

# Formulas Help You Decide When to Hold, When to Sell

## Answers Tough Investment Questions

- **Short-Term vs. Long-Term Tax Rates**
- **How to Compute Breakeven on Making Short-Term Gains Long-Term**
- **Use of Factors to Calculate Breakeven and Lower Taxes**
- **Use of Family to Lower Taxes**
- **Use of Charities to Lower Taxes**

## How Long Can You Afford to Hold A Stock That Has Peaked?

There are very compelling tax reasons for holding onto your investments until any gains can qualify as long-term gains. But it's also very tempting to cash in on a short-term gain on an investment that appears to be at its peak or positioned for a fall. This important **Resource Report** presents formulas and analyses that will be very helpful in making the decision on when to sell. Basically, it's a matter of evaluating the tax/gain tradeoff and establishing the breakeven point so you can time your investment sales and purchases to save taxes.

*Tax-saving facts:* For stocks and bonds held for more than 12 months, the maximum capital gain tax rate is 15% (5% for most children and retirees who are in the 10% and 15% tax brackets). In contrast, if the capital gain is short-term, it is taxed at personal income tax rates up to 35%.

Here is an illustration of the potential tax savings when you move a short-term gain to long-term. The *Tax Savings* column is your additional return per \$10,000 capital gain when that gain is long-term vs. short-term.

—— Tax Rates ——			
<u>Short-Term</u>	<u>Long-Term</u>	<u>Tax Savings</u>	<u>Savings per \$10,000</u>
10%	5%	5 points	\$ 500
15%	5%	10 points	\$1,000
25%	15%	10 points	\$1,000
28%	15%	13 points	\$1,300
33%	15%	18 points	\$1,800
35%	15%	20 points	\$2,000

**Question #1.** If I have a short-term gain (taxable at 35%) and want to make it long-term (taxable at 15%), how much can the stock drop in price before I break even on the tax savings?

To answer this important question, let's assume the following: You own 1,000 shares of ABC Company *purchased 10 months ago*, so you need to wait two more months to make the sale long-term.

Current Market Value (\$22)	\$22,000
Less: Cost Basis (\$12)	<u>12,000</u>
Capital Gain (Short-Term)	<u>\$10,000</u>
Your Tax Rate	<u>35%</u>

**Answer #1.** The first step is to compute your taxes and after-tax cash if you sold the stock *today* for a short-term gain:

Short-Term Gain	\$10,000
Less: Taxes at 35%	<u>3,500</u>
After-Tax Cash	<u>\$ 6,500</u>

**Breakeven: Short-term to long-term.** Now, to compute your tax *breakeven* by moving the \$10,000 short-term gain to long-term (taxed at only 15%), use the following formula:

$$\$6,500 \text{ After-Tax Cash divided by } .85 \text{ (1.00 minus } .15) = \underline{\underline{\$7,647}}$$

Thus, your \$10,000 short-term gain can drop to \$7,647 and you would have the same net after-tax cash of \$6,500. To test this, let's compute the after-tax cash on the lower \$7,647 gain (now long-term) — \$7,647 capital gain times 15% tax rate equals \$1,147 in taxes; \$7,647 gain less \$1,147 tax bill equals \$6,500 after-tax cash. *That's the same \$6,500* you would pocket (see above) by collecting the proceeds from a short-term gain and paying the higher tax rate.

**Breakeven: Stock price decline.** Since your \$10,000 gain can decline to the \$7,647 breakeven point, the market value of ABC's stock can decline \$2,353 or 10.7% of its current market value of \$22,000 (1,000 shares times \$22). Thus, the breakeven point on the stock is \$19,647 (\$22,000 less \$2,353) or \$2.353 per share. If the stock drops more than \$2.353 per share, waiting until the gain becomes long-term *isn't* tax advantageous.

## ***Breakeven Alternative: Use Factors***

You can go through the math on the prior page or you can apply the following factors to your tax rate and short-term profit to evaluate the tax/gain tradeoff. What you want to know is how much a stock can drop in price and still allow you to break even on an after-tax basis (i.e., at what point the drop in price and the tax savings cancel each other out). Here are the factors to apply to your capital gains to determine at what stock price it no longer pays to wait the additional two months to make the gain long-term:

<u>Tax Rate</u>	<u>Factor</u>
10%	0.9474
15%	0.8947
25%	0.8824
28%	0.8471
33%	0.7882
35%	0.7647

*Example:* In the 35% tax bracket, your current \$10,000 short-term gain can drop to \$7,647 before you lose the tax advantage of holding on to the stock and qualifying the gain as long-term — \$10,000 gain times the factor of 0.7647. That \$2,353 decline (\$10,000 less \$7,647 breakeven) represents a 10.7% decline in the stock's current value of \$22,000 — the same results you get with the formulas on the prior page.

*Observation #1:* The higher your tax bracket, the lower your breakeven point. Here's why:

	Tax Rate	
	<u>35%</u>	<u>25%</u>
Short-Term Capital Gain	\$10,000	\$10,000
Times Factor	<u>.7647</u>	<u>.8824</u>
Breakeven Point	\$ 7,647	\$ 8,824
Stock Can Decline by	\$ 2,353	\$ 1,176
Decline (% of \$22,000 FMV)	<u>10.7%</u>	<u>5.3%</u>

Thus, holding investments to qualify them for the 15% long-term tax rate is more advantageous for higher tax rate individuals since they are paying more taxes on their short-term gains and thus can suffer a bigger decline to break even (10.7% vs. 5.3% in the table on the prior page).

*Observation #2:* This analysis is only for federal tax rates. In some cases, states provide the same benefits in taxing long-term capital gains. Including the state tax impact in your calculations could further lower your breakeven point and further increase your potential tax savings from holding a short-term gain until it becomes long-term.

\* \* \*

**Question #2.** If ABC's stock *doesn't* drop in price, i.e., it stays at \$22, what is the added return for waiting two months to make the gain long-term?

**Answer #2.** You will save \$2,000 in taxes by making the \$10,000 gain long-term (again, taxed at 15% vs. 35%). If the stock stays at \$22 (\$22,000 total investment), your added return is 9.1% (\$2,000 tax savings divided by \$22,000 market value). However, that 9.1% return is based on only two months. If you annualize the 9.1% return for a full 12-month period, *the return is 54.6%* — 9.1% times 6 (12 months divided by two months). Thus, if you think the stock's price won't change, you should hold it for the 12-month period.

## How to Use Your Family to Lower Taxes

You have another choice if you are convinced a stock has peaked during the short-term holding period of 12 months or less: *give it away*. That way you get the advantage of the stock gain and pay less tax. For example, let's assume the same \$22,000 investment, which has an unrealized capital gain of \$10,000 (\$12,000 cost basis). *Here's how it works.*

You give the stock to your daughter, say, for college expenses, and she sells it for a short-term gain. Let's further assume that her tax rate is 10% (\$1,000 tax) versus your tax rate of 35% (\$3,500 tax). *That's a potential tax savings of 25*

*percentage points* or \$2,500 on the \$10,000 short-term capital gain. *Note:* For children under age 18, this strategy doesn't work as well since their income above \$1,700 is taxed at the parent's highest tax bracket.

Children age 18 and over pay taxes based on their own income. For 2007, the tax rate is 10% on the first \$7,825 of taxable income and 15% on the next \$24,025. The 5% capital gain rate applies to 10% and 15% tax bracket individuals. Thus, your children age 18 and over can take advantage of the 5% capital gain tax on taxable income up to \$31,850 (\$7,825 plus \$24,025).

## How to Use Charities to Lower Taxes

You might also decide to donate securities to a charity. But keep in mind that the length of time you have held the stock determines your charitable deduction.

For example, let's assume you purchased 1,000 shares of ABC Corp. 10 months ago at \$14 per share (cost basis of \$14,000). The current market value is \$24, for a capital gain of \$10 per share or \$10,000. Here are the tax savings (we will assume you're in the 35% tax bracket).

*Short-term gain:* Your **cost basis** in the stock gift determines your tax deduction. Thus, a \$14,000 cost basis times 35% tax rate equals a \$4,900 tax savings.

*Long-term gain:* The **fair market value** of the stock determines your tax deduction. Thus, a \$24,000 gift times 35% tax rate equals a \$8,400 tax savings versus a \$4,900 tax savings if the gain is short-term. The difference is \$3,500 (71% more cash in your pocket). It's your decision on whether or not it's worth the risk of the stock declining in value while you wait two months until the gain is long-term. But at least you have done the math to see the tax tradeoff of waiting.

\* \* \*

*Recommendation:* Set up a tickler system when purchasing securities to indicate the date the purchase becomes long-term. If there is a gain, try to sell the securities *after* 12 months. For investment losses, do the opposite. Take the losses within 12 months since short-term losses are *deductible* against personal income

at tax rates up to 35%. After netting your capital gains and losses, you can deduct up to \$3,000 of losses in each year. Any unused losses above \$3,000 can be carried forward indefinitely to apply against future capital gains.

It's an obvious point but we thought we should mention that this analysis assumes that your guess on when and whether the stock has peaked is accurate. That's always the big question in investments and the big risk as well. Forecast wrong and you undermine the value and accuracy of any analysis. However, if you strongly believe in the long-term value of the stock, it's usually best to hold the security until the gain is long-term. □

**Reference:**

*Exhibit #1* — Formula for Computing Breakeven, page 8

***The questions: Is it worth holding a stock for a long-term capital gain? If so, how much can the stock's price drop to break even on my tax bill?***

## Formula for Computing Breakeven

For our readers who like working with math, here is the formula for computing the drop in profit that will keep you at the breakeven point (referred to as “x”).

$$x = \text{Short-Term Profit times } [(1 \text{ minus Regular Tax Rate}) \text{ divided by } (1 \text{ minus Capital Gain Rate})]$$

$$x = \$10,000 \text{ times } [(1 - 35\% = 65\%) \text{ divided by } (1 - 15\% = 85\%)] = \$7,647$$

Thus, your \$10,000 capital can drop to \$7,647 — a loss of \$2,353. In terms of the stock’s current market value of \$22,000, the decline to breakeven is 10.7% (\$2,353 decline divided by \$22,000). Based on 1,000 shares, ABC’s stock can drop \$2.353 from \$22 to \$19.647 per share — the same numbers we got in the example on page 4 using factors. □

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