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Don't be unnerved if taxes rise on dividends, capital gains

TAXING MATTERS
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Higher tax rates are coming.

Unless Congress acts, on New Year's Day the tax rate on dividends will almost triple and the rate on capital gains will increase by 50 percent. There's no telling what Congress will do, but with President Barack Obama's re-election and the looming fiscal cliff, some increase in rates seems likely.

How should mutual fund and other stock market investors respond?

I'm a tax adviser, not an investment professional, so you may find my take on all of this surprising: I think the media are exaggerating the role taxes should play in these decisions.

If the Bush tax cuts end on Jan. 1, there will be two big changes that affect equity investors: For the highest earners, the tax rate on dividends will effectively increase from 15 percent to a whopping 43.4 percent and the capital gains rate will effectively increase from 15 percent to 23.8 percent.

Should you sell stock now to avoid the higher tax rate on capital gains?

If you're investing for the long run, don't let the higher rates scare you. Unless you think higher taxation will permanently depress the economy, by the time you're ready to sell when you retire 20 years down the road, the coming rate increase should be a distant memory.

For short-term investors, the question is more complex. On the one hand, the rate increase can be an important consideration for sales at substantial gain. On the other hand, as we've all learned in the last few years, markets are volatile; dips in the market that exceed the hit you'd take due to the increased tax rate occur all the time.

For example, as of this writing, on Nov. 9, the Standard & Poor's 500-stock index has been off 9.5 percent from its October peak. By the time you read this, it may be back up. Market fluctuation affecting the entire value of your portfolio could well affect after-tax yields to a much greater extent than an increase of 8.8 percentage points in the tax on gain.

Moreover, there's no telling what any tax rate increases will do to values in the short term. You don't want to sell in a temporary dip caused by anticipation of increased tax rates that erases all the savings from selling before rates go up—unless, of course, you believe the dip represents a real change in value that will last over your investment horizon.

Besides selling now, there is one strategy that investors who anticipate cashing out of stocks in the short term may wish to consider: a wash-sale to harvest gain.

The so-called wash sale rules prohibit investors from "harvesting" losses by selling shares at a loss and then buying them again shortly thereafter.

However, there's no wash sale rule for gains. If you were planning, say, to sell $50,000 of stock in 2013 but wanted to remain exposed to market risk until the funds are needed, you could sell in 2012 to pay the tax at the lower rate and then buy the shares again the next day. You'd lock in a 15 percent tax rate on the gains while keeping your exposure to the market, all at the cost of a bit of deferral.

What about dividend-paying stocks? Should an investor scale back on investments in companies that pay dividends, given the looming rate increase?

Certainly, the increase seems large. Rates in 2013 will be nearly three times those in 2012.

However, in today's low-yield environment, the actual tax cost in the short term is small. The yield as defined by the Securities and Exchange Commission for Vanguard's two leading dividend funds is currently only 2.25 percent. On a $1 million investment, the increased tax in 2013 will be well under $10,000. From this perspective, a decision to cash out can wait until dividend yields increase and the costs become material. Of course, however, there's no way to know how the market in general and dividend-paying stocks in particular will perform in the interim, or what capital gains rates will then be.

Additionally, there can be substantial performance differences between dividend-paying and non-dividend-paying stocks in both the long and short term. Many readers probably know more about this than I do, but the research I've seen suggests that over the long haul, dividend-paying stocks historically have delivered higher returns than non-dividend stocks. Your view of whether this analysis is correct and, if so, whether it will continue to hold true in a higher-tax environment is probably more important than the short-term impact of the tax on dividends received each year.

For many reasons, the impact of tax changes on equity performance is complex. Don't let the tail wag the dog.

For all of these reasons, the impact of tax changes on equity performance is quite complex. In the short term, there is sure to be a lot of fear surrounding the potential tax increases, but in the long run, corporate performance, not taxation, has historically had the biggest impact on return. Certainly taxes are one factor among many to consider in investment decisions, but they should rarely be the primary one. In your year-end planning, be sure not to let the tail wag the dog.

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