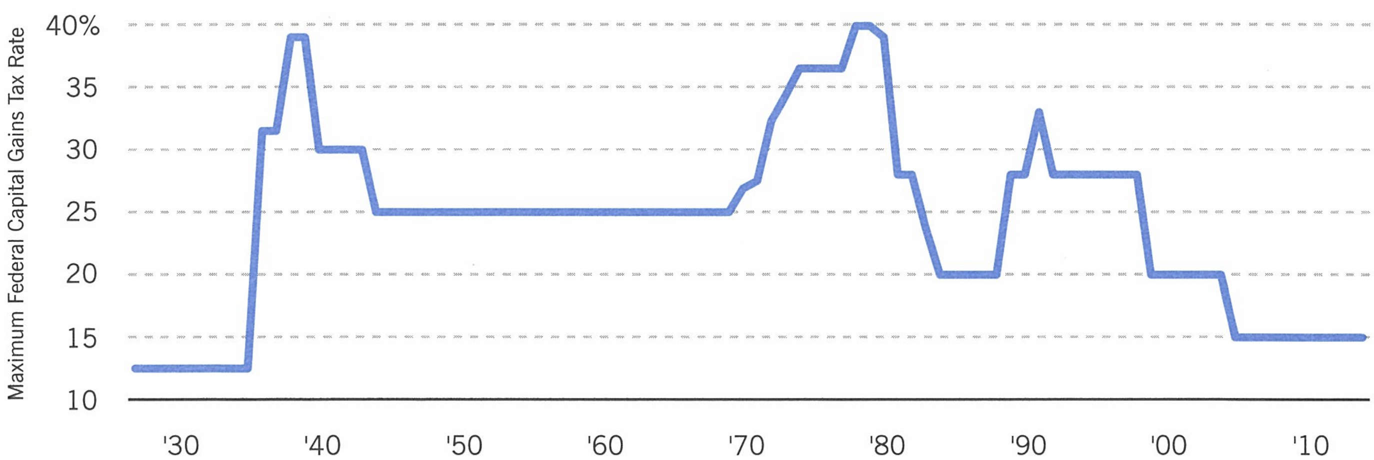
Preparing for Higher Taxes: Pay Now, or Pay Later?

If you're worried about the risk of rising taxes, you're not alone. With the federal budget deficit arguably unsustainable and current tax rates near historic lows in some cases (see Chart 1), many economists and investors fear that taxes may have nowhere to go but up—and it could happen sooner than you think. Unless the Bush-era tax cuts get extended, here's what may happen in 2013:

- **The top federal tax rate on ordinary income would rise from 35% to 43.4%—an approximately 25% increase.***
- **The top federal tax rate on dividend income would rise from 15% to 43.4%—an increase of almost 200%.***
- **The top federal tax rate on long-term capital gains would rise from 15% to 23.8%—a roughly 60% increase.***

*These potential tax rate increases assume the expiration of the Bush-era tax cuts at the end of 2012 and the imposition of a 3.8% tax increase on taxable investment income for families earning more than $250,000 a year ($200,000 for individuals) in 2013.

CHART 1: The Long-Term Capital Gains Tax Rate is Near Historic Lows



Source: Citizens for Tax Justice.

Upcoming Milestones

JUNE 2012

Supreme Court ruling on health care reform

As part of the 2009 health care reform law, a 3.8% tax increase on taxable investment income will take effect in 2013 for families earning more than $250,000 a year ($200,000 for individuals)—unless the law is overturned.

NOVEMBER 2012

Presidential and congressional elections

Election of a Republican president may make future tax hikes less likely. But regardless of the election outcome, President Obama will be in office through 2012 and has signaled that he may allow the Bush tax cuts to expire.

DECEMBER 2012

Impending expiration of Bush tax cuts

The tax cuts are scheduled to expire on December 31, 2012. The political battle over whether or not to extend them likely won't take place until late in the year—after the November elections.

A taxing question indeed

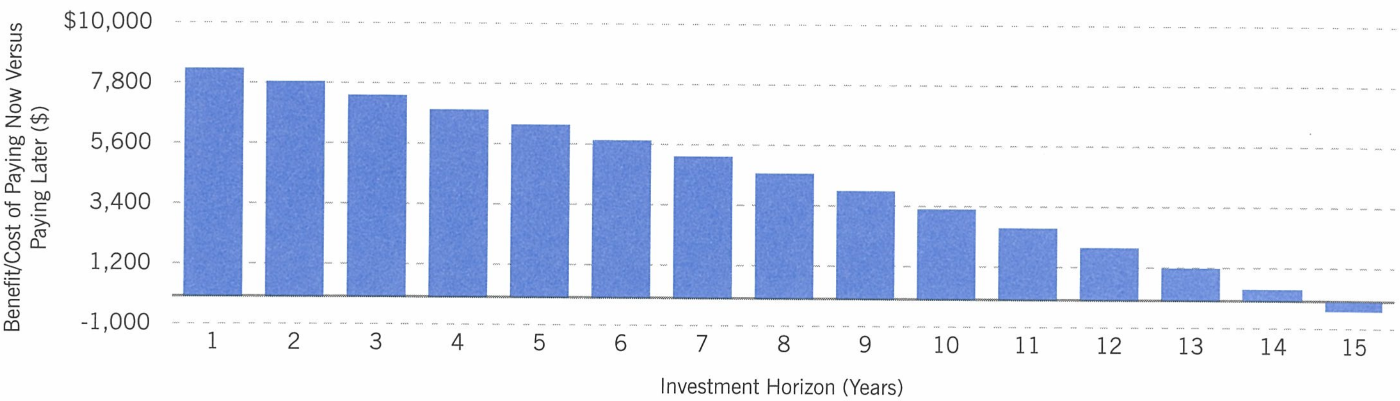
For investors faced with the decision of when to sell appreciated assets, the threat of higher capital-gains taxes requires especially careful planning. A key issue is the tradeoff between the tax savings associated with paying taxes sooner in a lower-rate environment, versus the benefit of greater tax-deferred growth potential if taxes are paid later at a higher rate. The longer the investor's time horizon, the more likely it is that deferring taxes could be advantageous.

A hypothetical example

To illustrate, assume a hypothetical portfolio with $100,000 in unrealized long-term gains, the potential capital-gains tax increase in 2013 (from 15% to 23.8%), and a 4% annual investment return each year compounded. As shown in Chart 2, the portfolio must be held for 15 years before the portfolio's hypothetical after-tax liquidation value exceeds the portfolio's after-tax value from paying taxes now (in 2012) at the lower rate. Naturally, all else being equal, an annual return above 4% could shorten that timeline.

The chart below shows the difference of hypothetical after-tax portfolio liquidation values if gains are realized and taxes are paid now in 2012 ("Pay Now" scenario) versus if both gains are realized and taxes are paid later in a higher tax environment ("Pay Later" scenario). Both portfolios pay taxes at the given investment horizon. The **"Benefit"** is when the difference of the "Pay Now" versus the "Pay Later" scenarios is positive, as this would hypothetically increase the portfolio's value. The **"Cost"** is when the difference is negative as this would reduce the portfolio's value. The "Pay Now" scenario assumes taxes are paid now in 2012, while the "Pay Later" assumes they are paid later in a higher tax environment on the Investment Horizon.

CHART 2: **The Hypothetical Benefit to the Portfolio's Value of Paying Taxes Now Shrinks as the Time Horizon Lengthens**



Source: Parametric Portfolio Associates. The "pay now" scenario pays taxes at time 0 (now), while the "pay later" scenarios do not; in all cases, taxes are paid at the horizon. The portfolio begins with an initial market value of $100,000 and a cost basis of 0. The 'benefit' is computed as the difference between the liquidation values of the "pay now" and "pay later" scenarios.

Key Takeaways

- Future tax rates are uncertain, but there is a distinct possibility they may rise—perhaps as early as 2013 if the Bush tax cuts aren't extended.
- Investors should gauge the likelihood of a near-term tax increase and decide if it makes sense to pay capital gains taxes sooner rather than later.
- In general, investors should bear in mind that taxes, while important, are one of many factors to consider when making investment decisions.

Timely tax ideas

Investors who choose to sell appreciated assets in 2012 may realize capital gains that offer the most potential tax benefit. Here are a few tips:

Realize gains on concentrated, low cost-basis positions. Some investors opt to sell a portion of such assets each year to spread out the tax bill, but given the prospect of rising taxes, it may be better to liquidate the entire position in 2012 and then either diversify into other holdings or repurchase the same asset at a higher cost basis.

Delay short-term gains. Investors may benefit from realizing long-term gains early, but it's generally still advisable to defer short-term gains (which are taxed as income) until they become long-term gains. Even if the long-term capital gains rate goes up, paying 23.8% on long-term gains in 2013 or later may be preferable to paying ordinary income tax on short-term gains in 2012.

Rebalance asset allocations. In a higher-tax setting, the tax cost of restoring an unbalanced portfolio to its target allocations can be steep if appreciated assets must be sold to accomplish that objective. As a result, investors may save money by completing the transition to the strategic targets in 2012—before the 'transition costs' (i.e. capital gains taxes) potentially spike in 2013.

For more tax insights, go to **www.eatonvance.com** and download Andy Friedman's *Investing in a Rising Tax Environment 2012* and *From the Hill to the Street: An Insider's Perspective*.

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