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Investment Research Brief: Accelerating Tax Gains in 2012

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Over the past several months, private investors and their advisors have been pondering the wisdom of accelerating long-term capital gains in the 2012 tax year. Yes, that's right, *accelerating* gains.

Normally the idea might seem a bit odd since one typically tries to defer taxable gains for as long as possible. However, this year is different, given the looming expiration of the very favorable Bush-era tax rates. Beginning January 1, 2013, long-term capital gains tax rates are scheduled to increase from 15% to 20% and short-term rates are scheduled to increase from 35% to 39.6%. But that's not all. An additional 3.8% is scheduled to be added to capital gains tax rates as a result of the passage of the Patient Protection and Affordable Care Act (aka "Obamacare").

Many investors and tax advisors with whom we have spoken are planning to wait until after November's election in order to gain better insights into the chances that the scheduled tax rate increases will be reversed (based on which party gains control of the White House and/or Congress). While waiting for more information is certainly not a bad thing, our analysis suggests that accelerating gains makes good economic sense no matter which party wins the election. We reach this conclusion by noting the following:

1. Even if 90% of the contested 33 seats in the Senate were to be won by Republicans (a somewhat unlikely outcome to be sure), Republicans would still not secure the required 2/3 majority needed to override potential Democratic objections to extending the current tax rates.
2. If Republicans were to somehow strike a deal with Democrats allowing for the further extension of current low tax rates for ALL investors, it is highly unlikely that Democrats will agree to eliminate the planned Obamacare 3.8% tax increase.
3. Even if only the Obamacare tax increase is enacted, realizing long-term taxable gains in 2012 still makes economic sense.

Our analysis is best illustrated by a simple example. Let's assume that an investment manager oversees a portfolio where the tax cost is only 50% of current market value. Let's further assume that this manager turns its portfolio over by 30% each year and that the manager will generate an annualized rate of return of 6% (equal to Greycourt's current projection for 3-year US large cap equity returns). Given this simple set of assumptions, the table below shows the benefit of accelerating long-term taxable gains in 2012.

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Applicable long-term tax rate:	
Current *(2012) Rate*	15.0%
Extend: *Current Rate + Obamacare Tax*	18.8%
Expire: *Pre-Bush Rate + Obamacare Tax*	23.8%
Manager turnover	30.0%
Principal amount	$10,000,000
Assumed return rate	6.0%
Cost basis (% Market value)	50.0%

	Present Value of Tax Payment	**Tax Savings**
Sell in 2012 – Current	$750,000	$0
Hold - Bush Tax Rates Extended	$829,697	$79,697
Hold - Bush Tax Rates Expire	$1,050,361	$300,361

The investor in this example is better off irrespective of whether current tax rates are extended or expire. So under what circumstances might an investor be better off deferring gains? All other things being equal, if the manager's pace of portfolio turnover is 14% instead of 30% AND Bush-era tax rates are extended, then deferring long-term gains becomes preferred. Similarly, if the manager's assumed rate of return for each of the next three years increases from 6.0% to 11.5% AND Bush-era tax rates are extended, then deferring gains again becomes preferable. In our view, the conditions required for favoring gain deferral seem highly unlikely. (By the way, just as the looming tax rate increases argue for accelerating gains, they also argue for deferring losses as at higher tax rates capital losses become more valuable.)

One word of caution for purposes of this analysis: we have made the assumption that the manager(s) in question will dampen their normal level of portfolio turnover for the next 12 months since any gains realized during this period would incur short-term capital gains taxes. Most of the equity managers approved by Greycourt are highly tax aware and would likely adjust their behavior accordingly. More institutionally-focused managers, however, may be less sensitive to these tax considerations.

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As always, we recommend that investors consult their tax advisors in order to evaluate their specific situations. As your investment advisor, we look forward to discussing this important topic with you in the coming weeks.

This brief was written by Gregory Friedman, CEO and CIO of Greycourt & Co, Inc. The author can be reached by phone at 503.797.6400 or by email at gfriedman@greycourt.com.

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