

Parametric Portfolio Associates

Commentary

Do you Anticipate an Increase in Tax-Rates? Deferring Capital Gains is Not Always the Best Strategy

David M. Stein

July 2004

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 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. It is like getting a free loan from the government, and is particularly valuable if the 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, with the 2003 tax legislation, long-term capital gains tax rates are at their lowest rate since 1942, and they are scheduled to revert to their former higher rates in less than four years (see Table 1 below).

Table 1:

Maximum Federal Rate on:	Prior Tax Rate	2003 JGTRRA Tax Rate	Provision
Stock Dividends	38.6%	15%	Ends December 31, 2008
Long-Term Capital Gains	20%	15%	Ends December 31, 2008
Short-Term Capital Gains	38.6%	35%	Ends December 31, 2008
Ordinary Income (includes interest)	38.6%	35%	Ends December 31, 2010

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Parametric Portfolio Associates, 1151 Fairview Avenue N., Seattle, WA 98109. 206.694.5575.

dstein@paraport.com or <http://www.parametricportfolio.com/> © Parametric Portfolio Associates, 2004



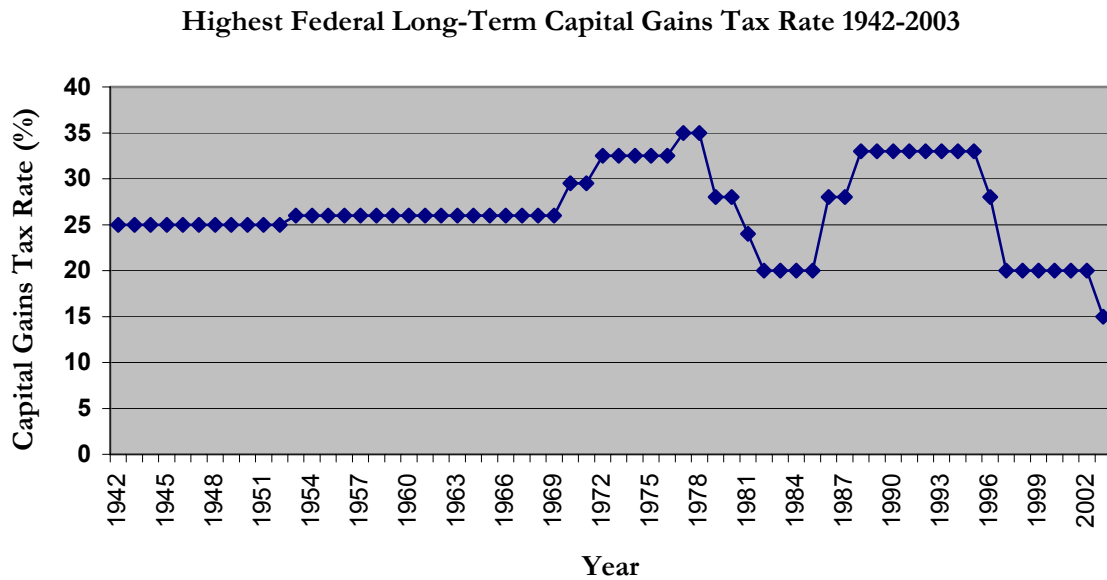
Additionally, there are growing budget deficits, increasing budget demands, and 2004 presidential elections. These may prove to catalyze a tax-rate increase even sooner. If we expect capital gains rates to rise, the question is this: should we take advantage of the current low rates and realize appreciated capital gains now, or should we instead defer taxation and pay at a future higher rate?

The answer depends on a number of factors – the future tax rate, the time horizon, the expected investment return, and the risk tolerance. It is often possible to improve on the pure tax-deferral strategy in a rising tax-rate environment.

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

Anticipating a Change in the Capital Gains Tax

A review of federal capital gains tax rates reveals that there have been thirteen rate revisions since 1942. If one includes changes to the way “long-term” is defined, there have been sixteen 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 chart below displays the top federal capital gains 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 managers forecast or predict future tax rates, but it seems to me that 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 embed 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.

Advisor's Value Add

Even though future tax rates are unclear, it is possible to provide a decision-making framework for evaluating 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 trade-off 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."*

The hurdle rates are presented in Table 2 – following page. 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 2 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.

Table 2:

Liquidation Tax Hurdle

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

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 re-purchase immediately.

An investor who expects a market return of 8% per year, who has an investment horizon of 5 years, and who expects long-term capital gains to rise 5.6% (to just slightly more than where they were before last year’s legislation), 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 larger. For extremely long horizons, the compounding of deferral swamps the benefit of locking in the current lower tax rate.

A few additional notes:

1. It is interesting to note that the decision does not depend on market value or cost basis.
2. We are assuming 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.
3. 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, etc.) 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 provide a great opportunity for undiversified investors to reduce investment risk.

Conclusion

Taxes should not always be avoided; they should be managed. 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 gain tax rate gives advisors an opportunity to deliver proactive value to their clients. This requires some new thinking and careful client education. Few want to pay taxes early, and the tax-averse will be reluctant to pay taxes today. But, the common recommendation to always defer taxation may sometimes need to be suspended. There is money to be thoughtfully made or inadvertently lost by tax management.

David M. Stein, Ph.D., is chief investment officer at Parametric Portfolio Associates, a Seattle-based investment firm specializing in customized separate accounts. Robert J. Breshock, J.D., director of client services, and Peter Madsen, research analyst, contributed to this article. Stein can be reached at dstein@paraport.com or 206.694.5575.

Appendix/Sidebar

The Mathematical Model

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 then 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 $(1+r)^n t / (1-t)$.