

Anthony P. Curatola, Editor  
By Sonja Pippin and Richard Mason

# Basis Bumping: Tax Planning for the Tax Sunsets

Projected higher tax rates on long-term capital gains starting in 2011 may negate the benefit of delaying tax-related cash outflows. Consequently, taxpayers may be faced with the unusual situation where it may be a good investment strategy to accelerate cash outflows instead of postponing them for future years.

Conventional wisdom suggests that a dollar is worth more today than in the future, so good business people generally always look for methods to speed up their cash receipts and to postpone cash expenses. Thus, the consensus among financial planners and tax consultants is that sensible planning involves accelerating cash inflows while at the same time delaying cash outflows. But this logic may be turned upside down in light of changes to the tax rate—especially if the new rates aren't phased-in over a period of time and involve an increase of the marginal rate. In this month's column, we'll look at how some investors may be better off by taking a tax hit now instead of postponing it into the future because the projected higher tax rates will negate the discounted benefit of delaying the payment of the tax. (Though deflation has been a topic of much discussion lately, we

didn't consider its effect in this discussion because only a small minority of economists appears to see it as a "real" possibility.)

## Long-Term Capital Gains Tax Rates

Currently, long-term capital gains tax rates are set at a historical low of 15% for individuals with taxable incomes over \$34,000 or married couples with income over \$68,000. A 0% capital gains tax is in place for individual taxpayers in the lowest two tax brackets. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27 117 Stat. 752) lowered the capital gains rates from 8%, 10%, and 20% to 5% and 15%. These lower rates—as well as the lower rates for qualified dividends—were scheduled to sunset in 2008. In 2006, the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222 120 Stat. 345) extended the rates through 2010 and reduced the lower rate from 5% to 0%. As it currently stands, the low rates will sunset starting in 2011, and long-term capital gains will be taxed at 10% for those in the 15% tax bracket (individuals with income of approximately \$35,000 or less and married couples with income of \$70,000 or

less) and at 20% for those in the 28% and higher tax brackets.

## Benefits from Accelerating Cash Outflows

Facing this tax increase, individuals with unrealized long-term capital gains may consider selling and repurchasing their investments in order to receive a step-up in basis ("basis bumping") at a lower tax cost than what it would be in the future. The potential benefit of basis bumping depends on the discount rate used to compare the value of future tax costs to a current tax expense as well as the original intended sale date. Further, the commission and fees associated with selling and repurchasing must be included in the calculation. The calculation involves a net present value (NPV) formula comparing the tax cost of recognizing the long-term capital gain now with the tax cost of postponing the gain to a future year:

$$NPV = -15\% * (URG) + 20\% * \frac{(URG)}{(1+r)^n} - FEE$$

URG: Unrealized gain in 2010

r: discount rate

n: originally planned life of the investment

FEE: Commission and fee(s) to sell and repurchase the investment

**Table 1. NPV of basis bumping for unrealized gain of \$1,000**

	<b>r = 4%</b>	<b>r = 6%</b>	<b>r = 8%</b>	<b>r = 10%</b>	<b>r = 12%</b>
Sale today vs. next year (n = 1)	\$42.31	\$38.68	\$35.19	\$ 31.82	\$28.57
Sale today vs. two years (n = 2)	\$34.91	\$28.00	\$21.47	\$ 15.29	\$ 9.44
Sale today vs. three years (n = 3)	\$27.80	\$17.92	\$ 8.77	\$ 0.26	\$ (7.64)
Sale today vs. four years (n = 4)	\$20.96	\$ 8.42	\$ (2.99)	\$ (13.40)	
Sale today vs. five years (n = 5)	\$14.39	\$ (0.55)			
Sale today vs. six years (n = 6)	\$ 8.06				
Sale today vs. seven years (n = 7)	\$ 1.98				
Sale today vs. eight years (n = 8)	\$ (3.86)				

Table 1 illustrates the potential savings for an unrealized gain of \$1,000. Sales commissions and other selling costs have been ignored since they have become almost *de minimis* for traders in many cases.

Any positive value in Table 1 suggests that basis bumping will lead to a higher after-tax value. Thus, according to the calculations, basis bumping is beneficial if the original holding period was supposed to be seven years or less (4% discount rate) or three years or less (12% discount rate). At lower discount rates, the benefits

would last longer.

Instead of calculating the NPV in terms of absolute numbers—based on the investment’s current unrealized gain—the benefits can be expressed in percentage points and normalized by dividing the results by the unrealized gain. This formula demonstrates the expected net benefit of basis bumping as a percentage of the investment’s unrealized gain:

$$NPV_{factor} = \frac{(-15\% * (URG) + 20\% * \frac{(URG)}{(1+r)^n})}{URG}$$

Table 2 presents the multiplication factors for the discount

rates of 4%, 6%, 8%, 10%, and 12%. The practical application of Table 2 is that investors can quickly estimate the benefit of basis bumping for any unrealized gain. For an investment with an unrealized gain of \$100,000 and an intended holding period of three years past 2010, for example, basis bumping would net \$1,790 before commission and/or fee.

**Benefits for Low-Income Taxpayers**

The relative benefits of basis bumping are even higher for low-

**Table 2. NPV of basis bumping as percentage of unrealized gain**

	<b>r = 4%</b>	<b>r = 6%</b>	<b>r = 8%</b>	<b>r = 10%</b>	<b>r = 12%</b>
Sale today vs. next year (n = 1)	4.23%	3.87%	3.52%	3.18%	2.86%
Sale today vs. two years (n = 2)	3.49%	2.80%	2.15%	1.53%	0.94%
Sale today vs. three years (n = 3)	2.78%	1.79%	0.88%	0.03%	-0.76%
Sale today vs. four years (n = 4)	2.10%	0.84%	-0.30%	-1.34%	
Sale today vs. five years (n = 5)	1.44%	-0.05%			
Sale today vs. six years (n = 6)	0.81%				
Sale today vs. seven years (n = 7)	0.20%				
Sale today vs. eight years (n = 8)	-0.39%				

**Table 3. NPV of basis bumping as percentage of unrealized gain for low-income taxpayers**

	<b>r = 4%</b>	<b>r = 6%</b>	<b>r = 8%</b>	<b>r = 10%</b>	<b>r = 12%</b>
Sale today vs. next year (n = 1)	14.42%	14.15%	13.89%	13.64%	13.39%
Sale today vs. two years (n = 2)	13.87%	13.35%	12.86%	12.40%	11.96%
Sale today vs. three years (n = 3)	13.33%	12.59%	11.91%	11.27%	10.68%
Sale today vs. four years (n = 4)	12.82%	11.88%	11.03%	10.25%	9.53%
Sale today vs. five years (n = 5)	12.33%	11.21%	10.21%	9.31%	8.51%
Sale today vs. six years (n = 6)	11.85%	10.57%	9.45%	8.47%	7.60%
Sale today vs. seven years (n = 7)	11.40%	9.98%	8.75%	7.70%	6.79%
Sale today vs. eight years (n = 8)	10.96%	9.41%	8.10%	7.00%	6.06%
Sale today vs. nine years (n = 9)	10.54%	8.88%	7.50%	6.36%	5.41%
Sale today vs. 10 years (n = 10)	10.13%	8.38%	6.95%	5.78%	4.83%

income taxpayers because of the larger tax rate jump for taxpayers in the bottom two tax brackets. Current long-term capital gains tax rates of 0% imply that the NPV of basis bumping is calculated as follows:

$$NPV_{low} = -15\% * \frac{(URG)}{(1+r)^n} - FEE$$

Using the same parameters as in Table 2, the tax benefit as a percentage of unrealized gain is calculated in Table 3.

In 2010, the 0% tax rates are available for individual taxpayers with ordinary (noncapital gain) income of less than \$34,000 (single filers) or \$68,000 (joint filers). Specifically, the 0% tax rate applies to all adjusted net capital gains (ANCG) if the total taxable income (i.e., non-ANCG income and ANCG) is below the \$34,000 or \$68,000 thresholds. The 0% rate also applies to part of the ANCG if the taxable income is above the threshold but ordinary

income (i.e., non-ANCG income) is less than the limit. ANCG are defined as net long-term capital gains plus qualified dividend income less short-term capital losses. They exclude gains from the sale of collectibles, small business stock, and depreciable investment real estate.

### Tax Savings

As the tax acts expire and bring about a return of higher tax rates, some investors may benefit from selling and repurchasing securities in 2010 in order to bump up their basis to the current fair market value. Looking at calculated benefits on an absolute and relative basis, lower-income taxpayers may benefit even more from basis bumping because their tax rates are projected to jump from 0% to 10%.

While no one can predict future taxes for certain, the fact that Congress is currently contemplating making the 20% long-term capital

gains rate permanent—at least for some individual taxpayers—further supports the notion that now may be a good time for many to consider basis bumping as a tax savings strategy. **SF**

*Sonja Pippin is an assistant professor at the University of Nevada Reno. You can contact Sonja at (775) 784-1337 or [sonjap@unr.edu](mailto:sonjap@unr.edu).*

*Richard Mason is an associate professor at the University of Nevada Reno. You can contact Richard at (775) 784-6886 or [mason@unr.edu](mailto:mason@unr.edu).*

*Anthony P. Curatola is the Joseph F. Ford Professor of Accounting at Drexel University in Philadelphia, Pa., and a member of IMA's Greater Philadelphia Chapter. You can reach Tony at (215) 895-1453 or [curatola@drexel.edu](mailto:curatola@drexel.edu).*

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