TALKING TAXES: PORTFOLIO CONSIDERATIONS FOR BIDEN'S TAX PLAN

Since US President Joe Biden unveiled his proposal for a broad tax overhaul, investors have been asking whether it makes sense to recognize investment gains before a potential rise in the capital gains tax. The answer? We think it depends on three key variables: expected future tax rate, expected returns, and investment horizon

Let's start with a look at the current tax policy and what might change. Investment gains on equity positions owned for more than one year are known as long-term capital gains (LTCG), and these are currently taxed at a rate that's significantly lower than the rate applied to positions held less than one year, which are known as short-term capital gains (STCG). Under the proposed tax policy changes, tax rates on LTCG and Qualified Dividend Income (QDI), which also receives preferential tax treatment, would nearly double for investors in the highest income bracket, bringing them in line with the current STCG rate (Exhibit 1).

Exhibit 1: Proposed Changes in Biden Plan

	Current Tax Policy	Potential Tax Policy	
Federal Tax Rates: Highest Bracket, > $1Mn Income			
Long Term Capital Gains	23.8%	**43.4%[1]**	Tax rates may nearly double for long-term capital gains and qualified dividends.
Short Term Capital Gains	40.8%	**43.4%[1]**	
Qualified Dividend Income	23.8%	**43.4%[1]**	
Inside Estate: Federal Tax Treatment Upon Death			
Taxes Paid on Unrealized Gains	No	**Yes**	Taxes are paid on unrealized gains upon death.
Estate Tax Rate	40.0%	40.0%	
Estate Tax Exemption	$11.6 mn	**$3.5 mn**	Taxes are paid on your estate value above the lowered exemption.

Potential Change in Policy

Source: Goldman Sachs Asset Management.

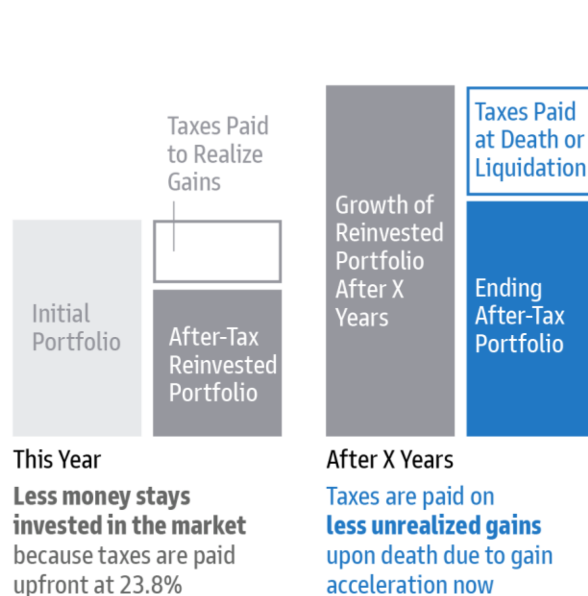
In addition to changes in the LTCG and QDI tax rates, the president's plan includes changes to the tax treatment of assets transferred at death. As it stands now, the tax code "steps up" a portfolio's cost basis to current market value when assets are transferred upon death and does not tax the unrealized gains. In the Biden plan, taxes on unrealized gains in a portfolio would be owed when the owner dies.

The combination of a higher LTCG tax rate and the removal of the "step up in basis" provision suggests it may potentially benefit investors to take action now to reduce the tax impact of portfolio liquidation or death. Still, it's important to remember that tax rates are variable and can change when presidential administrations change. That's

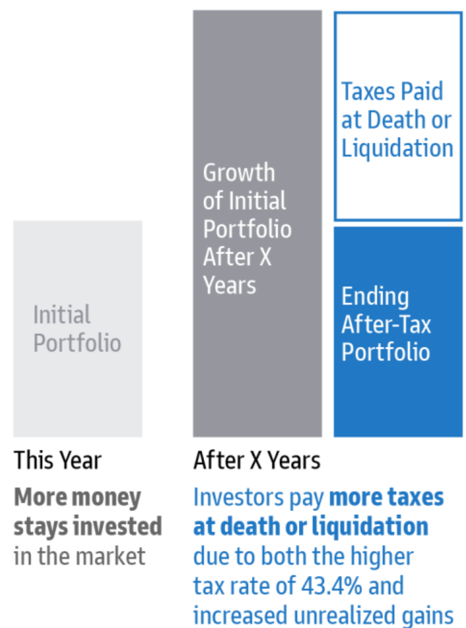
why the primary consideration for this gain recognition exercise is to determine in which scenarios it is most beneficial to realize gains and pay taxes now instead of deferring until later. If these proposed changes were to come into effect, an investor who realizes gains now would pay taxes at current rates, while one who waits would pay a higher tax rates later (Exhibit 2).

Exhibit 2: Realizing Gains vs Taking No Action

Option 1: Realize Gains at Current Tax Rates



Option 2: Take No Action



The breakeven year is when the ending after-tax portfolio value is the same for both options

Source: Goldman Sachs Asset Management.

In Option 1, realizing gains now would reset the cost basis in the portfolio, resulting in fewer unrealized gains in the future. Put another way: taxes would be paid now at a lower rate to reduce the amount of capital gains on which the higher rate would be applied. But realizing gains now also means paying taxes now, so the reinvested portfolio would be smaller than it would have been if the investor had opted to stay invested.

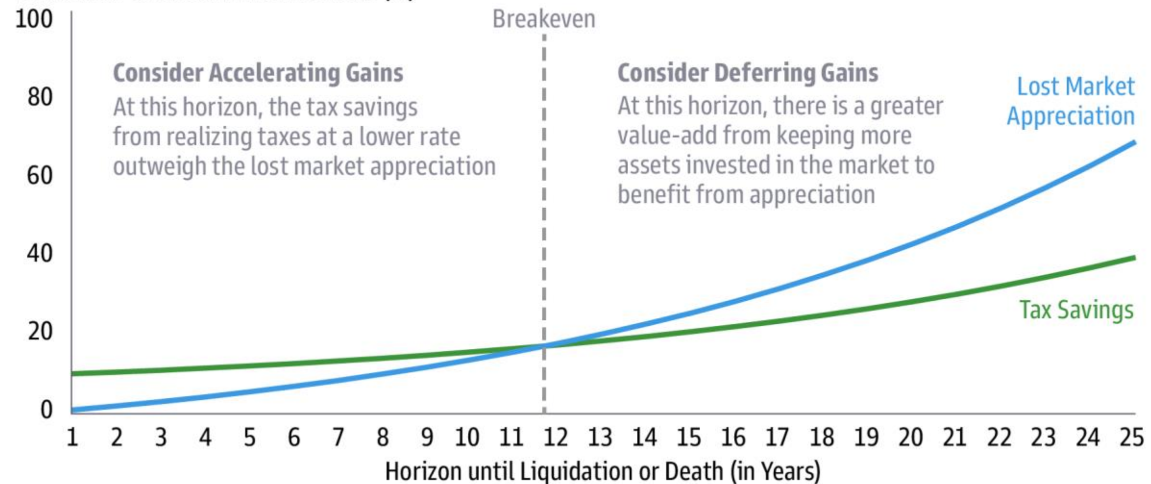
Compare that to the scenario highlighted in Option 2. By deciding not to realize gains now and defer paying the taxes until later, the portfolio stays invested and experiences more growth. But that means more unrealized gains that would eventually be taxed at a higher rate, leaving the investor with a larger tax bill.

Finding the Breakeven Point

The trade-off between these two options depends on expected market returns, future tax rates, and time until liquidation. We think determining one's breakeven year—the year in which the portfolio's ending after-tax value is the same for both option 1 and option 2—may help investors decide on the best course of action.

Exhibit 3: The Trade-Off, Recognize Gains Now or Later?

Breakeven for Accelerating Realized Gains

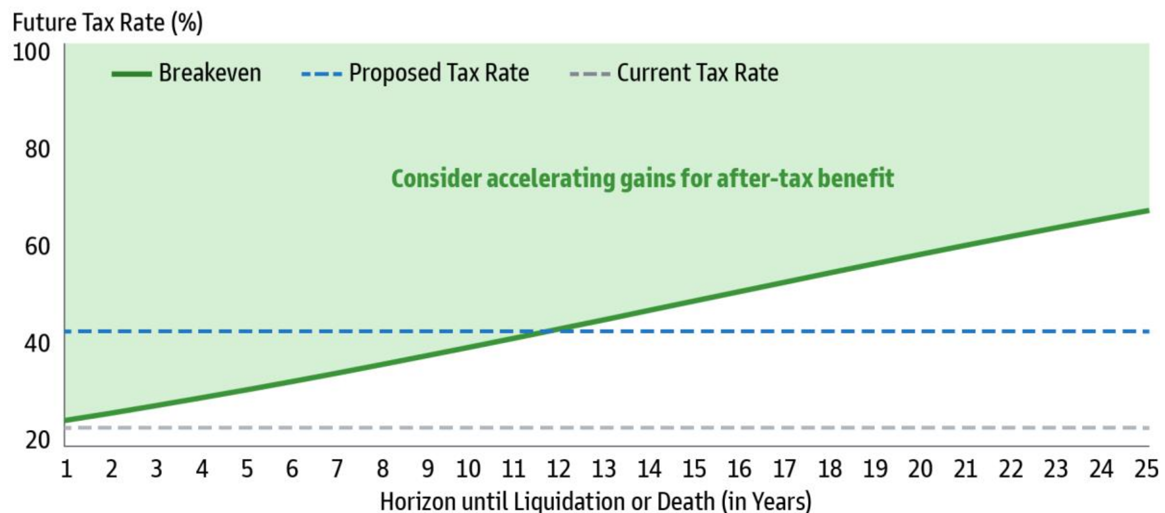


Source: Goldman Sachs Asset Manatement.

The breakeven point is the number of years until liquidation or death at which the value of accelerating gains (paying taxes now at the lower rate) is equal to the value of deferring gains (allowing more capital to stay invested and grow and compound with the market). In Exhibit 3, we reach this point around year 12. For the purposes of our analysis we are assuming[1] maximum federal tax rates, no additional state or local taxes and an 8% annual market return. Future tax rate is assumed to be the proposed tax rate in the year of death or liquidation as discussed above.

Exhibit 4: Time Horizon Matters

Breakeven for Accelerating Realized Gains



Source: Goldman Sachs Asset Manatement.

[1] These examples are for illustrative purposes only and are not actual results. If any assumptions used do not prove to be true, results may vary substantially.

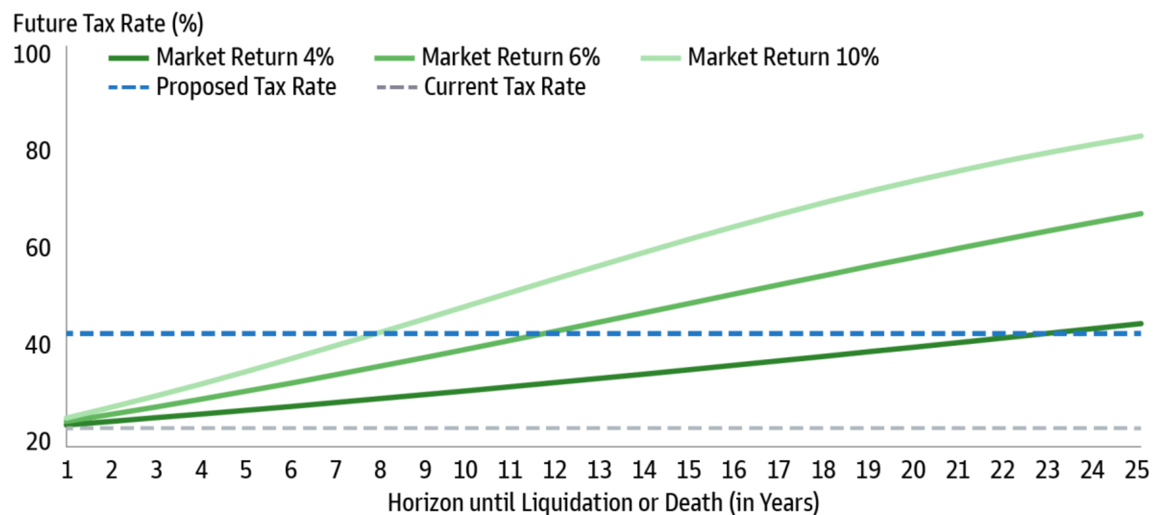
Holding all else equal, a higher tax rate would require a longer investment horizon to reach the breakeven year. This would suggest it may benefit investors to accelerate gain realization and pay taxes now at the lower rate. See exhibit 4.

From interpreting the graph, we can see that because the current tax rate (dotted gray line) is below the green line, it is not attractive to accelerate gains. At the proposed tax rate (dotted blue line), the intersection with the green line is the same breakeven (year 12) from the prior graph.

However, a higher expected market return would make it more valuable to keep more of a portfolio invested to give assets the chance to grow from a higher starting point. If the expected market return is high enough, it may be more valuable to defer realizing gains, provided portfolio liquidation or death is not expected to occur soon. For example, in exhibit 5 we show that under a 10% annual market return scenario the breakeven year is pulled forward to year 8, after which point the investor is better off not having recognized any gains before liquidation. Under a 4% annual market return scenario, the breakeven point is extended to year 23.

Exhibit 5: Market Returns Effect Timing

Breakeven for Accelerating Realized Gains



Source: Goldman Sachs Asset Management.

The Power of Compounding Returns

Lastly, we think an investor's time horizon is a crucial variable to be considered before deciding between gain acceleration and deferral. In general, a longer time horizon requires a higher expected tax rate to justify accelerated gain realization. For example, if an investor does not expect to liquidate until year 25, the expected future tax rate would need to be nearly 70% before accelerating gains makes sense (Exhibit 4 – 8% market return scenario). We can chalk this up to the potential benefit of compounding returns on a larger capital base. The longer a portfolio stays invested, the more time it has for growth to compound.

None of us has a crystal ball. Fortunately, we don't believe that determining a suitable tax management strategy requires one. In our view, investors who take into account their expectations for tax rates, market returns and investment horizon can identify the approach that best suits their portfolio.

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