RESEARCH MEMO

The Gain Budget

The cost of realizing a capital gain is not linear, and the planning should be built around the points where it jumps

Steven Ede, CFA

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Framework memo. Illustrative throughout; no client facts are described. Thresholds and rates are described structurally rather than by dollar amount, since the amounts are adjusted annually. Nothing here is tax advice.

1 · SUMMARY OF CONCLUSIONS

Any portfolio with embedded gain faces the same recurring question: how much should be realized this year. It arises when unwinding a concentrated holding, when rebalancing a portfolio that has drifted, when transitioning a new client out of legacy positions, and when funding a large expenditure. The answer is usually produced by dividing the position by a number of years, which is a schedule rather than a plan.

> The marginal cost of a realized dollar of gain is not the capital gains rate. It is the capital gains rate plus the surtax, plus the state rate, plus whatever phase-outs and premium surcharges that dollar triggers. Those additions do not arrive smoothly. They step, and the steps are where the planning lives.

A gain budget built around the brackets and thresholds a client actually faces will realize more total gain, at lower total cost, than a schedule built around a target date. It will also be lumpy, which is the correct shape and the hardest part to explain.

Findings

1 · The cost curve has cliffs, not just slopes. Bracket boundaries produce a step in the rate applied to subsequent dollars, which is a slope change. Premium surcharges and eligibility phase-outs produce something worse: a dollar of additional income triggers a fixed cost applied to the whole year. The effective marginal rate on the dollar that crosses such a threshold can run into the hundreds of percent. (§2)

2 · Medicare premium surcharges operate on a two-year lookback. Income recognized today determines premiums two years later. A client realizing gains in the years before Medicare eligibility is setting premiums they have not yet started paying, and will usually not connect the two when the bill arrives. This is the most frequently missed interaction in the category. (§2.3)

3 · Low-income years are the scarcest resource in the plan, and they are predictable. The window between the end of employment income and the start of required distributions and social security is a period of unusually low taxable income, and in some cases unusually low capital gains rates. Clients routinely spend those years realizing nothing, then face compressed, expensive realization later. (§4.1)

4 · Gain realization and Roth conversion compete for the same room. Both consume bracket space in a low-income year, and both are usually recommended by someone who has not checked whether the other is also planned. The two should be sized against a single budget rather than independently. (§3.3)

5 · Within a given budget, lot sequencing determines how much position is actually moved. Selling the highest-basis lots first moves the most market value per dollar of gain recognized. A client with a fixed annual gain budget and a well-laddered position can diversify substantially faster than the same client transacting at average cost. (§4.2)

Three standing rules

1. **Build the budget from the client's tax position, not from a target date.** A schedule that ignores where the thresholds sit will cross them by accident.
2. **Project at least three years forward, and recalculate annually.** The budget is a sequence, not a number. A year of unusually low income is worth more than the two around it and should be used deliberately.
3. **Coordinate with everything else that consumes bracket room.** Conversions, distributions, business income, and exercised options all draw on the same space, and none of them are visible from inside the investment account.

What would change these conclusions

- A flat capital gains rate with no surtax, no phase-outs, and no premium linkage would make the cost curve linear and reduce this memo to a scheduling exercise.
- A client with income so high that every threshold is already exceeded faces a genuinely flat marginal cost, and for them the budget is a cash flow question rather than a tax one. That case is more common at the top of the wealth scale than the framework implies, and it is worth confirming before building anything.
- Legislative change to the basis step-up would alter the terminal comparison in §5 substantially, since much of the argument for restraint rests on the value of unrealized gain at death.

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2 · WHY THE COST IS NOT LINEAR

The mental model most clients hold, and a surprising number of practitioners work from, is that realizing a gain costs a fixed percentage of that gain. Under that model the only question is how much tax the client is willing to pay in a year, and the plan is arithmetic.

The actual cost is assembled from several components that each behave differently.

2.1 The rate schedule itself

Long-term capital gains are taxed in brackets, and the lowest of those brackets is zero. A client whose total taxable income sits below the first threshold pays nothing on long-term gains realized up to it. That is not a loophole; it is the design, and it is the single largest planning opportunity in this memo for clients with variable income.

Above that, the rate steps up at each boundary. The step applies only to the dollars above the line, so crossing a bracket boundary is a slope change rather than a cliff. This is the well-understood part, and the part people tend to plan around when they plan around anything.

2.2 The surtax

The net investment income tax applies an additional flat rate to investment income above a modified adjusted gross income threshold. Because it attaches to a different income measure than the capital gains brackets do, it crosses at a different point, and a client can be inside one bracket while over the surtax threshold.

The practical consequence is that the marginal cost of a gain dollar is frequently a combination nobody quotes. The commonly cited figure for a high earner is the top long-term rate plus the surtax, and then state tax on top of that, which in a high-tax state produces a combined marginal cost meaningfully above the number most clients have in mind.

2.3 Premium surcharges, which are cliffs

Medicare Part B and Part D premiums are adjusted upward for beneficiaries whose modified adjusted gross income exceeds a series of thresholds. The adjustment is tiered rather than graduated: income one dollar above a tier boundary produces the full surcharge for that tier, applied for the entire year.

> On the dollar that crosses the threshold, the effective marginal rate is the surcharge divided by one dollar. It is not a rounding error, and it is entirely avoidable with a projection.

Two features make this the most commonly missed item in the category.

First, the determination uses income from two years prior. A gain realized at sixty-three sets premiums at sixty-five. By the time the client sees the cost, the transaction that caused it is two tax years in the past and will not be connected to it.

Second, it applies per beneficiary. For a married couple both enrolled, the surcharge is assessed on each, which doubles the cost of crossing.

A client can appeal the determination following certain qualifying life events, which is worth knowing but is not a plan. The plan is to project the income and stay below the line, or to cross it deliberately and in full rather than by a few hundred dollars.

2.4 Phase-outs and eligibility

A range of deductions, credits, and contribution eligibilities phase out over income ranges. Each phase-out effectively raises the marginal rate across its range, because an additional dollar of income both is taxed and reduces a benefit. These are individually small and collectively material, and they are invisible unless the projection includes them.

2.5 What the curve actually looks like

Assembled, the marginal cost of realizing an additional dollar of long-term gain is a step function with several discontinuities, not a constant. It is low or zero at the bottom, rises in steps, spikes at each surcharge boundary, and flattens at the top once every threshold has been exceeded.

Planning against a constant is therefore planning against the wrong shape, and the error is not symmetric. A client who stops short of a threshold loses a small amount of available realization. A client who crosses one by a small margin pays a large fixed cost for very little benefit.

3 · BUILDING THE BUDGET

3.1 Start from projected income without the gain

The budget is the distance between the client's projected income for the year, excluding any discretionary realization, and the next threshold worth respecting. That requires a projection of wages, business income, interest, dividends, distributions, and anything else landing on the return, which is why this is a conversation with the client and their tax preparer rather than an exercise inside the investment account.

Which threshold is the binding one varies. For a working client in a high bracket, it may be a state-level boundary or nothing at all. For a retiree on Medicare, it is almost always a premium surcharge tier. For a client in a gap year, it is the top of the zero-rate bracket.

3.2 Decide whether to respect the threshold or clear it

Stopping just below a boundary is the default and usually correct. But where a client has a large position and a limited number of years, deliberately crossing can be the better answer, provided the crossing is decisive. The cost of a surcharge tier is fixed, so having paid it, the marginal cost of additional gain within that tier returns to the ordinary combined rate.

The failure mode is crossing by a small amount: paying the full fixed cost and receiving almost none of the realization it would have funded. Where a projection shows the client landing just over a line, the choice is to pull back below it or to go well past it. The middle is the only genuinely wrong answer.

3.3 Account for what else draws on the same room

Capital gain realization is one of several discretionary uses of bracket space, and the others are frequently being planned by someone else.

Roth conversions are the most direct competitor. A conversion is ordinary income stacked on top of everything else, and a client with room in a low bracket can use that room for a conversion or for gain realization, but not twice. Both are commonly recommended, often by different advisers, and the total is rarely checked. Where both are desirable, they should be sized against one budget, and the sequencing should reflect which benefit decays faster.

Discretionary retirement distributions have the same effect and are sometimes taken for cash flow reasons without reference to the realization plan.

Business income, exercised options, and deferred compensation are lumpy, frequently known in advance, and often not communicated to whoever is managing the portfolio. A year with a large option exercise is not a year for discretionary realization.

4 · EXECUTING WITHIN THE BUDGET

4.1 The sequence matters more than any single year

A gain budget is a multi-year plan, and the years are not interchangeable. The most valuable years are those with unusually low other income, and for many clients these are predictable well in advance.

The clearest case is the window after employment income ends and before required distributions and social security begin. Taxable income in that window can be low enough to sit inside the zero-rate bracket, and realization there can be genuinely free. The window is finite and it does not recur.

Clients routinely under-use it, partly because the years feel financially uncertain and realizing gains feels like a cost rather than an opportunity. The framing that works is that the gain will be realized eventually by someone, and these are the cheapest years in which it will ever be realized.

Other low-income years arise from a business loss, a sabbatical, a year between roles, or a large charitable deduction. Each is a realization opportunity, and each is usually treated as a year to do nothing.

4.2 Lot sequencing determines how much gets moved

Within a given gain budget, the amount of market value that can be repositioned depends entirely on which lots are sold.

Selling the highest-basis lots first moves the most market value per dollar of gain recognized. A lot at 90% basis moves ten dollars of position for every dollar of gain; a lot at 20% basis moves one dollar and a quarter. For a client with a fixed annual budget, the difference compounds across years and can change a ten-year unwind into a five-year one.

Two requirements follow, and both are operational rather than analytical. Specific identification must be elected at the custodian, since default treatment is frequently average cost or first-in-first-out, neither of which will select the lot the analysis identifies. And the lot detail has to be visible to whoever is placing the trade.

The corollary is that basis diversity within a position is itself an asset. A position acquired over many years through contributions, reinvested dividends, or a gifting-and-repurchase program carries a ladder of lots at varying basis, and that ladder is what makes an efficient unwind possible. A position acquired in a single transaction offers no such flexibility.

4.3 Offsets expand the budget

Realized losses elsewhere in the portfolio directly increase the gain that can be recognized at no incremental tax cost. A client executing a multi-year realization plan should have every other taxable account running an active harvesting program, because harvested losses are worth more to this client than to one with no planned realization.

Charitable deductions reduce taxable income and can create room below a threshold, which makes a gifting program and a realization plan complementary rather than competing. Where the gift is funded with appreciated securities, the effect is larger still, since the gifted shares carry their gain out of the portfolio entirely.

5 · WHERE RESTRAINT IS THE ANSWER

Everything above assumes the gain will be realized. For a meaningful share of clients it will not be, and the budget framework should not obscure that.

Shares held until death receive a basis adjustment that eliminates the embedded gain entirely, and shares given to charity carry their gain out without anyone recognizing it. For a client whose intention is either of those, realization during life is a cost incurred for no reason, and the correct annual budget may be zero regardless of how much room the brackets allow.

So the budget question sits downstream of the disposition question. Establish what eventually happens to the position, then size the realization to the portion that will actually be sold. A client with a large position, charitable intent, and no liquidity need may need no realization plan at all.

This also sets the comparison for the concentrated position case specifically, treated in the companion framework memo: a staged sale is one of several dispositions, and its advantage is that it is predictable, cheap to implement, and reversible at any point. Those are real advantages and they are easy to undervalue next to structures that look more sophisticated.

6 · LIMITATIONS

This is a tax framework, not a market view. A realization schedule built around thresholds says nothing about whether the position should be sold at today's price. Where a client holds a view on the security, that view belongs in the sizing decision and the two should be reconciled explicitly rather than allowed to argue with each other across years.

Thresholds move. Rates, brackets, surcharge tiers, and phase-out ranges are adjusted and occasionally restructured. A multi-year plan should be re-derived annually rather than executed from a schedule set at the outset.

State treatment varies substantially. Some states tax capital gains as ordinary income, some have no income tax at all, and a client who expects to change residence has a planning variable this memo does not address.

The projection is only as good as its inputs. The most common failure is not an analytical error but an unreported item: a bonus, a distribution, a business event that nobody mentioned. The projection should be built with the client's tax preparer, and revisited late in the year before the final transactions are placed.

Framework memo prepared for illustrative purposes. Not tax advice. Thresholds, rates, and eligibility rules are adjusted periodically and should be confirmed against current figures with qualified tax counsel before any transaction.

This memo is one of a set on concentrated positions. The framework that determines which tool applies is in Concentrated Positions.