

## Shopping for Tax Rates

*With careful planning, investors who pay taxes as soon as possible end up with more money.*

By David Stein

January 1, 2005- Here's a new twist on tax planning strategies: Tell your clients to hurry up and pay their taxes. This won't just make the IRS happy--it can leave your clients better off, too.

Yes, the traditional aim of tax planning is to do everything legally possible to pay the least tax and to defer that amount for as long as possible. But paying taxes early can be a beneficial part of clients' tax planning strategy. In a changing landscape of investments and taxation, there are times when it's beneficial to realize capital gains.

Investors usually assume for simplicity purposes that current tax rates will stay static. But, as a result of the 2003 tax legislation, capital gains taxes are now at their lowest rate since 1942, and the difference between short-term and long-term rates is high--in fact, the spread is larger than before the new law. These favorable rates are scheduled to revert to their former higher levels by 2008--and increasing deficits and growing budget demands may serve as catalysts for a rate increase sooner.

If you believe capital gains rates are likely to rise, you and your clients have two choices. They can take advantage of the current low rates and realize capital gains today, or they can defer and pay taxes at a higher future rate. This choice depends on several variables, of course, including the expected increase in tax rates, the time horizon of the investment (because this determines the value of deferring the gain), and the overall market environment.

When the current tax rates are sufficiently lower than future rates, it makes sense to pay the expected tax in what are essentially installments; the strategy is to pay for the realized appreciation at the current lower rate and for the future appreciation at the future rate. Such an approach allows clients to create a progressive rate structure for long-term capital gains when there isn't one. Indeed, it is possible for clients to sell an appreciated security and immediately repurchase it, as there is no wash sale rule for realized gains.

With a longer investment horizon or a higher return on investment, a higher tax rate increase is required in order to overcome the value of deferral. Consider this example: Your client has a single stock position and wants to maintain that same equity exposure for five years. Assume that she sells the stock now at the current low rates (15%) to take the gain and then buys the stock back. If the stock delivers 8% performance and she waits five years to sell the stock, was this a smart move? Based on our calculations, it was--provided long-term capital gains tax rates rise to 20.6% or higher in the fifth year.

A more complex example applies to investors with tax-managed core equity portfolios who own alternative investments, which realize higher short-term capital gains on a routine basis. (Many hedge funds, for example, typically distribute short-term gains.) So in this case, the tax-managed core portfolio tracks large-cap equity performance while systematically harvesting any losses that may be used to shelter short-term hedge fund gains.

For investors like these, the current wide short-term/long-term tax differential provides an opportunity that they can exploit through what we call enhanced tax-rate management (ETRM). At its core, ETRM involves giving up on tax deferral and selectively paying taxes on the long-term gains in the core portfolio; resetting the cost basis in this way allows clients to increase their future ability to do short-term loss harvesting and reduces the tax cost of alternative investments. There is a current tax cost, but the benefits can outweigh this.

A closer look at the mathematics of ETRM illustrates how it can save your clients money. Consider an investor with the following scenario:

- Stock A is a long-term holding with a value of \$100 and a cost basis of \$100.
- Stock A is volatile, and its value can be expected to oscillate.
- Stock A moves to \$100 in month one, \$105 in month two, and \$90 in month three.
- The investor also has money in a hedge fund, from which he expects to realize \$50 in short-term capital gains and \$50 in long-term capital gains.

A traditional tax-managed strategy would defer gain realization on Stock A and systematically harvest losses. In this case, there would be no activity during month two, and then the investor would harvest a \$10 long-term loss from Stock A in month three. He would have a net long-term gain of \$40 and a short-term gain of \$50. His tax bill would be  $(\$40 \times 0.15) + (\$50 \times 0.35) = \$23.50$ .

The ETRM approach differs in that during month two, the investor would take a long-term gain of \$5 on Stock A and then immediately repurchase it. In month three, the investor would harvest a short-term loss of \$15 from Stock A.

He would then have a net long-term gain of \$55 and a net short-term gain of \$35. His tax bill would be  $(\$55 \times 0.15) + (\$35 \times 0.35) = \$20.50$ . That is, the tax bill would be substantially lower. This represents an approximate savings of 12% on the investor's tax bill. (Of course, a more detailed analysis would need to take into account other variables, such as transaction costs and the changed value of deferring taxation.)

Using such an ETRM strategy, both realized long-term gains and short-term losses are higher, and it's important to note that short-term losses can be regenerated over time. Of course, implementing ETRM is more complex than a simpler loss-harvesting strategy. Trading is more frequent, transaction costs are typically higher, and taxpayers must be reasonably certain of their need for short-term capital losses. In a diversified core portfolio, an investor can expect to realize losses, but their eventual magnitude and timing will depend on overall market conditions.

Turnover, although high, can be limited. Your clients can realize gains when they are "not too large"--they evaluate the trade-off between current tax cost and any potential future saving, realizing built gains of 10% to 30%, for example, but deferring gains at the 50% to 60% level. Similarly, your clients realize losses when they are "large enough"--they trade when the tax benefit of the loss is a multiple of the transaction cost.

The moral of the story is that when advisers seek to add value through tax, management, it's important to think ahead. There are times when simply biting the bullet and paying taxes on long-term capital gains is a wise choice. This is particularly true when it's possible for clients to obtain a much larger tax benefit than by just deferring the gain. When they employ the ETRM strategy, clients are essentially trading 15% rate gains for a more valuable 35% rate on any short-term capital losses.

An ETRM strategy isn't for everyone. It does require careful tax planning and management of trading costs, but the proactive value it can add to a client's aggregate investment portfolio makes it well worth considering. In a regular program of realizing long-term capital gains and short-term capital losses, ETRM can provide a solid tax alpha.

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