A taxing dilemma

Tom Jacobs

It is a truth universally acknowledged that no one should pay one single shekel more of tax than required to stay out of jail. Therefore, it follows that investors should consider taxes when selling shares and taking profits, right? Wrong. Beginning investors incorrectly hold stocks too long to pay lower taxes on their profits ('capital gains' taxes or rates), whereas expert investors invest in a tax neutral manner, buying and selling according to consistent criteria, not emotion. They are correct to do so.

Taxes, long and short

If you are a reader in a tax Nirvana, such as Taiwan, Belgium, Italy or the Netherlands, you may now turn to your latest issue of *Giddy Rich Investor* (with all the glossies of private islands for sale) because you pay no capital gains taxes. For the rest of us who must suffer, our governments pose a dilemma by applying lower capital gains rates to profits from shares we've held longer.

In the United States, if you sell shares you've owned for 12 months or less and for a profit, you pay short-term capital gains taxes at the highest tax rate for your ordinary income, from 10% to 35%. But if you have held the stock for more than 12 months, the capital gains tax rate is much lower, either 5% (if your ordinary income highest tax rate is 10% or 15%) or 15% (if your tax is 25–35%). Such a large percentage savings leads investors in many countries to consider tax implications when selling. But they're wrong.

Selling with knowledge

Consider the decision to sell. Novices rarely know why they bought a stock in the first place. They lack even a rudimentary valuation or knowledge of the business, products, management and competition. They act emotionally, buying when everyone else is buying (thus prices are high), and selling when everyone else is selling (prices are low). The herd thus buys high and sells low, losing money.

But expert investors buy and sell according to valuation and knowledge of all the key factors. They devour reports, crunch numbers, learn all about management and scrutinize company products and markets. They estimate what the business is worth per share and they sell when the stock price gets there; things change so that the potential no longer beats the risk; or another investment offers better opportunity.

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Although neither novice nor expert knows when a stock price will reach any level, the expert, who knows at what price or under what conditions to sell, may rationally want to do so in less than 12 months and a day. Despite the increased tax bite, it's the right move.

A happy dilemma

Let's use a real-life biotech example to drive the point home. After much research, you bought biotech drug maker Amgen (Thousand Oaks, CA, USA: Nasdaq: AMGN) at $60 on June 30, 2005, determining that the company was worth $80 and that you would sell at that price. Meanwhile, the potential 33% gain is worth the downside risk to wait a few years to secure your gain.

Delightfully, the gods are on your side, and Amgen rockets to $80 by July 20—a 33% gain in a mere three weeks! You know how fantastic that is, because you've read that the vast majority of professional money managers can't even produce a 'mere' 15% gain compounded annually (let alone three weeks!) for more than five years, and the Yale University endowment manager is reputedly unique for his 17% compounded annual gain over 20 years!

So, because you have determined Amgen's intrinsic value to be $80 and have a better place for your money, you decide to sell. This presents a happy dilemma: should you sell and pay taxes at your 25% rate (assuming you have a middle class US income) or wait to pay 15%? If you sell now, your $20 a share gain incurs taxes of $5 a share, reducing your 33% gain to 25%. If you wait, you pay only $3 a share in taxes, giving you a 28% gain.

This is what experts know: it makes no sense at all to wait to save $2 a share for the difference between a 25% and 28% after-tax gain. Any potential savings comes at the cost of a possibly greater loss. If you've already determined that $80 is your sell price, holding longer risks a stock decline and damage to your gains. Add to that the opportunity cost, which is the value forgone of what you might be able to earn on the money elsewhere. This is why that except when only a short period remains, experts believe that waiting to sell for tax reasons is simply not worth the risk.

Taxes, shmaxes

In short: if the only reason you are waiting to sell a profitable stock holding is to lower your taxes, it only makes sense to do so if you have only a few days or weeks. Or, at length: the only rational reason to wait to sell in order to pay less tax is if the amount you save in taxes is both greater than the opportunity cost (the possible gain you could make elsewhere by redeploying the money) and the amount you could possibly lose if you hold longer. Neither factor may be measured with precision, but to consider them is an investor's brave and giant step from the world of the novice to that of the expert—and to making more money.

Tom Jacobs is cofounder of Complete Growth Investor (http://www.completegrowth.com), a stock service for individual investors. He cannot give individual investment advice but welcomes your comments at tom@completegrowth.com. Tom is not a tax advisor; for all tax questions, please consult a tax professional.