

# CAN EARLY TAX HARVESTING REAP GREATER GAINS?

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Capital gains taxes are scheduled to rise from 15% to 20% in 2011, but many think that the increase could be greater and could come two years sooner, when the next president takes office and a new Congress convenes. Should a prospective change in tax policy influence your investment strategy?

WHEN ASKED WHAT THE STOCK MARKET would do, J.P. Morgan famously asserted, “It will fluctuate.” The same is true of tax rates, and, as with the markets, their fluctuations can have a sizable impact on individual wealth.

## Timing the Taxman

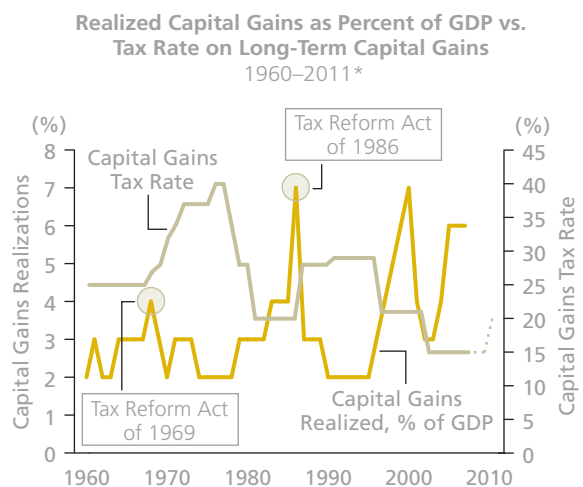
Throughout history, both the level of the capital gains tax rate and expected increases in rates have influenced investor behavior. Specifically, investors tend to defer more gains during periods of higher taxes and become more willing to harvest gains in low-rate regimes. Investors have also been tempted to realize embedded gains in anticipation of higher tax rates, reflecting their desire to get a jump on any expected tax increases. For example, investors realized unusually large gains in the last quarter of 1986, in advance of a scheduled tax rate increase of eight percentage points (from 20% to 28%) on January 1, 1987, as a result of the Tax Reform Act of 1986 (*Display 1*).

The increase in capital gains rates in 1987 must have seemed like a locomotive coming down the line: Many investors simply leapt off the tracks to avoid it. Under current tax law, the long-term capital gains tax rate increases five percentage

*Bernstein does not provide tax, legal, or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.*

Display 1

## Tax rates and gains realizations: A contrary relationship



\*Realized gains as % of GDP in 2006 and 2007 reflect Bernstein estimates; the capital gains tax rate from 2008–2011 reflects the current schedule. Source: Department of the Treasury—Office of Tax Analysis and AllianceBernstein

points, from 15% to 20%, in January 2011. But there’s widespread belief that the rate increase could be higher and that it could come as early as mid-2009, after the next president takes office and a new Congress convenes. The question this raises is: Should investors accelerate their harvesting of embedded capital gains before higher rates become a reality?

### A Taxing Matter: No Easy Answers

At first blush, realizing taxable gains in the face of higher future tax rates may seem like the obvious thing to do. But trying to sidestep any presumed or even scheduled shift in tax rates before a comprehensive assessment of all the investment variables involved could prove both untimely and imprudent. After all, the benefit of deferring taxes is well established—when we defer taking gains, money that would otherwise have gone to the government instead can continue to grow, leading to greater future wealth. And, of course, the investment objective is to maximize the likelihood of better *after-tax* returns, not simply to minimize taxes.

To complicate matters further, there's another important (and often overlooked) factor in examining the value of skirting any prospective rate increase: the very real possibility that tax rates at the *end* of an investor's expected holding period may be very different from the rate expected in the near term. In our 1986 example, rates fell a decade later by as much as they rose, and then dropped another five percentage points a few years after that. In fact, rates have varied considerably over the years: The maximum tax rate on long-term capital gains has ranged from a high of almost 40% in 1978 to the current, historic low of 15%.

Given that tax rates have fluctuated and likely will continue to do so over the coming years, there may be real danger in focusing myopically on the *next* rate regime, which, if history is any guide, is not likely to persist for long. Even more dismaying, changes in capital gains rates have, on occasion, been enforced *retroactively*, so that almost any strategy of anticipating a change may have an outcome other than the one expected.

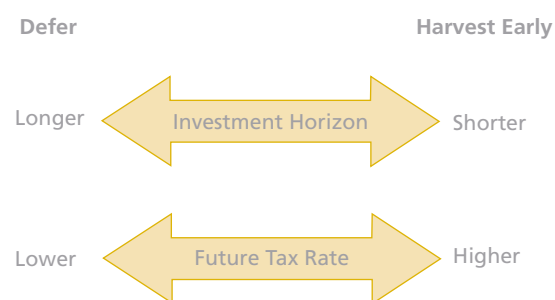
Finally, if your expected holding period is *forever* (or at least until death parts you from your investment, assuming the law still allows a step-up in basis), the question whether to harvest or defer is moot—capital gains taxes are not an issue. But the situation is more complicated if you anticipate selling the position in the future, either as part of your natural turnover or to raise cash for a particular need. To help investors take a more clearheaded, objective view of this difficult and emotional topic, let's explore the drivers that determine whether or not accelerating gains ahead of an anticipated tax increase makes sense.

### To Harvest Early or Defer Gains: A Framework

At the most basic level, the decision to tax-trade ahead of an expected increase in rates hinges on the interplay of two key variables: the investor's expected horizon, or holding period before liquidating the portfolio, and the expected increase in tax rates (*Display 2*).<sup>1</sup> Generally speaking, the shorter the investment horizon, the more valuable it is to harvest gains in the lower-rate regime—the benefits of deferral are offset by larger future taxes paid under the higher-rate regime. And, of course, the higher the future tax rate, the more incentive there is to capitalize on the current lower rate.

Display 2

#### Harvest or defer? The decision hinges on two key factors



Source: AllianceBernstein

<sup>1</sup> This leaves out the important question of existing cost basis. Realizing gains on a lower-cost-basis holding means a larger tax upon liquidation, so a higher future tax rate might appear to incline investors to accelerate their gains realizations. But ultimately, while cost basis will magnify the difference in wealth between a strategy of harvesting or deferring, it does not significantly impact the likelihood that a harvesting strategy is preferable.

To bring this framework to life and illustrate the trade-offs at a very simplistic level, imagine an investor, Earl E. Gaines, who has a \$1 million portfolio of diversified equities with a cost basis of \$500,000. Let's say he plans on selling the portfolio a year from now, and expects it to earn 8% during that period. Convinced that rates will increase in the following year from 15% to 20%, Earl wants to look at two scenarios. In the first, he sells his entire portfolio now, pays taxes at the current 15% capital gains rate, reinvests the proceeds in an identical equity portfolio, and then cashes that out a year hence, paying tax again, but now at the prevailing 20% long-term capital gains rate. In the second scenario, Earl simply holds on to his current portfolio and liquidates the entirety a year later, paying all of the capital gains taxes once, at the going 20% rate. *Display 3* shows how the two portfolios fare over that period, the capital gains taxes they incurred, and their final wealth values.

Display 3

**The harvest or defer trade-off:  
Greater growth or lower taxes?**

	Harvest Strategy	Deferral Strategy
Initial Value	\$1 Mil.	\$1 Mil.
Cost Basis	\$500,000	\$500,000
Tax Rate	15%	N/A
Tax on Gain	\$75,000	
Proceeds	\$925,000	
Tax Rate Next Year	20%	20%
Value Next Year	\$999,000	\$1.08 Mil.
Gain Next Year	\$74,000	\$80,000
Tax on Next Year's Gain	\$14,800	\$116,000*
Combined Tax Rate	16%	20%
<b>Total Taxes</b>	<b>\$89,800</b>	<b>\$116,000</b>
Liquidation Proceeds	\$984,200	\$964,000
Advantage	2.1%	

\*Includes tax on the embedded gain of \$500,000  
Source: AllianceBernstein

**KEY CONCEPTS**

- > Shifting capital gains tax rates have influenced investor behavior in the past
- > Capital gains taxes are scheduled to rise from 15% to 20% in 2011, but many think that the increase could be even greater, and come sooner
- > For holders of diversified equity portfolios, an increase in rates to 20% would not present a particularly strong case to actively tax-trade ahead of the policy change; but an increase in rates to 28% may suggest a clearer rationale to take action
- > For investors holding concentrated stock positions, any rise in capital gains rates increases the appeal of harvesting embedded gains in a lower-rate regime and diversifying the proceeds into a lower-risk portfolio

The “deferral” strategy shows higher pretax growth (ending at \$1,080,000), as the original sum, undiminished by any up-front tax hit, continues to compound for an additional year. But it also has the highest tax bill: The larger total gain (of \$580,000) was all taxed at the higher 20% rate. The “harvest” strategy saves on taxes, but reinvests less principal: It ends the year with a pretax value of \$999,000. However, the initial embedded gain (of \$500,000) was taxed at the lower 15% rate, while only the following year's gain (of \$74,000) was taxed at the higher 20% rate, for a combined capital gains tax of 16%. In this case, harvesting early (at the end of one year) provides an advantage of about 2% in overall wealth versus the deferral scenario.

## Looking for Breakeven

But our example extends out only one year. What if Earl had a longer investment horizon, as most investors typically do? A more practical way of framing the decision, therefore, is to examine what we call the “break-even” horizon, the expected holding period that would result in the same wealth outcome whether one defers the tax hit for some time or realizes gains, pays tax at today’s rate, and then reinvests the proceeds before realizing a gain at the end of the investment horizon.

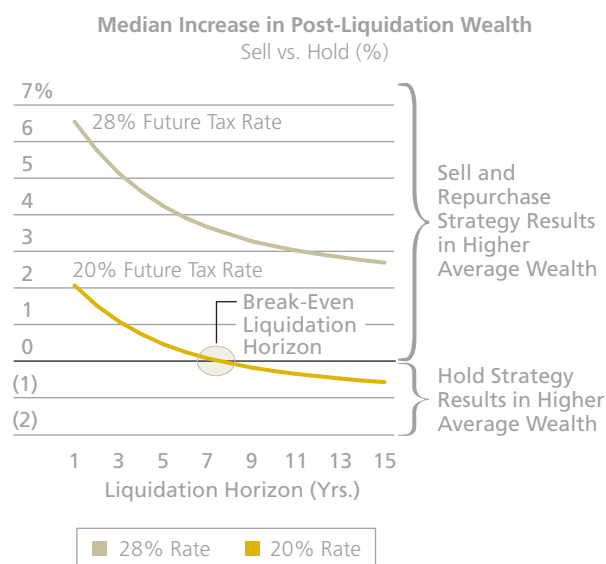
*Display 4* shows the break-even horizon for the same portfolio calculated with two different future tax scenarios in mind: a moderate increase in the capital gains tax rate from 15% to 20% in one analysis, and a more aggressive move from 15% to 28% in the other. The area below the zero line indicates those outcomes where the deferral strategy is optimal; above the line the harvest strategy wins out. You can see that at a 20% future capital gains rate, the advantage of harvesting versus deferring over a one-year horizon is Earl’s 2%, as detailed in the example above. But that modest advantage declines over time and turns negative at about year seven, as the benefits of tax deferral win out.

For investors with a liquidation horizon of less than seven years, there is some benefit to harvesting early, though it is modest. The average increase in wealth over this horizon is less than 1%. For investors with longer holding periods, deferring appears to make sense.

However, when we look at a potential increase in rates from 15% to 28%, the story changes dramatically: Here the benefit of harvesting

Display 4

## Time and taxes: Break-even time horizons for different rate scenarios



The initial position is a \$1 million diversified equity portfolio (35% US value/35% US growth/25% developed international/5% emerging markets) with an existing cost basis of \$500,000. The current tax rate on capital gains is 15% and either 20% or 28% in all future years, while the ordinary income tax rate is 39.6% in all years. The analysis reflects post-liquidation proceeds and 15.25% annual gains realizations and assumes future capital losses are used to offset outside gains. See Notes on Wealth Forecasting Analysis, page 34.  
Source: AllianceBernstein

early is more than 6% at year one, and while that advantage too declines over time, there is *no* liquidation horizon within which the portfolio’s growth can overcome the drag of the higher future tax.<sup>2</sup>

## From the Possible to the Probable

But the analysis is still too simplistic, as we’ve considered only a scenario in which the future return was assured. We haven’t yet taken account of the uncertainty surrounding the level and path of future returns, and the success of early harvesting depends critically on the return environment over the course of

<sup>2</sup> The break-even horizon for a diversified portfolio actually depends not only on portfolio performance and the liquidation horizon but also on what percentage of the portfolio’s embedded capital gains are realized annually—what we refer to as the gains realization rate. The gains realization rate is often proxied by the more common metric of portfolio turnover—although, strictly speaking, efficiently tax-managed portfolios can endure higher turnover without excessive gains realizations. High rates of gains realization, which typically characterize a less tax-efficient portfolio, will extend the break-even horizon, and in extreme cases can overcome any advantage to tax deferral over any time horizon. For example, an investor with a gains realization rate approaching 100% (he pays taxes on all of his gains every year) leaves no opportunity for the compounding benefit of tax deferral to work to his advantage, and as such is almost always better off realizing embedded gains at today’s lower rate than at “tomorrow’s” higher rate.

the holding period. If future markets are better than average, then tax deferral has higher value. Should future markets be disappointing, then harvesting early becomes more attractive.

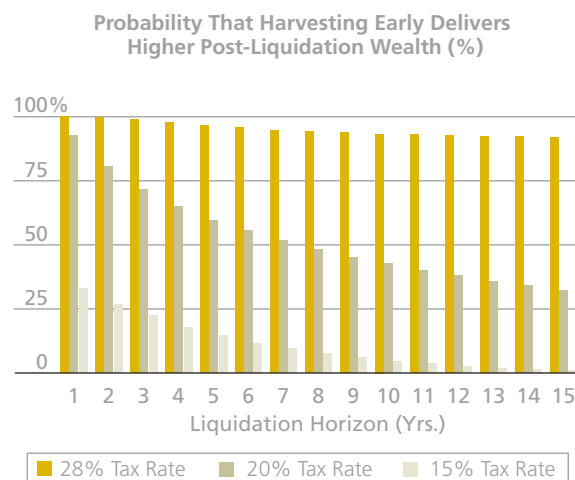
Of course, we cannot divine the future. But to help our clients make thoughtful decisions based on a realistic assessment of potential future outcomes, we've developed a quantitative capital markets model. Our Wealth Forecasting System<sup>3</sup> takes the known facts—our clients' assets, income needs, risk tolerance, tax brackets, and time horizon—and runs various investment scenarios through our model to project 10,000 possible return paths. With it, we can analyze the impact of changes in tax rates across the spectrum of possible future capital market outcomes, thus helping clients make informed decisions regarding the *probability* that accelerating gains realizations will result in greater wealth.

In *Display 5* you can see that should the capital gains rate stay constant at 15%, accelerating gains will typically be a poor decision, although there still would be scenarios—that is, when markets are particularly hostile—in which the client is better off. But if rates increase to 20%, the appeal of harvesting embedded gains early rises, and the likelihood of being better off remains above 50% for investors with a horizon of up to seven years (our break-even holding period).

But is a 50/50 shot at success enough enticement to take gains early? If an investor with a five-year horizon wants to be 75% certain that realizing gains early is in his best interest, he will *not* want to take action if rates rise to 20% (given there is only a 60% probability of success). However, the same investor can be very comfortable he is making the right decision if rates are scheduled to rise to 28%, in which case the probability of success is high

Display 5

### Gauging the likelihood of a successful early harvest



The initial position is a \$1 million diversified equity portfolio (35% US value/35% US growth/25% developed international/5% emerging markets) with an existing cost basis of \$500,000. The current tax rate on capital gains is 15% and either 20% or 28% in all future years, while the ordinary income tax rate is 39.6% in all years. The analysis reflects post-liquidation proceeds and 15.25% annual gains realizations and assumes future capital losses are used to offset outside gains. See Notes on Wealth Forecasting Analysis, page 34.

Source: AllianceBernstein

across all investment horizons, and the magnitude of success, in terms of greater after-tax wealth, is higher too.

But considering the inherent uncertainty as to what tax rates will be at the end of the prospective holding period (itself not known with certainty), as well as whether tax rates will in fact be higher next year (who knows what Congress will approve?), one should be cautious when contemplating harvesting gains as part of a strategy of “front-running” the rate increase.

### The Perils of the Concentrated Position

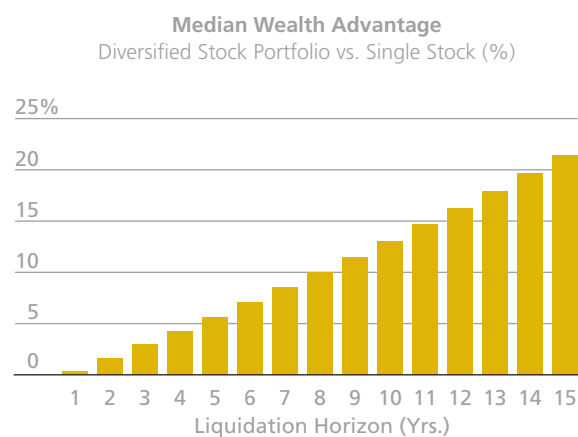
There is one situation, however, in which a prospective shift in capital gains tax rates has powerful relevance to the “harvest or defer” decision: concentrated positions of low-cost-basis stock. In this case, in addition to taking advantage of a lower tax rate on your sale, you also reinvest the proceeds in a lower-risk portfolio.

<sup>3</sup> See Notes on Wealth Forecasting Analysis at the end.

While the allure of building massive wealth by concentrating your portfolio in one or several holdings is great, the likelihood of achieving returns superior to the markets' is low, and the volatility one can expect to encounter is high. This higher volatility has a real cost. Our research has shown that historically, a typical single stock has compounded at a growth rate almost three percentage points *below* that of the S&P 500. And for single stocks with the highest volatility, the results were even worse, compounding at a rate of only half that of the market.<sup>4</sup> In fact, if we look at a similar liquidation analysis but without any change in tax rates, simply exchanging a single stock position for a diversified portfolio of global equities, the median wealth outcome is superior over every time period (*Display 6*).

Display 6

#### Exchanging a single stock for a diversified portfolio



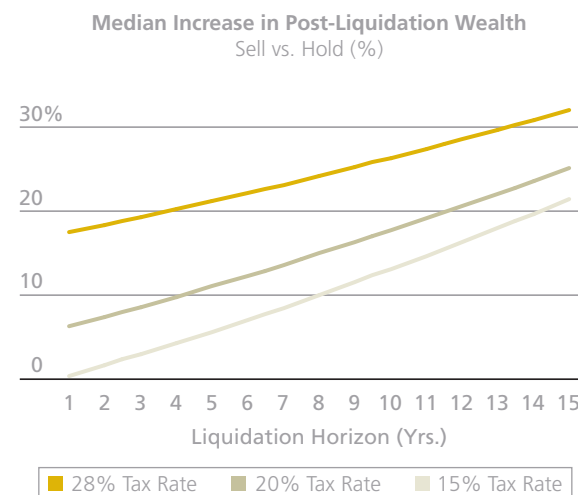
The initial position is a \$1 million single stock position with 30% volatility and 1.0 beta to US equities; the analysis assumes a zero cost basis, a current tax rate of 15% on capital gains and 15% in all future years, and an ordinary income tax rate of 39.6% in all years. The portfolio's allocation is 35% US value/35% US growth/25% developed international/5% emerging markets, and the portfolio's results reflect post-liquidation proceeds and 15.25% annual gains realizations; the analysis assumes future capital losses are used to offset outside gains. See Notes on Wealth Forecasting Analysis, page 34.

Source: AllianceBernstein

When we add the future capital gains rate increases into the mix, the “harvest or defer” decision is easier: In all of our prospective tax regimes (a static 15% rate, as well as increases to 20% and 28%), the benefits of harvesting and diversifying the concentrated position, in the median case, appear significant: With an increase in rates to 28%, the magnitude of the benefit of harvesting early amounts to about 18% in the first year (*Display 7*). And, unlike a diversified portfolio, for which the advantage of front-running the tax increase declines over time, with a single stock portfolio the advantage of selling and diversifying never sets on this particular horizon, rising to over 30% in year 15.

Display 7

#### A magnitude of difference: Harvesting a single stock versus diversified portfolios



The initial position is a \$1 million single stock position with 30% volatility and 1.0 beta to US equities; the analysis assumes a zero cost basis, a current tax rate of 15% on capital gains and 15% in all future years, and an ordinary income tax rate of 39.6% in all years. The portfolio's allocation is 35% US value/35% US growth/25% developed international/5% emerging markets, and the portfolio's results reflect post-liquidation proceeds and 15.25% annual gains realizations; the analysis assumes future capital losses are used to offset outside gains. See Notes on Wealth Forecasting Analysis, page 34.

Source: AllianceBernstein

<sup>4</sup> See our comprehensive research study on single stock positions, *The Envious Dilemma: Concentrated Stock—Hold, Sell, or Hedge?*

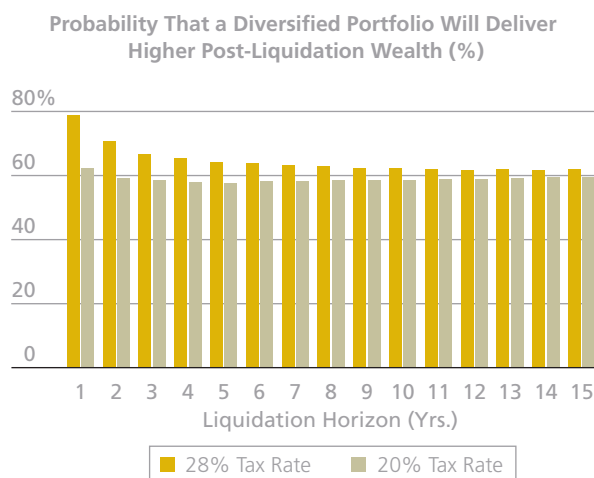
But once again, looking only at scenarios in which the future returns are known with certainty is not enough. We must consider the full spectrum of portfolio outcomes to judge the likelihood of any strategy's success. When harvesting gains and diversifying the single stock position, we found that the probability of success remains above 50% across the entire 15-year time frame of our analysis, and does so in both of our prospective rate regimes (*Display 8*). Yet even here, of course, the questions of how much to sell—and how quickly—are matters that must be tailored to each investor's risk tolerance, spending needs, and overall financial profile.

### Decision Time?

The moral of the story: Tax rates change over time—and they change often and fairly unpredictably. For investors whose expected holding period is not *forever*, it's a difficult decision whether to forgo tax deferral in favor of locking in today's low tax rate. For holders of substantial single stock positions, the appeal of harvesting gains on those stocks now and diversifying their portfolio is high, in terms of both the magnitude and the probability of success, regardless of the level of any future tax rate. But for investors who already hold diversified portfolios, the decision is less clear: It will depend both on the investor's time horizon and the size of the anticipated change in tax rates. At a future capital gains rate of 20%, the magnitude of the benefit from harvesting early is modest, and the probability of success declines quickly

Display 8

### Positively probable: Tax-trading out of a single stock



The initial position is a \$1 million single stock position with 30% volatility and 1.0 beta to US equities; the analysis assumes a zero cost basis, a current tax rate of 15% on capital gains and 15% in all future years, and an ordinary income tax rate of 39.6% in all years. The portfolio's allocation is 35% US value/35% US growth/25% developed international/5% emerging markets, and the portfolio's results reflect post-liquidation proceeds and 15.25% annual gains realizations; the analysis assumes future capital losses are used to offset outside gains. See Notes on Wealth Forecasting Analysis, page 34.

Source: AllianceBernstein

with time. But in the event that a 28% rate looms, there is a higher probability of success in accelerating gains, and a superior average wealth outcome, and this may bias some toward taking preemptive action.

Regardless of the future tax regime, our Wealth Forecasting System can help clients quantify the *likelihood* and *magnitude* of success of different investment strategies so that they can make the most informed decision. ■

## Notes on Wealth Forecasting Analysis

The Bernstein Wealth Forecasting Analysis<sup>SM</sup> (WFA) is designed to assist investors in making a range of key decisions, including setting their long-term allocation of financial assets. The WFA consists of a four-step process: (1) Client Profile Input: the client's asset allocation, income, expenses, cash withdrawals, tax rate, risk-tolerance goals, and other factors; (2) Client Scenarios: in effect, questions the client would like our guidance on, which may touch on issues such as which vehicles are best for intergenerational and philanthropic giving, what his/her cash-flow stream is likely to be, whether his/her portfolio can beat inflation long-term, when to retire, and how different asset allocations might impact his/her long-term security; (3) The Capital Markets Engine: our proprietary model, which uses our research and historical data to create a vast range of market returns, taking into account the linkages within and among the capital markets (not Bernstein portfolios), as well as their unpredictability; and (4) A Probability Distribution of Outcomes: based on the assets invested pursuant to the stated asset allocation, 90% of the estimated returns and asset values the client could expect to experience, represented within a range established by the 5th and 95th percentiles of probability. However, outcomes outside this range are expected to occur 10% of the time; thus, the range does not establish the boundaries for all outcomes. Further, we often focus on the 10th, 50th, and 90th percentiles to represent the upside, median, and downside cases. Asset-class projections used in this publication are derived from the following: US value stocks

are represented by the S&P/Barra Value Index, with an assumed 20-year compounding rate of 8.2%, based on simulations with capital market conditions as of December 31, 2007; US growth stocks by the S&P/Barra Growth Index (compounding rate of 8.1%); developed international stocks by the Morgan Stanley Capital International (MSCI) EAFE Index of major markets in Europe, Australasia, and the Far East, with countries weighted by market capitalization and currency positions unhedged (compounding rate of 8.0%); emerging markets stocks by the MSCI Emerging Markets Index (compounding rate of 6.6%); taxable bonds by diversified securities with seven-year maturities (compounding rate of 5.4%); real estate investment trusts (REITs) by the NAREIT Index (compounding rate of 5.3%); a single stock with a beta of 1.0, volatility of 30%, and a dividend yield of 0% (compounding rate of 5.3%); and inflation by the Consumer Price Index (compounding rate of 2.5%). Expected market returns on bonds are derived taking into account yield and other criteria. An important assumption is that stocks will, over time, outperform long-term bonds by a reasonable amount, although this is by no means a certainty. Moreover, actual future results may not be consonant with Bernstein's estimates of the range of market returns, as these returns are subject to a variety of economic, market, and other variables. Accordingly, this analysis should not be construed as a promise of actual future results, the actual range of future results, or the actual probability that these results will be realized.