
0.0%	Up to $48,350*

* Gains may be taxable on the state level.

The above long-term capital gains rates include an additional 3.8% surtax when income exceeds $200,000.

2. **Carryforwards.** Consider utilizing any carryforward capital losses from prior tax years to offset any potential capital gains.

3. **Harvesting capital losses.** Consider the potential benefit of harvesting unrealized capital losses to offset recognized capital gains, and do so every calendar year. Note, however, that tax loss harvesting is only effective if “wash sale” rules don’t apply. A wash sale occurs if a security is sold at a loss and the same or a substantially similar security is purchased within a 61 day window (30 days before the day of purchase, the day of purchase, and 30 days after the day of purchase).

   Always evaluate prior purchases and do not buy the same or a similar security within the window period. Note that wash sales apply to all of an individual’s accounts. For example, if a security is sold in one account to capture a loss, and the same or a similar security is purchased in another account within the window period, the loss cannot be recognized. Be sure to consult a tax advisor for the application of the rules to your particular circumstances.

4. **Utilize a portfolio view versus an account view to effectuate rebalancing.** Oftentimes, we find investors hold sizeable retirement assets that can be used to start rebalancing decisions without triggering immediate taxes on recognized capital gains.

5. **Consider spreading the tax cost over multiple tax years.**

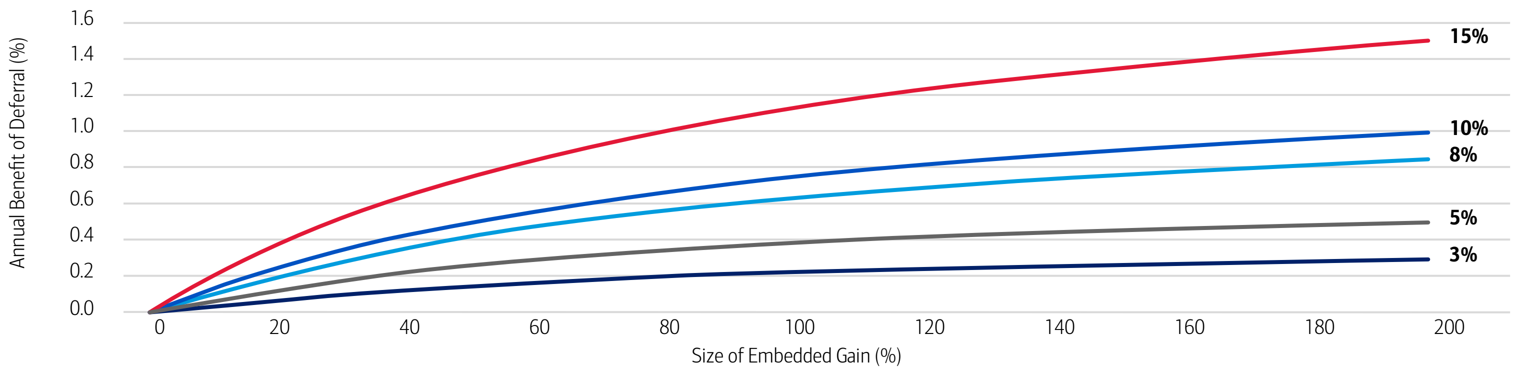
6. **Manage holding periods.** A recognized capital gain can be taxed at preferential rates if the security has been held for greater than one year.

7. **Tax law changes.** In addition to considering how changes in your personal income might impact your capital gain tax rate, you should also be mindful of how future tax policy could affect your tax burden, either through the scheduled sunset of current tax law, or tax law changes that may be passed by a new administration in Washington.

ELIMINATE CAPITAL GAINS OR FIND A WAY TO DEFER?

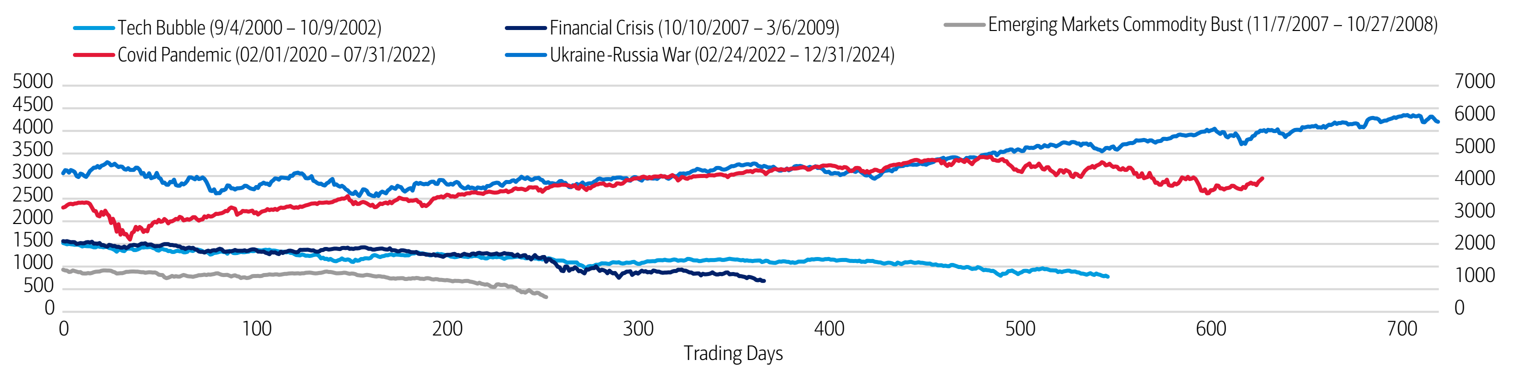
There are a few ways to eliminate or defer paying taxes on capital gains. Holding appreciated assets until death or donating appreciated assets to qualified charities may be some of the only ways to eliminate the capital gains tax. However, deferring capital gains temporarily is possible and it allows the assets to grow tax deferred. The benefit of deferring capital gains will vary by the size of the gain, the expected investment return and an investor's capital gains tax rate. The annual overall benefit of deferring capital gains is generally smaller than most taxpayers think.

Exhibit 2: Small Benefits to Deferring Capital Gains



Source: Michael Kitces. Data as of June 19, 2018, latest available.
The Y axis is the annual benefit of deferral in terms of a percentage of the net value of the investment (net of capital gains tax). The X axis is the percentage of appreciation of the investment (for instance, an investment purchased at $100,000 that is now worth $160,000 has an embedded gain of 60%). Assumes a capital gain tax of 15%.
For example a $1 million gain on an initial investment of $3 million is a 33% gain. The tax liability is $150,000 (at a 15% rate). That liability exists perpetually unless the gain is lost. By deferring the gain, the investment grows by the rate of earnings going forward. In this case let's say 8%, or $12,000. That equates to 0.3% of saving by deferring the gain. The savings is relatively low and can easily be eaten up by volatile markets or future tax increases. For illustrative purposes only.

Exhibit 3: Maximum Drawdown Periods of the S&P 500 Index & MSCI Emerging Markets Index



Source: Chief Investment Office. Data as of December 2024. **Past performance is no guarantee of future results.**

MANAGE THE TAX BRACKET

Deferring capital gains can actually reduce wealth by pushing a taxpayer into a higher capital gains tax bracket when that deferred gain is recognized all at once. If you monitor your annual tax situation, you may recognize enough capital gain each year to avoid bunching up the gain and pushing you into a higher tax bracket. In a similar vein, whether a taxpayer is in the 23.8% capital gain bracket will also depend on other income, so controlling that other income might allow the capital gain rate to remain in the 15% bracket.

OTHER METHODS TO CONSIDER

Consider rebalancing by leveraging gifting, charitable donations and wealth structuring, using appreciated holdings. Investors should talk to their tax advisor about the following strategies as these are general strategies and may not be applicable to everyone.

Donate-and-Replace Strategy: Rather than giving cash to a charitable recipient, investors could consider transferring appreciated stock to a charity and then use the cash that otherwise would have been used for gifting to replace the stock. This strategy only makes sense if you normally make charitable gifts.

Gift-and-Replace Strategy: Rather than giving cash to a child or other individual recipient, investors may transfer appreciated stock to that person and then use the funds that otherwise would have been used for gifting for redeploying or towards rebalancing the investment portfolio. This strategy only makes sense if you normally make gifts to family members or others. Keep this in mind: If the gift recipient is a young child, he or she may be subject to the so-called kiddie tax, which could subject the child's capital gain, or a portion of the capital gain, to the marginal rate paid by the child's parents rather than the child's rate.

Charitable Remainder Trust (CRT): A taxpayer can defer long-term capital gains by contributing appreciated property to a CRT. Gains realized by the CRT may be attributable to the taxpayer when payments are made from the CRT to the taxpayer.

Look at the portfolio level to facilitate rebalancing: For instance rebalancing in a tax advantaged account can reduce the tax burden in the taxable account.

Offset Gains with Losses: Taxpayers can harvest capital losses to offset gains, being mindful of wash-sale rules.

Opportunity Zones: A taxpayer can defer short- and long-term capital gains by timely reinvesting an amount, up to the capital gain that would otherwise be recognized, into a qualified opportunity fund. In order to take advantage of the tax benefits of the program, a taxpayer can reinvest an amount up to the capital gain in a qualified opportunity fund within 180 days from the date of the sale or exchange of a capital asset.

The deferred gain would be recognized on the earlier of December 31, 2026 or when the opportunity fund investment is sold or disposed of.

OUR PERSPECTIVE: MARKET CYCLES AND PORTFOLIO POSITIONING

Overall, the U.S. economy has proven resilient in the face of higher long term interest rates, the consumer remains stable, supported by a still healthy jobs market, and inflation, albeit sticky, has descended to improved levels which has allowed the Fed to cut rates. Our preference is to remain diversified and balanced within traditional asset classes, as rotations within market leadership unfold, and utilize Alternative Investments and Real Assets for further diversification, income opportunities and inflation protection.

We maintain our preference for Equities based on a constructive outlook for corporate earnings and see potential opportunities within high quality Fixed Income for portfolio income and diversification.

CONCLUSION

As the cliché goes, "don't let the tax tail lead the investment dog". Given the assumed success investors have had in both the equity and fixed income markets, especially since the equity market lows in March 2009, recognizing gains should be viewed as a result of successful active management.[1]

In order to help keep any gains and not lose appreciated value, investors should consider aligning to a strategic asset allocation, such as that offered by the Chief Investment Office. To the extent that the cost of rebalancing is large, spreading the tax burden over multiple years, and/or using other tax-mitigation strategies, might help other strategies.

[1] Active management seeks to outperform benchmarks through active investment decisions such as asset allocation and investment selection.

Index Definitions

The indices defined below are unmanaged, include the reinvestment of dividends when applicable, do not reflect the impact of transaction fees, management fees, or incentive compensation, and are not available for investment. They are included here for illustrative purposes. It is not possible to invest directly in an index.

S&P 500 Index, widely regarded as the best single gauge of the U.S. equities market, includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market.

Russell 2000 Index® measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

MSCI World ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries — excluding the United States. With 1,022 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI Emerging Markets Index captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 832 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. EM countries include: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Russia, Qatar, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

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Investing involves risk, including the possible loss of principal. Past performance is no guarantee of future results.

All recommendations must be considered in the context of an individual investor's goals, time horizon, liquidity needs and risk tolerance. Not all recommendations will be in the best interest of all investors. Asset allocation, diversification and rebalancing do not ensure a profit or protect against loss in declining markets.

Investments have varying degrees of risk. Some of the risks involved with equities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Bonds are subject to interest rate, inflation and credit risks. Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration.

Qualified Opportunity investing, is a relatively new and evolving investment opportunity in an Opportunity Zone program, which is highly speculative and involves a high degree of risk, as well as limited liquidity. An investor could lose all or a substantial amount of their investment. An investment in a Qualified Opportunity fund has all of the normal risks associated with the underlying investments in the Qualified Opportunity fund, including but not limited to the risks associated with real-estate investments. To take advantage of certain tax benefits, regarding the exclusion of future gains, investors must hold their investments in the Qualified Opportunity fund and the Qualified Opportunity fund must maintain its status as Qualified Opportunity fund, for 10 years.

Alternative investments are intended for qualified investors only. Alternative Investments such as derivatives, hedge funds, private equity funds, and funds of funds can result in higher return potential but also higher loss potential. Changes in economic conditions or other circumstances may adversely affect your investments. Before you invest in alternative investments, you should consider your overall financial situation, how much money you have to invest, your need for liquidity and your tolerance for risk.