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**WHITE PAPER**

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## **PAY NOW, OR LATER?**

Making Investment Decisions in a Changing Tax Environment

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The goal of tax planning is, of course, to reduce taxes, typically by deferring the realization of capital gains for as long as possible. Rarely, if ever, do we consider actually paying taxes early. However, if we anticipate a rise in tax rates, we should ask a question on behalf of our clients: should we take advantage of the current low rates and realize appreciated capital gains now, or should we defer taxation and pay at a possibly higher rate in the future? Our aim is not to predict exactly when or if a capital gains rate increase will occur; rather, we provide some background perspective and analysis to help shed light on when it makes sense to pay taxes sooner rather than later. ▶▶

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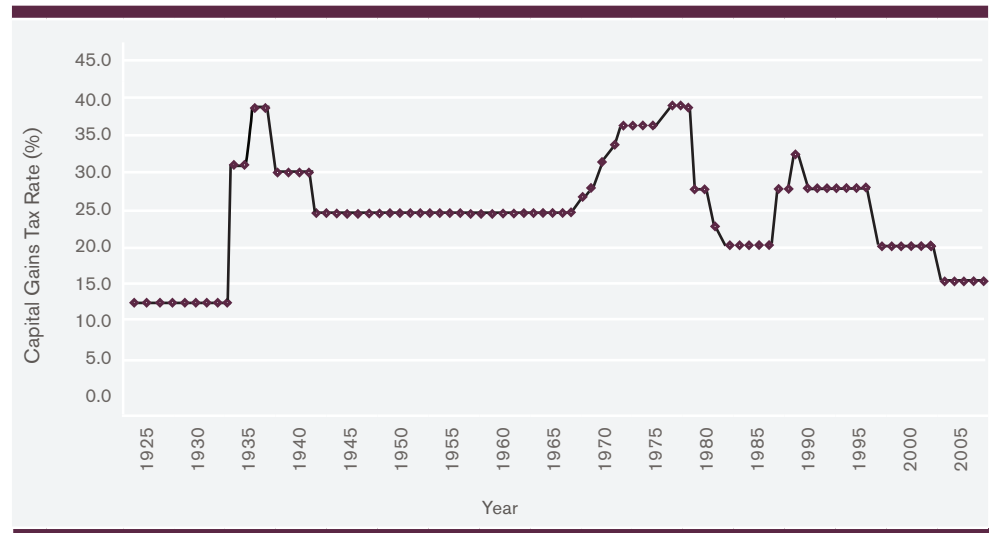
Tax rates on long-term capital gains are at their lowest since 1933. Congress cut tax rates with the 2003 tax legislation (JGTRRA), but included an expiration date in 2008; in 2005, it extended the sunset provision by two years to 2010 (TRRERA). However, uncertainty around the 2008 federal election and the government's need for additional revenue—to fund the military, Medicaid, Medicare, and the expanding US debt—puts the current tax policy in flux. Not only are many tax cuts scheduled to expire at the end of 2010, but it is clear that in 2009 the new Congress will start reviewing—and perhaps change significantly—the sections of the tax code that have guided investor decisions for the past five years. It seems unlikely that Congress will simply extend the sunset provision or make the tax cuts permanent; we see a clear possibility of a capital gains tax rate increase.

**Exhibit 1:**  
CURRENT RATES AND THEIR SUNSET PROVISION

MAXIMUM FEDERAL RATE ON:	PRIOR TAX RATE (%)	2003 JGTRRA TAX RATE (%)	2005 TRRERA SUNSET PROVISION
Stock Dividends	38.6	15.0	Ends December 31, 2010
Long-Term Capital Gains	20.0	15.0	Ends December 31, 2010
Short-Term Capital Gains	38.6	35.0	Ends December 31, 2010
Ordinary Income (includes interest)	38.6	35.0	Ends December 31, 2010

A review of federal capital gains tax rates reveals that there have been 19 rate revisions since 1925 (Exhibit 2). If one includes changes to the way “long term” is defined, there have been 22. This is a relatively small number of changes for an 80 year period, but most have occurred since 1970, changing, on average, once every three years.

**Exhibit 2:**  
TOP FEDERAL LONG-TERM CAPITAL GAINS TAX RATE  
1925 to 2007



**Exhibit 3:**  
LIQUIDATION TAX HURDLE

	EXPECTED RETURN (%)				
	2	4	8	10	12
YEARS:					
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

While we can't know the future with any certainty, we can build a framework for how to think about investment decisions in this uncertain environment.

The central issue is this: Should we forfeit the value of tax deferral in order to derive a potentially larger future benefit? Answering this question 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 anticipated future tax rate; all of which in turn, affect our decision.

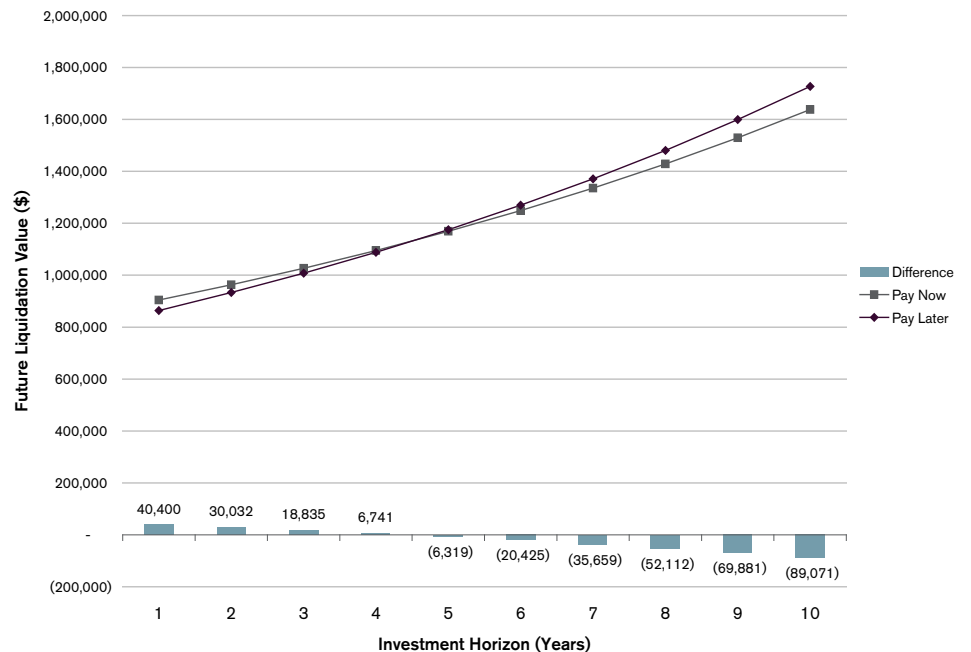
For example, given an expected return on investment and a liquidation horizon, how much do tax rates need to increase in order to justify liquidating and paying taxes on gains now? Our analysis solves for this number, which we call the "Liquidation Tax Hurdle."

Here is how to read Exhibit 3: for a given expected return and a particular investment horizon, the grid shows how much the current long-term tax rate of 15% would have to increase in order to justify paying taxes now rather than deferring—this is the Liquidation Tax Hurdle. For example, suppose you expect the asset to return 4% and your horizon to be two years, then your Liquidation Tax Hurdle is 1%. Thus, you should pay taxes now if the tax rate in two years will be greater than 15% + 1%, (i.e. 16%).

As you can see, 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 outweighs any benefit of locking in the current lower tax rate.

To better illustrate the importance of the investment horizon, Exhibit 4 isolates an expected return of 8% and a Liquidation Tax Hurdle of 5% (current taxes will increase by 5%) on an investment of \$1 million while assuming a cost basis of zero.

**Exhibit 4:**  
COMPARING LIQUIDATION VALUE FOR DIFFERENT TAX STRATEGIES



## THE 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  $t_1$ . The capital gain is  $V - B$  and the taxes liability is  $(V - B)t$ . The current liquidation value is the value of the portfolio minus the tax liability:

$$L = V - (V - B)t$$

Case 1:

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

$$L_1 = V(1 + r)^n - (V(1 + r)^n - B)t_1$$

Case 2:

Suppose we liquidate now, and again after  $n$  years. The final value after liquidation is:

$$L_2 = L(1 + r)^n - (L(1 + r)^n - L)t_1$$

We can use these relationships to estimate our future liquidation value and to derive our own Liquidation Tax Hurdle.

As one can see, the greater future liquidation value of the “Pay Now” tax strategy results in greater savings (Exhibit 4) until just before the 5-year investment horizon. After that, the compounding of deferral that comes with the “Pay Later” tax strategy overtakes the future liquidation value of the “Pay Now” strategy. Thus, while the liquidation tax hurdle is crucial, the investment horizon is just as important in deciding whether to pay now or pay later.

What does further analysis tell us? When you expect tax rates to increase substantially, it makes more 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.

Additionally, notice that the decision to pay now or later does not depend on market value or cost basis. Furthermore, our model assumes liquidation at the horizon. If you are expecting a basis step-up at death, then the investor should avoid realizing gains and paying taxes beforehand. However the basis step-up rules may also change with potential changes to estate taxes.

It is important to note that our analysis focuses only on reducing the overall tax burden. Myriad issues may call for 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 (e.g. a closely held business, stock options, a single stock concentration) defers capital gains taxes at the high cost of risk. A reduction in risk should be the more compelling reason to realize gains while the low tax rate is simply a bonus. In all, current low rates provide a great opportunity for many undiversified investors to reduce investment risk.

Taxes should be managed, not simply avoided. In fact, tax management is an integral aspect of portfolio management; yet, as with all investment ideas, it must adapt to changing market environments and opportunities which will evolve as tax rates and rules change.

Given the relatively low current tax rates, changing executive and legislative control, and the increasing need for government revenue, there is a distinct possibility of a capital gains tax rate increase. Rather than creating anxiety, this environment gives advisors an opportunity to deliver proactive service to clients. It will require some new thinking and client education. Few will want to pay taxes early, and the tax-averse will be reluctant to pay taxes today. However, the common recommendation always to defer taxation may need to be suspended. There is money to be made when we thoughtfully consider this question on behalf of our clients, “Pay now, or later?”

This information should not be considered investment advice or a recommendation to buy or sell any particular security. Parametric does not provide tax advice. Investors should seek advice from their own financial advisor prior to entering into any investment strategy.