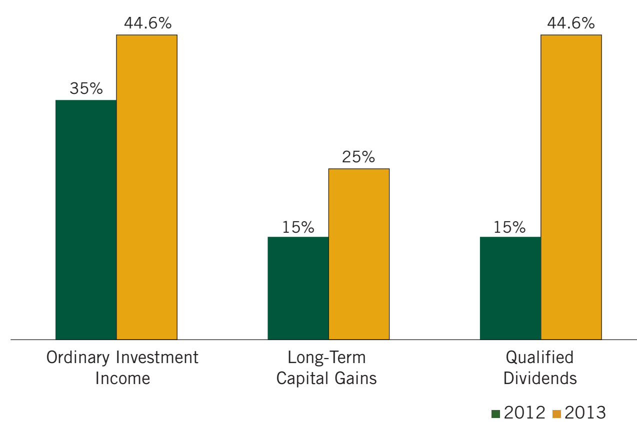
Expected Tax Changes: What Should Investors Do?

Tax rates are expected to increase for high-income taxpayers in 2013, prompting many to consider different strategies to minimize tax liability. In this update, we address some common questions investors may have regarding the upcoming changes, particularly whether it makes sense to harvest capital gains or losses. Of course, our general responses outlined below aren't meant to consider every conceivable nuance to the tax code, but rather to provide a basis for conversations with your Client Account Manager and tax advisor.

How much are tax rates expected to rise?

Potential 2013 increases are big. Factoring in the expiration of the Bush tax cuts, the new tax on net investment income from the Affordable Care Act, and the Pease provision (which could reduce itemized deductions that are currently allowed by as much as 80%), the expected tax increases for high-income families are significant, as shown in Exhibit 1. Absent any new legislation, these are the changes that will occur January 1, 2013.

Exhibit 1: Scheduled Federal Tax Rate Changes



Given the outcome of the recent election, it seems likely that tax rates will go up, but the exact changes are still uncertain at this point. President Obama has pledged not to extend the Bush tax cuts for higher-income taxpayers, but he has also voiced a desire to limit the federal increase in dividend taxes to 20% instead of the scheduled jump to 39.6%. The president cannot make tax policy changes with an executive order, so he must work with Congress if he wants to alter the current path.

Given that tax rates are expected to rise in 2013, does Bessemer recommend long-term gain harvesting in 2012?

For clients with:

Significant capital loss carryforwards	**No**
Low-basis positions	**Client discretion**
Concentrated low-basis positions	**Yes**
Transition/custody accounts	**Yes**

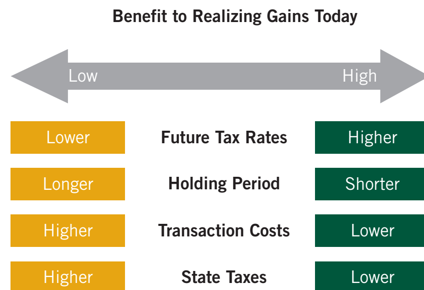
Generally it is good advice to delay paying taxes as long as legally possible. But since tax rates are poised to rise significantly, clients should at least consider realizing long-term gains (we would not recommend realizing additional short-term gains) ahead of the potential rate increases. (For a brief recap on the basics of harvesting capital gains and losses, please see page 4.)

No action is recommended for clients with loss carryforwards. For clients with large capital loss carryforwards, realizing gains in 2012 doesn't really change their tax position and should be avoided; while realizing a gain will increase the investor's basis on the position that is sold and then repurchased, it will also reduce the investor's capital loss carryforwards, leaving the client in a similar tax position (and not paying capital gains tax for the year either way) despite having paid transaction costs. Additionally, realizing the gain will reset the holding period to the date the security is repurchased.

Key sensitivities for clients with no loss carryforwards. For clients who don't have capital loss carryforwards, the key factors to weigh are the magnitude of the

expected increase in tax rates, the intended holding period, transaction costs, and state income taxes (Exhibit 2).

Exhibit 2: Realize Long-Term Gains Today?



Tax rates and holding period are key. A client who otherwise was planning to sell a stock in January 2013 at a 25% rate would be better off selling in December 2012 at a 15% rate. In that case, the benefit of the lower rate outweighs the fact that the investor is paying taxes a year earlier than planned. At the other extreme, an investor planning to hold a stock "forever" (and eventually receive a step-up in basis at death) won't likely be impacted by the changing tax rates and should continue to hold the stock.

For those with holding periods in between these two extremes, it's a closer call. For example, in Bessemer's managed equity portfolios, turnover is approximately 30-35%, meaning the average holding period for a stock is about three years. In cases like these, clients have to weigh the disadvantage of paying taxes a few years early with the advantage of locking in today's low capital gains rate. With gain harvesting, portfolio disruption is minimal, as an investor can sell the stock at a gain and buy it back immediately.

Consider transaction costs and state income taxes. In evaluating the benefits and drawbacks of harvesting gains, clients should remember that selling a stock and buying it back involves transaction costs (two ways — selling and then buying). Also, those who live in states with income tax must quantify the cost of paying their state income taxes sooner.

Bessemer is not planning to harvest gains. If we were certain capital gains rates were heading from 15% to 25%, we would recommend harvesting gains on shares currently trading at a gain of approximately 50% or more. In our view, this would provide a reasonable "risk and return" tradeoff for most clients (the "risk" is paying taxes sooner than you need to, the "return" is doing so at a lower rate).

But the future is never clear: Tax rates might not change as expected next year, and paying taxes sooner than necessary contradicts basic human instincts, so we will leave the decision of whether or not to harvest gains to the discretion of our clients and their tax advisors. At this point, we are not planning to realize additional gains in our managed portfolios solely for income tax purposes. Additionally, we are not recommending clients harvest gains in the Old Westbury equity mutual funds, as the funds' longer-term horizon makes realizing gains today less beneficial.

Exception for investors with concentrated positions. For clients with concentrated, undiversified assets such as a large single stock holding, selling at least part of the concentrated position in 2012 probably makes sense. Even when tax rates aren't expected to increase, we encourage our clients to lower their overall portfolio risk by reducing exposure to their concentrated holdings. But the fact that future tax rates could move higher makes this especially timely and improves the odds that investors will be better off by diversifying today.

Revisiting transition and custody accounts. We would encourage clients with "transition" accounts at Bessemer or unmanaged investments in custodial accounts to review their current holdings and determine if any of the positions should be sold in light of the expected tax changes. If these are stocks that are very likely to be sold in the near future anyway (for instance, as they transition to Bessemer managed accounts), this is the year to make the sales.

Does Bessemer recommend tax-loss harvesting in 2012?

For clients with:

Significant capital loss carryforwards	**No**
Realized long-term capital gains	**No**
Realized short-term capital gains	**Yes**

Loss harvesting is normally helpful. Normally, towards the end of the tax year, we advise clients who have net realized gains to consider offsetting those gains by harvesting losses. Doing so can be beneficial, although the benefit is often overstated. The strategy doesn't eliminate capital gains; it simply defers them (as the cost basis is lowered when the position is repurchased and a bigger gain is realized later). Also, loss harvesting involves transaction costs, and to use the losses to offset gains, an investor needs to be out of the security that is sold for 31 days, causing portfolio disruption.

Little benefit for investors with carryforwards. A client with capital loss carryforwards in excess of realized gains will not pay capital gains tax this year, so loss harvesting is of little value. Harvesting losses increases the capital loss carryforward amount, but also reduces the existing basis (as shares are sold and later repurchased), leaving the client in a similar tax position.

Bessemer is not recommending loss harvesting for long-term gains — only for short-term gains. Clients with realized long-term gains who don't have capital loss carryforwards are also likely to be better off saving the potential losses for future years when tax rates are higher. In other words, a loss is more valuable if it's used to offset a capital gains tax of 25% instead of 15%. We are therefore not recommending loss harvesting in 2012 to offset net long-term capital gains. We would rather offset gains in future years when tax rates are likely to be higher, and we would also like to avoid disrupting the portfolio. We would, however, continue to recommend loss harvesting for any client who has net short-term capital gains. Offsetting gains that are taxed at the much higher ordinary income rate continues to be worthwhile in our judgment.

Will Bessemer's investment strategy change if dividend and capital gains tax rates increase?

No major change in investment philosophy. With a client base of high-net-worth investors with significant taxable assets, we have always been cognizant of the impact of taxes on our investments and the tax ramifications of any changes made to portfolios. As always, we attempt to generate competitive, risk-adjusted, after-tax returns. This philosophy doesn't change even if the specific tax rates do.

We do not expect changing tax rates to significantly alter our investment process or strategy. On the margin, the tax "penalty" from selling a successful stock will go up, which means we need to be even more conscious of this tax cost when determining whether to sell a winner and replace it with something else. However, we don't expect this to meaningfully alter our investment philosophy or turnover, which should remain at approximately 30-35% for our equity portfolios.

We also don't anticipate changing our perspective on dividends or dividend-paying stocks. We think dividend tax rates will most likely be higher next year, but we believe the federal dividend rate will move from 15% to 20%, not 39.6%. A company's dividend is one of many things we evaluate in figuring out whether or not we want to own the stock, but other attributes (earnings power, cash flow, quality of management, competitive advantage) are more important over the long run. A higher dividend tax rate reduces the after-tax value of the dividend, but higher capital gains rates will have a similar impact on the capital appreciation of stocks. While the ratio of dividend versus capital gains tax rates is something we will monitor, we don't expect any tax changes to meaningfully alter our investment strategy.

Should investors increase their allocation to municipal bonds since tax rates are expected to go up?

No change in asset allocation is recommended. Most of our clients allocate between bonds and stocks based on their risk tolerance and return goals and objectives. While higher federal tax rates make municipal bonds more attractive after taxes, we still expect municipal bonds to earn significantly less than stocks, net of taxes, over the long run. Furthermore, a few proposals to raise federal tax revenue would involve limiting the federal tax exemption of municipal bond interest. Were this to make its way into law, it would likely have the opposite effect on the demand and performance of municipal bonds. Given this uncertainty, we are not recommending increasing exposure to municipal bonds.

Tax Strategies: The Basics

Potential tax changes in 2013 have brought to the forefront tax strategies such as harvesting capital gains or losses and using tax loss carryforwards. Below is a brief refresher on these tax-related terms, with examples.

What does it mean to "harvest" or realize a capital gain or loss?

Realizing a capital gain is when you sell an investment (such as a stock) that has increased in value during the time you've held it. Realizing a capital loss is the opposite: you sell the stock for less than the price at which you bought it. The price you originally paid to buy the stock is called its cost basis. If an investment has gone up in value but you continue to hold it, it's an unrealized gain, which isn't taxed. An investment that has gone down in value but hasn't been sold is an unrealized loss.

Generally, when investors talk about "harvesting" a gain or loss for tax purposes, they ultimately buy back the position after it is sold to maintain the same exposure. With gains, this can be done immediately (although investors would have less money for reinvestment if they set aside a tax reserve) — but with losses, an investor has to be out of the stock for 31 days for the losses to be able to offset gains (avoiding what's called a "wash sale"). Harvesting losses can introduce new portfolio complications — for example, what happens if the stock you sold does well in the 31 days you don't own it? To address this risk, many investors will buy a similar holding (for example, if the stock they are selling is Ford, they might buy GM and hold it for 31 days) so they maintain somewhat similar exposure. But this too isn't a perfect solution — the two stocks may perform very differently in the short term, and even if the new stock goes up, the investor will realize a short-term capital gain (see next question) when the replacement stock is sold after 31 days, potentially negating the benefit of the loss harvesting. So, realizing losses for tax purposes isn't always as straightforward as it seems, and any short-term portfolio disruption needs to be carefully considered.

Loss harvesting is something investors typically consider towards the end of any tax year; gain harvesting, on the other hand, is especially relevant in 2012 given investors' expectations that capital gains rates are headed higher.

How are capital gains taxed?

Any time you realize a capital gain, you have to pay capital gains tax on it, but the rate depends on how long you've held the investment. If you've held it for one year or less, you have to pay short-term capital gains taxes (35% as of 2012), while anything held more than a year is subject to long-term capital gains taxes (15% in 2012).

If you bought a stock for $10 (per share) back in 2010 and sold it for $15 in 2012, you'd be realizing a long-term capital gain of $5 and have to pay a 15% long-term capital gains tax on it (or 75 cents per share).

What does it mean to "offset" gains?

You can use capital losses to offset capital gains. So, using the same example above, let's say that, in the same year that you realized a $5 gain, you decided to sell a separate stock that had fallen in value from $25 to $20. In this case, the $5 loss would cancel out, or offset, the $5 gain, so you would not owe the government any capital gains tax for 2012.

Can you provide an example of harvesting a gain or loss for tax purposes?

Let's say that, back in March 2012, you sold stock that you had held for nine months at a $1 million gain. If nothing changes, you will owe $350,000 in short-term capital gains taxes (35%) when taxes come due for 2012. But let's say that, in November 2012, you recognize that one of your other stock positions is trading $1 million below what you initially paid for it, although you still think the stock is attractive. You can sell the stock (realizing a $1 million loss), therefore offsetting the gain and avoiding having to pay the $350,000 in capital gains taxes, and after 31 days, you can buy back the stock.

Harvesting a gain is different. Let's say you held a stock that had a $1 million unrealized gain and you thought tax rates were heading significantly higher next year. You might consider "harvesting" the gain in 2012, selling the stock at today's low tax rates. You can then buy the stock back, and your new basis would be equal to the price at which you just purchased the stock.

What is a tax loss carryforward?

If you have more realized losses than realized gains in a given year, you can take any excess losses and carry them forward to future years. This is called a tax loss carryforward. So if you incur $1 million in gains but $3 million in losses in a given year, your losses would cancel out the gains (meaning you wouldn't pay tax on anything) and then you'd have a $2 million loss carryforward that you could use to offset realized capital gains in the years ahead.

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