Making Stock Sales Less Taxing

As explained in the article, "Putting stock market volatility in perspective," patient investors generally have prospered over the long term. Nevertheless, there are many reasons for selling stocks. Knowing the basics can help improve your tax position.

Selling shares held in a taxable account will trigger taxable capital gains or losses, unless the sale proceeds are exactly the same as your basis — your cost for tax purposes. If you are making a complete sale from an investment position, the calculation of basis is fairly simple.

Example 1: Joan Harris has owned shares of ABC Large Company Growth Fund in a taxable account for many years. In March 2019, she sells all of those shares for $42,000. Joan has invested $25,000 in those shares and reinvested $2,800 of dividends from the fund, so her basis is the total: $27,800. Thus, her taxable gain is the $14,200 difference.

Many fund companies will track purchases and dividend reinvestments for shareholders; the companies also will report the amounts of long-term and short-term gains (reflecting whether assets were held for more than a year), which are taxed at different rates. Not all fund companies provide complete records, so it's a good idea to keep careful track of your securities transactions.

Note that Joan will have a tax obligation even if she asks fund company ABC to move all of her money in ABC Large Company Growth Fund to ABC Small Company Value Fund. If this transaction occurs in a taxable account, a gain or loss will be reported.

Partial Parting

The situation is different if an investor sells part of a position in a security.

Example 2: Suppose Joan requests a sale of $20,000 from the large company growth fund, out of her $42,000 holding. As noted in example 1, Joan has invested and reinvested in those shares over a period of years. In this case, Joan can choose among multiple options for tax reporting.

- **First in, first out (FIFO).** Assume that this fund's shares are priced at $20 on the date of the sale. Joan will be selling 1,000 shares; with FIFO, that would be the first 1,000 shares that she purchased. As long as fund company ABC keeps track, it will report the amount Joan paid for those 1,000 oldest shares. If Joan paid a total of $11,000 for those shares, her gain will be the $9,000 difference.

- The disadvantage of choosing FIFO is that the taxable gain may be high after a long period of stock market growth. On the other hand, the entire sale may qualify as a favorably taxed long-term capital gain, if all the shares were held for more than a year.
- **Specific identification.** As the name indicates, with this method the investor designates the shares to be sold. To sell 1,000 shares, Joan might indicate the 500 shares bought in January 2016 and the 500 shares bought in April 2017. Assuming those shares were those with the highest purchase prices, Joan may be able to minimize her capital gain or obtain a capital loss, which can provide tax benefits. This method requires careful record keeping, and you will have the burden of proving the basis in the designated shares at the time of the sale.

  The preceding choices are available to all investors, whether they hold mutual funds or individual securities. Another method is available only to mutual fund investors and to investors in certain dividend reinvestment plans.
- **Average cost.** With this method, you divide the amount you have invested and reinvested in a given fund, before a sale, by the number of shares you held then. If you choose this method, you must use it for all future sales of that fund's shares.

Example 3: As previously explained, Joan calculates that she has put a total of $27,800 into ABC Large Company Growth Fund. At the time of her sale, she owns 2,100 shares, trading at $20. Dividing her $27,800 investment by her 2,100 shares, Joan calculates the average cost at $13.238 per share.

In our example, Joan sells $1,000 shares at $20, to receive $20,000. With an average cost of $13.238 a share, Joan's basis in the 1,000 shares sold is $13,238. By receiving $20,000, she has a $6,762 taxable gain. Note that some of those gains may be short-term if Joan has bought any shares in the fund within a year or less from the sale date.

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Double Category Averaging

- Another method, "double category" averaging (separate averages for long-term and short-term holdings), was used in the past. That option has been abolished.
- Investors who were using the double category method for stock acquired before April 1, 2011, must figure basis by averaging together all identical shares of stock in the account on that date, regardless of the holding period.
- This applies when an investor sells, exchanges, or otherwise disposes of that stock.