

By David M. Stein

Pay Now, or Later?

THE TRADITIONAL AIM OF TAX PLANNING is to do everything legally possible to reduce current taxes. One common approach is to defer realizing capital gains for as long as possible. Tax deferral, like the miracle of compound interest, is often seen as a “no brainer,” an idea that always makes sense. After all, it’s like getting a free loan from the government, and is particularly valuable if the client’s investment horizon is long and the return on the investment is high. Rarely, if ever, do we consider actually paying taxes early as a benefit in our tax planning strategy.

But under JGTRRA, the 2003 tax legislation, long-term capital gains tax rates are at their lowest level since 1942, and they are scheduled to revert to their former higher rates in less than four years (*See Rates Now table below*). Additionally, the growing federal budget deficit, increasing budget demands, and the 2004 presidential elections may catalyze a tax increase even sooner. If we expect capital gains rates to rise, we should ask this question on behalf of our clients: Should we take advantage of the current low rates and realize appreciated capital gains now, or should we instead defer taxation and pay at a future higher rate?

The answer depends on a number of factors and will vary for individual clients, including the expected future tax rate, the client’s investing time horizon, the anticipated investment return, and the client’s overall risk tolerance. It is often possible as well to improve on the pure tax-deferral strategy in a rising-tax-rate environment, which we appear to be in.



While we do not wish to engage in a detailed discussion of the likelihood of a capital gains rate increase, we can provide background perspective and judgment as to when it makes sense to pay taxes sooner rather than later.

Anticipating Change

A review of federal capital gains tax rates reveals that there have been 13 rate revisions

If you anticipate a rise in tax rates, deferring capital gains may not be the answer

since 1942. If one includes changes to the way “long term” is defined, there have been 16 changes. This may not seem like many changes over 62 years, but most have come since 1970, and the recent average period between changes is less than three years. The “Top of the Charts” table on page 170 displays the top rate each year.

It is my opinion that current tax rates are as low as they are likely to be in the near-term future. Whether one uses inside information, thoughtful analysis, or political argument, a change in tax rates can be expected, even though the timing and magnitude are uncertain. Few investment advisors forecast or predict future tax rates, but doing so can be a rewarding financial endeavor. Certainly, tax rate changes occur more slowly and with more public discussion and debate than interest rate changes, for example. Unlike other financial market predictions, prices do not imbed consensus estimates of capital gain taxes, and the benefits of prediction are not arbitrated away by other market participants. A prediction, though uncertain, is often a better choice than the easy assumption that rates will remain static.

The Advisor’s Contribution

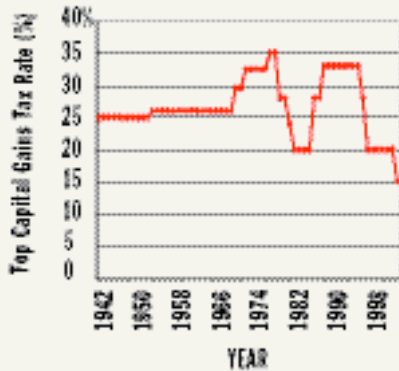
Even though future tax rates are unclear, it is possible to provide a decision-making framework for eval-

RATES NOW, AND THEIR SUNSET

Maximum Federal Tax Rate on:	2003 Prior Tax Rate	JGTRRA Tax Rate	Provision
Stock Dividends	38.6%	15%	Ends 12/31/08
Long-Term Capital Gains	20.0%	15%	Ends 12/31/08
Short-Term Capital Gains	38.6%	35%	Ends 12/31/08
Ordinary Income (includes interest)	38.6%	35%	Ends 12/31/10

TOP OF THE CHARTS

Top Federal Long-Term Capital Gains Tax Rate: 1942-2003



uating a tax strategy of paying taxes now rather than later. The central issue is this: Should we give up on the value of tax deferral in order to derive a larger future benefit? This requires a tradeoff between the value of the deferral and the benefit. The value of the deferral is affected by the investment horizon, the expected future return, and the expected future tax rate, and so these influence the decision.

The following is a simple model to integrate the key issues. We ask: Given an expected return on investment and a liquidation horizon, by how much do tax rates need to increase in order for an investor to prefer to liquidate and pay taxes on gains now? Our analysis solves for this number, which we call the "Liquidation Tax Hurdle."

Here is how to read Table 1. For the given expected return and an investment horizon, the grid shows the additional tax above the current long-term tax rate of 15% that is needed in order to prefer to pay taxes now rather than deferring. For example, suppose you expect the asset to return 4%, and your horizon to be two

years; then your Liquidation Tax Hurdle is 1%. This means that you would do better to pay taxes now if the tax rate in two years is greater than 15% + 1%, i.e., 16%. So, in this case, if you expect the tax rate to increase by more than 1%, you should consider paying the current capital gains taxes instead of deferring them.

What does the analysis tell us? Of course, when you expect tax rates to increase substantially, it makes sense to pay the expected tax in two installments: pay taxes on the current appreciation at the current lower rate and pay future appreciation at the higher future rate. Doing so does not trigger the wash-sale rule, and the investor can repurchase immediately.

An investor who expects a market return of 8% per year and who has an investment horizon of five years, and who expects the long-term capital gains tax rate to rise 5.6% (to just slightly higher than where they were before JGTRRA), would prefer to liquidate now.

The tax hurdle is higher if the horizon is longer or if the market return is greater—in these cases, the value of deferral is greater. For extremely long horizons, the compounding of deferral swamps the benefit of locking in the current lower tax rate.

A few additional observations are in order. First, it is interesting to note that the decision to pay now or later does not depend on market value or cost basis. Secondly, our model assumes liquidation at the horizon. If you are working with an expectation of basis step-up at death, then the investor should avoid realizing gains and paying taxes beforehand.

Finally, our analysis only focuses on reducing the overall tax burden. Other issues may necessitate the payment of taxes early, even if there is no expectation of an increase in taxes. For example, an investor who has extremely concentrated wealth (a closely held business, stock options, and so on) defers capital gains taxes at the high cost of risk. A reduction in risk should be the compelling motivation to realize gains; the low tax rate is just sugar on the pill, making it more palatable. Current low rates

THE FORMULA

CONSIDER A PORTFOLIO, VALUE V AND cost basis B . Let the current tax rate be t , the horizon be n years, the return be r , and the new tax rate at the horizon be t_1 . The current liquidation value is $V(1-t)+Bt$.

Case 1

Suppose we hold, and liquidate in n years. The value after n years is $V(1+r)^n$, and the final value after liquidation is:

$$V_1 = V(1+r)^n(1-t_1) + Bt_1$$

Case 2

Suppose we liquidate now, and again after n years. The initial value is $V(1-t)+Bt$ and the final liquidated value is:

$$V_2 = [V(1-t)+Bt](1+r)^n(1-t_1) + [V(1-t)+Bt]t_1$$

It is straightforward to show that V_2 exceeds V_1 when $t_1 > q/(1+q)$, where q is defined as $(1+r)^n t / (1-t)$.

provide a great opportunity for undiversified investors to reduce investment risk.

Taxes should not always be avoided; they should be managed. In fact, tax management is an integral aspect of portfolio management. All investment ideas need to adapt to changing market environments and opportunities; this applies also to tax management, which will evolve as tax rates and tax rules change.

The possibility of an increased capital gains tax rate gives advisors an opportunity to deliver proactive service to clients. This requires some new thinking and client education. Yes, few will want to pay taxes early, and the tax-averse will be reluctant to pay taxes today. But the common recommendation always to defer taxation sometimes may need to be suspended. There is money to be made thoughtfully—or inadvertent losses to be avoided—by tax management. IA

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TABLE 1: THE LIQUIDATION TAX HURDLE

Years	Expected Return				
	2%	4%	8%	10%	12%
1	0.3%	0.5%	1.0%	1.3%	1.5%
2	0.5%	1.0%	2.1%	2.6%	3.1%
3	0.8%	1.6%	3.2%	4.0%	4.9%
4	1.0%	2.1%	4.4%	5.5%	6.7%
5	1.3%	2.7%	5.6%	7.1%	8.7%
10	2.7%	5.7%	12.6%	16.4%	20.4%
20	5.8%	12.9%	30.1%	39.3%	48.0%
30	9.2%	21.4%	49.0%	60.5%	69.1%