Investment Taxes: Defer or Not?

Deferral time frames, changes in tax rates and other factors to consider.

BY ROBERT GORDON

The presidential election has seen a variety of tax proposals floated by the candidates. One of the most aggressive, proposed by Bernie Sanders, would take away the tax advantage given to investments. Specifically, he proposed that dividends and long-term gains be taxed the same as ordinary income.

If such a proposal ultimately passed, it wouldn't be the first time there was no differential in tax rates between ordinary and investment income. As a matter of fact, up until the 1970s, investment income was taxed at a higher rate than ordinary income, the opposite of more recent times.

With more tax changes possible, as history shows, it's important that advisors point out for their clients the factors to mull when deciding to defer taxes on investments — or not.

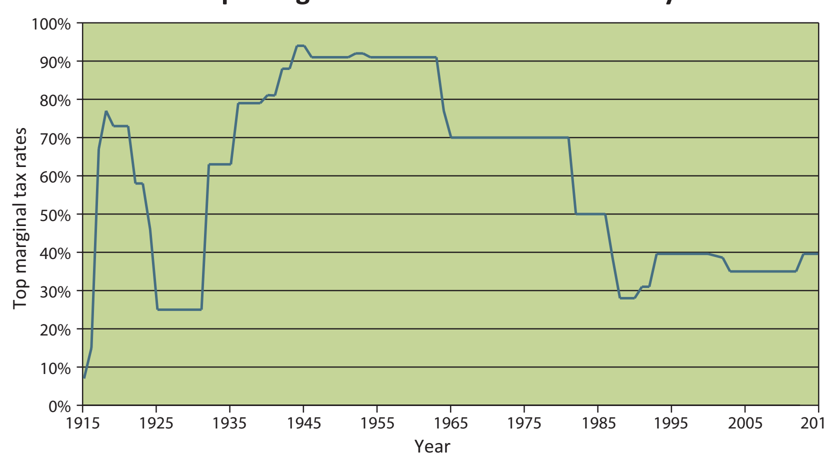
Clients may believe it's always better to defer. The theory behind this tenet is that money should be allowed to grow before any tax bite is inflicted. But no one knows what the tax rate will be when the time comes to take the money out.

Research suggests that the benefits of tax deferral depend on the interaction of investment returns, deferral time frames and, most important, changes in tax rates. That explains why deferral is sometimes not a very good idea.

Clients who defer generally assume their tax rate will remain the same. But over the past 90 years, rates have actually been quite volatile.

When the income tax was introduced in 1913, the top rate was only 7%. Within a decade, it rose to 77%, then fell to 25%. At the end of World War II, the top marginal rate was 94%. In this context, the current top rate of 39.6% seems relatively low.

Top Marginal Tax Rates Over a Century



Source: Twenty-First Securities

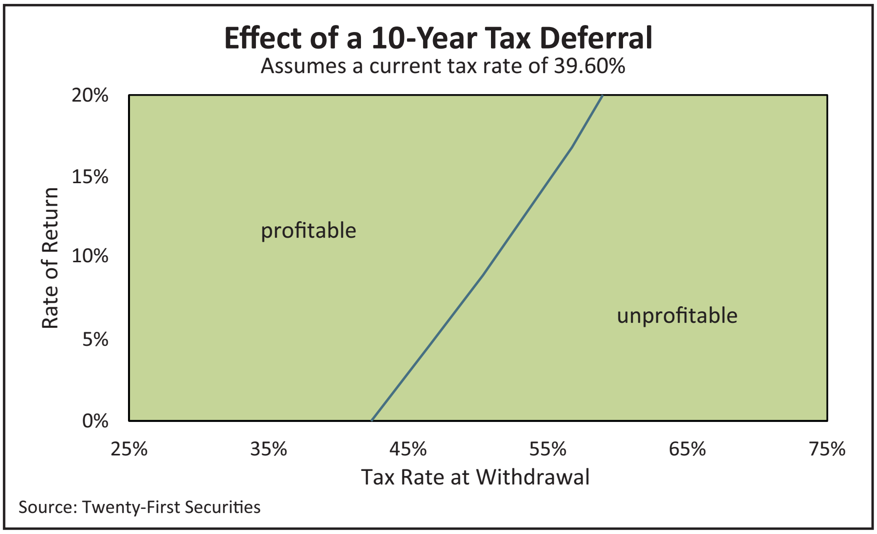
The danger for clients and other investors is clear. If you choose to defer taxes now and rates move to 90%, you've exchanged a tax of 39.6% for one of 90%. Such a drastic rate spike seems highly unlikely in the near future, but any tax increase can shrink or even outweigh the benefit of deferral.

Time Frames and Returns

In this context, two other factors become important: time frames and investment returns. The longer your client's time frame, the greater the value of compounding through deferral. If your client is investing for their grandchild's retirement 65 or 70 years from now, then deferral is almost certainly the best strategy: Even if rates do rise to 90% by then, deferral would be better than paying tax now at 39.6%, as long as annual returns are over 7%.

On the other hand, if your client needs money for his or her own retirement in 20 years and tax rates at that time reach 90%, returns would need to have compounded at 45% a year in order for deferral to have made sense. And these calculations assume no added costs or fees or frictions to create the deferral.

The chart on page 28 shows the tax rates and approximate investment returns required for deferral to be profitable for investments with a 10-year time frame. It assumes tax rates remain at 39.6% until the 10th year. You can see that a 10% return is outstripped if tax rates are above 50%; a 5% return can support a tax rate of only 45% or less at the end of the 10 years.



This research builds on earlier academic studies by James Poterba of MIT. In "Saving For Retirement: Taxes Matter," Poterba found that, if an investor's tax bracket remains the same or falls upon retirement, that investor would largely benefit by having retirement savings in tax-deferred vehicles.

However, if the investor moves to a higher tax bracket upon retirement, then, in some situations, immediate taxation would have been a better choice. **OWS**

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TDF Winning Streak Ends

Losses come after fund managers increased their glidepath allocation to equities.

BY DONALD JAY KORN

Target date funds stumbled in 2015, after posting six years of returns following the financial and economic crisis.

Target date funds had losses of -0.86% for the year — still much better than the "carnage" of 2008, according to Lori Lucas, head of the defined contribution practice at Callan Associates, the San Francisco-based investment consulting.

"In 2008, the median target date fund lost 26.41%," Lucas said. "After that, target date fund managers generally decreased their glidepath allocations to equities and improved their overall diversification."

She noted that the 2015 downturn came as several large target date fund managers have reported increasing their glidepath allocation to equities in recent years.

Equities performed well in the fourth quarter of 2015: the S&P 500 Index gained 7.04%, boosting its Target Date Index by 3.01% in the quarter and narrowing the annual loss to a modest amount, compared with the results from 2008.

Callan Target Date Index Performance*

	2015	2014	2013	2011
10th percentile	-0.07	3.03	8.07	7.53
25th percentile	-0.21	2.73	7.44	6.96
Median	-0.93	2.40	6.57	6.18
75th percentile	-1.27	1.51	5.32	5.30
90th percentile	-1.78	0.75	4.61	4.42
Callan Target Date Index	-0.86	2.43	6.64	6.53

*Average of All Vintages

Source: Callan Associates

The range of target date fund performance also narrowed considerably when compared to 2008. The gap between the best- and worst-performing target date funds (those that were in the 10th percentile versus those in the 90th percentile) was more than 22 percentage points.

In 2015, the performance difference between the funds in the 10th and 90th percentiles was less than two percentage points: -07% to -1.78%. Still, advisors and their clients have benefitted recently by choosing well-performing target date funds. Callan puts the five-year performance of the 10th percentile target date funds at 7.53%, versus 4.42% for the 90th percentile funds, through 2015. **OWS**

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