The Impact on Taxable Investment Programs from a Biden Presidency and Democratic Congress

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Executive Summary

While national polls suggest Joe Biden's lead has narrowed since July, he remains favored to win the White House. The race for control of the Senate is closer but similarly leaning towards Democrats, which would result in their control of both houses of Congress. A Biden presidency and Democrat controlled Congress would pave the way for progressive tax reform that would significantly impact the optimization of after-tax investment returns for US taxpaying individuals.

This white paper summarizes the impact to investment programs for US taxpayers from Biden's announced policy initiatives. We start with an explanation of Biden's tax-related proposals, their impact on forward looking asset class after-tax returns and then we lay out five key action implications for individuals. The actual implementation of the changes to the tax code will depend on both a Biden presidency and Democratic control of Congress. While the many details of Biden's tax plan have not been announced, we aim to provide a view on what we believe are the most important tax strategy actions you may need to take.

[1] Estimated and expected after-tax returns presented throughout this material are hypothetical returns based on forward looking assumptions. Hypothetical returns have certain inherent limitations and are calculated with the benefit of hindsight. Unlike actual returns, hypothetical returns do not represent actual trading. There is no guarantee that the assumptions presented will be realized. Please see important disclaimers at the back of this material for further detail.

Summary of Biden's Proposed Changes to the Individual Tax Code and Impact on After-Tax Returns

Biden's proposed changes to the tax code for individuals result in increased taxes for top income earners. The most relevant proposals are:

1. increasing the top federal tax-rate from 37% to 39.6% (43.4% including the net investment income tax),
2. raising the maximum capital gains tax rates for those with over $1M in income from 20% to the level of ordinary income rates above,
3. decrease in estate tax exemption and elimination of the step-up in basis relating to wealth transfer and
4. the elimination of many tax-related benefits for real estate investing.

Using our US taxable client model portfolio (2019 US Taxable Strategic Asset Allocation), we estimate the highlighted proposals will increase the effective federal tax-rate of our average US tax-paying client from 26% to 42%, which lowers the estimated forward-looking after-tax return[1] by -1.4%. Overall, we estimate that forward-looking after-tax returns decrease to 4.9% annually from 6.3% under the current tax regime. They have a similar effect on the tax rate of traditional 60% equity and 40% bond portfolios, which we expect will rise from 23% to 39%, lowering estimated forward-looking after-tax returns to 2.6% from 3.3%. As seen in Exhibit 1, taxing long-term capital gains at the same rate as ordinary income drives the bulk of the tax increase, lowering estimated after-tax returns by -1.3%. The remaining proposed changes reduce the estimated after-tax return by only -0.1%. This is due to the increase in ordinary income rates being modest and the limited impact of extending the residential real estate depreciation schedule.

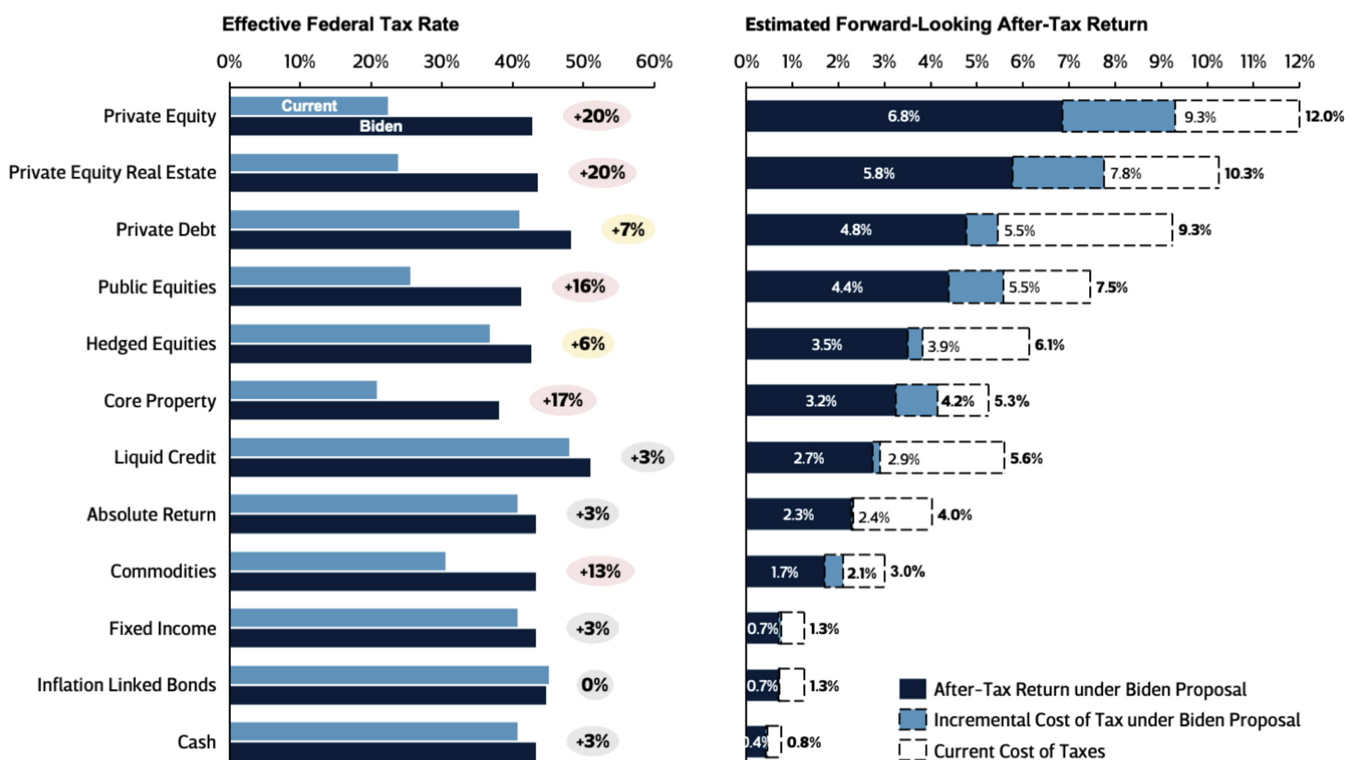
Exhibit 1: The After-Tax Return Impact on Investment Portfolios from Biden's Proposed Tax Changes

Select Anticipated Tax Changes Addressed in This Paper	Estimated Annual After-Tax Return Impact
2019 US Taxable Strategic Asset Allocation – Estimated After-Tax Return (Current Rates)	**6.3%**
1. Increase the top individual income tax rate to 39.6% (43.4% with NII tax)	-0.1%
2. Tax long-term capital gains and qualified dividends at the ordinary income tax rates	-1.3%
3. Decrease the estate tax exemption and eliminate the step-up in basis	No annual income tax effect
4. Eliminate tax preferences for real estate (e.g., accelerated depreciation, 1031 exchanges)	-0.0%
2019 US Taxable Strategic Asset Allocation – Estimated After-Tax Return (Biden Proposal)	**4.9%**

Biden's proposal to make all capital gains tax-rates equal to ordinary income rates significantly increases the level, and tightens the spread, of effective tax-rates across asset classes as seen in Exhibit 2.

The most dramatic changes in forward-looking estimated tax-rates are within traditionally tax-efficient asset classes such as Private Equity, Private Equity Real Estate and Public Equities. These asset classes generally have a significant portion of their return characterized as long-term capital gains or unrealized gains. The tax-rates of traditional tax-inefficient asset classes, such as Credit, Absolute Return and Hedged Equities, largely remain the same given that their return was already characterized as ordinary income or short-term capital gains. The rank-ordering

Exhibit 2: Forward-Looking Estimated Federal Tax Rates and After-Tax Returns by Asset Class



of expected asset class after-tax returns under Biden's proposal remains largely the same as today, but the differential after tax returns are significantly reduced. For example, Private Equity's expected after tax return drops from 9.3% to 6.8% while there is no change in the 2.3% after tax return expected from Absolute Return hedge funds. Private Equity, Private Equity Real Estate, Private Debt and Public Equities continue to have the highest expected after-tax returns at the asset class level, while Commodities, Fixed Income and Cash are expected to return the least after-tax.

There are several key implications for US taxpayers that arise from the anticipated changes to the US tax code under Biden.

Implications for US Taxable Investment Programs

1. Prioritize investments with long-holding periods, where gains compound tax-free until realization

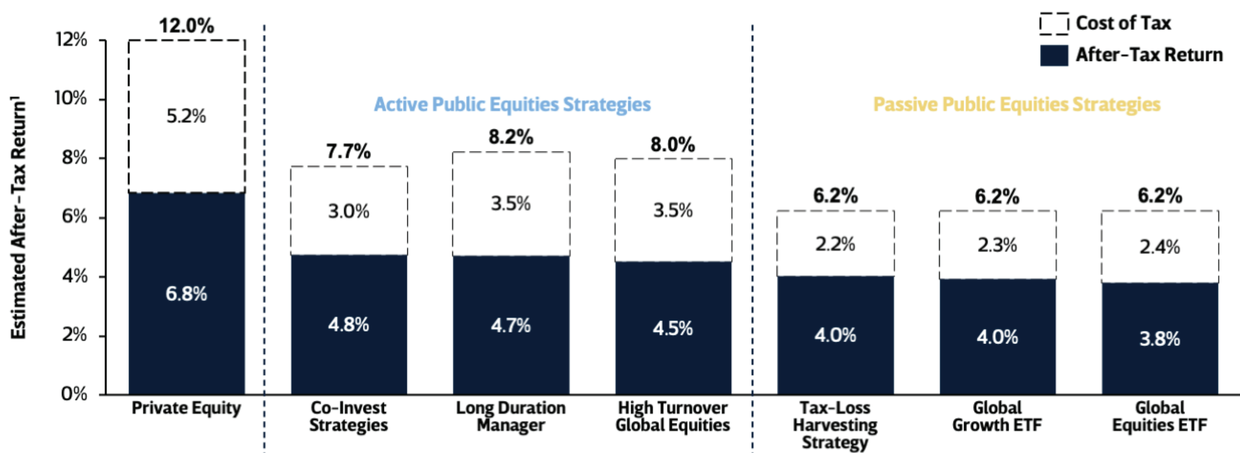
As the difference in effective tax-rate between long-term and short-term capital gains goes to zero under Biden's proposals, deferral of gains becomes the main avenue for lowering effective tax-rates. Increasing holding period length and the benefit of depreciation are concepts that help increase deferral of realized gains. Quite simply, lower portfolio turnover diminishes realized gains that would be taxable. Depreciation, to the extent that existing rules remain intact under Biden, provides taxable losses that can offset income or other realizations of capital gains.

Currently, we estimate that there is a ~5% reduction in the effective tax-rate by deferring capital gains over a 10-year period compared to realizing all gains as long-term capital gains at the end of each year[2]. That benefit increases to ~7% under Biden's proposal to tax long-term capital gains as ordinary income. As a result, US tax paying portfolios should continue to emphasize exposure to Private Equity and Public Equities, which often have a large portion of their gains unrealized in any given year.

Within Public Equities, multi-year buy-and-hold approaches, such as concentrated long-duration managers and co-investment strategies, will be preferred given their high expected after-tax return driven by our expectations of significant pre-tax alpha and the benefit of deferred gains, as seen in Exhibit 3. Additionally, growth-oriented investments may become more attractive. Growth-stage companies typically do not pay dividends that would be subject to ordinary income rates under Biden's policy and defer capital gains. For liquidity and portfolio rebalancing, taxable investors should prioritize tax-loss harvesting strategies even more over traditional exchange traded funds or mutual funds. Tax-loss harvesting classically sells stocks in loss positions over stocks with embedded gains when rebalancing, and the Biden tax plan would see all gains subject to full ordinary income tax rates.

[2] Assumed 8% pre-tax rate of return per annum.

Exhibit 3: Expected After-Tax Returns on Different Public Equity Strategies under Biden Proposals



Estimated Tax-Rate	42.9%	38.5%	42.4%	43.4%	35.0%	36.4%	38.5%

Outside of Public Equities, depreciation generating assets include investments such as real estate and less correlated assets, such as rail car leasing. We highlight rail car leasing as a strategy that benefits from deprecation given Biden's focus on real estate tax-treatment. While Biden has commented that he would prefer to eliminate certain preferential tax rules for real estate investments, he called for the elimination of only a few provisions by name including accelerated depreciation for residential real estate and 1031 like-kind transfers. For residential real estate the current depreciation schedule is 27.5 years; Biden proposes moving this to 39 years to match commercial real estate. Like-kind transfers will mostly impact individual real estate owners and investors compared to institutional real estate asset managers. While both increase real estate's effective tax-rate, we do not believe that the impact will be dramatic compared to losing long-term capital gain tax benefits.

2. Previously tax-inefficient strategies increase in relative attractiveness

With long-term capital gains taxed as ordinary income, the relative attractiveness of Hedged Equities, Credit and Absolute Return hedge funds is increased. When compared to their respective beta-adjusted passive public equity exposure, all three asset classes are estimated to generate more after-tax outperformance (alpha) under Biden's plan than under the current tax regime as seen in Exhibit 4. Importantly, this is not driven by increasing our expected level of alpha within the asset classes but rather this is simply a mathematical outcome of the decrease in expected after-tax public equity returns which forms part of the benchmark against which alpha is measured for these asset classes. As the expected after-tax returns from equity market beta decrease under the proposed changes by Biden, the return from after tax alpha becomes a more material and important part of an investor's return.

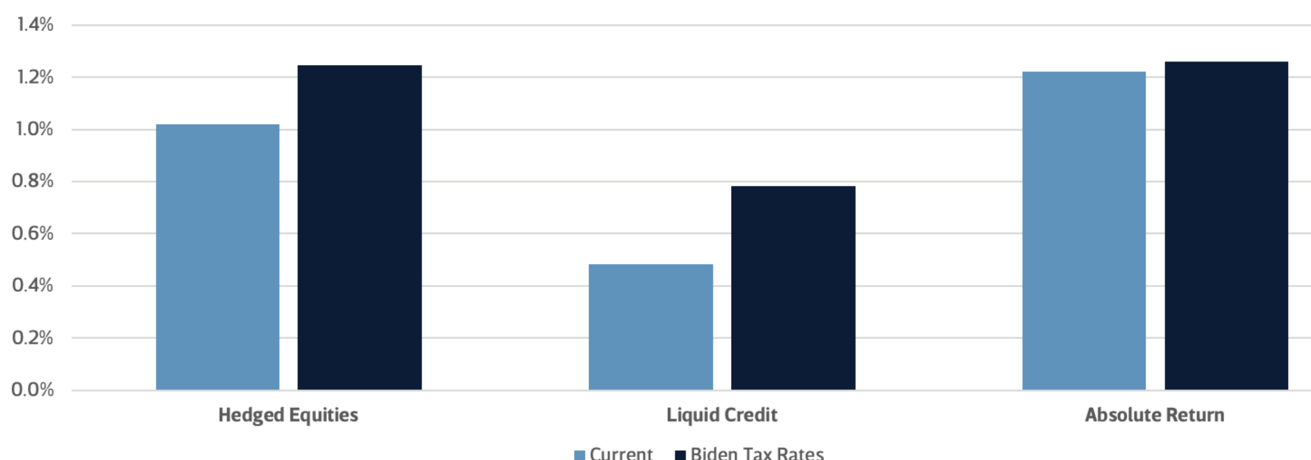
3. Continue to set high overall portfolio risk budgets, as after-tax volatility decreases with higher taxes

A core tenet of our approach to portfolio construction for US taxpayers is increasing the overall risk level of portfolios, as taxpayers should budget their risk level based on after-tax volatility. As effective tax-rates increase from the anticipated changes under Biden, US taxpayers should theoretically increase the targeted level of risk in their portfolios beyond the previously recommended level. As a reminder, in our tax-optimized asset allocation for US taxpayers, we recommend a portfolio that targets 12% annualized pre-tax volatility, or 80% equity-like risk, which is ~20% higher than the typical tax-exempt endowment-style asset allocation which has 10% annualized pre-tax volatility, or 60% equity-like risk.

4. Embrace estate tax planning legal structures

As a result of the reduction in estate tax exemption and elimination of the step-up in basis, individuals should look to reduce unrealized gains within an individual's estate that will be passed down to the next generation. Individuals should consider using their full lifetime gift exemption, $11.4M for individuals and $22.8M for joint filers, before yearend to ensure that the maximum amount can be moved to the next generation before there are any changes to the exemption. A compelling

Exhibit 4: Estimated Forward-Looking After-Tax Alpha Returns over Beta-Adjusted Equity Exposure



avenue arising from the elimination of the step-up in basis is the increased use of private life insurance products for estate planning. In general, as life insurance payments upon the death of the insured are not considered part of an estate and are not subject to income tax, private placement life insurance ("PPLI") should continue to grow in attractiveness to taxpaying investors. Additionally, high net worth individuals may look to increase philanthropic activity and trust creation to reduce unrealized gains. This includes gifting securities with high unrealized gains in lieu of securities with lower imbedded gains or cash. Further examples of tax-planning legal structures include charitable lead annuity trusts ("CLATs"), grantor retained annuity trusts ("GRATs") and donor advised funds ("DAFs") which are detailed in Exhibit 5.

Exhibit 5: Tax Efficient Legal Structures

Structure	Description	Benefits
Private Placement Life Insurance ("PPLI")	• Enables investors to construct an investment portfolio within a life insurance policy, allowing for tax-free compounding of returns. • Upon the insured's death, the cash value of the policy passes to beneficiaries free of income tax. If structured properly in a trust, estate tax can also be avoided.	• Life insurance provision • Transferring wealth to children with little or no gift or estate tax
Charitable Lead Annuity Trust ("CLAT")	• Trust that requires annual distributions to be made to a charity for a defined period (e.g., 15 years). The level of required distribution from the trust is based on the initial value of assets transferred into the trust and applicable interest rates determined by the IRS. • After the defined term ends, any remaining assets may generally be transferred with little/no gift tax to related beneficiaries (e.g., children). Types: – Grantor CLAT: Allows donor to take a tax deduction on the present value of annuity payments up front, and the donor pays taxes on annual income/gains in the CLAT enlarging what is passed on to beneficiaries. – Non-Grantor CLAT: All taxes on gains are paid by the CLAT.	• Donating money to charity • Creating a tax deduction for the donor • Transferring wealth to children with little or no gift or estate tax
Grantor Retained Annuity Trust ("GRAT")	• Trust that requires annual distributions (loan repayments) to be made to the grantor for a period (e.g., 2 years), based on the initial value of assets transferred into the trust, charging interest rates determined by the IRS. Growth in value of assets is passed on to beneficiaries without using lifetime exemption. • The grantor pays taxes on any gains realized within the GRAT preserving asset values passed on to beneficiaries.	• Transferring wealth to children with little/no gift or estate tax
Donor Advised Fund ("DAF")	• Vehicle into which donors make contributions of cash and/or assets to eventually donate to charity. The donor receives a tax deduction at the time they move assets into the trust (DAF). • Assets grow tax-free and can be distributed to charities in the future.	• Donating money to charity • Creating a tax deduction for the donor

5. Consider realizing large unrealized gains before yearend

Taxpayers with a significant amount of unrealized gains within their taxable portfolios should consult with their tax advisor on whether to crystalize unrealized long-term capital gains in 2020. Realizing long-term capital gains this year and paying the lower 23.8% tax rate will be the economically optimal action where there are no tax structures to eliminate the realization of gains in the future and you are expecting to need to sell the assets within a certain number of years from today. That number of years can be estimated, depending on the annual rate of gain expected, using the model illustrated in Exhibit 6. This shows that an individual would need to hold an equity portfolio for 16 years to allow the tax-free compounding to make up the difference in portfolio value from the proposed changes in tax-rates under Biden[3] assuming normal annual equity market returns of 6.2%. Under this assumption, those that realize their currently unrealized gains after the change in proposed long-term tax rates but before year 16 always have a lower after-tax portfolio value compared to a portfolio that fully realized its unrealized gains under the current rates, before the change. Assets with higher expected returns (e.g., early stage biotech stocks) will compensate for the tax differential in fewer years of course.

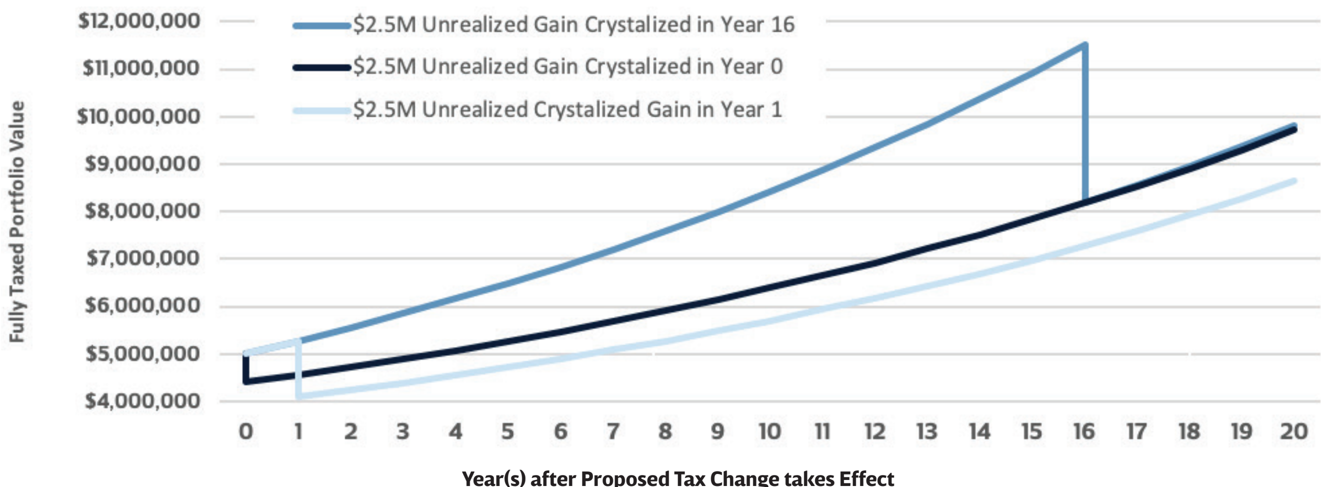
[3] The example above assumes a $5M global equities portfolio with $2.5M of unrealized long-term capital gains. Additional assumptions are that the 43.4% effective tax rate remains in place from year 1 to year 20, that the portfolio returns +6.2% per annum with 2% from dividend income that is taxed on an annual basis and that any unrealized return is fully taxed at the end of any year.

Conclusion

With this note, Partners Capital are not expressing any political leaning and we are not making a prediction about the election outcome or changes to the tax code, but rather we are focusing on what changes in investment strategy you should be thinking about should the proposed tax changes be put into force in 2021. There are many possible outcomes other than this one.

The immediate action implication is to examine the attractiveness of long-term capital gain realizations prior to year-end based on your own assessment of the likelihood of the proposed Biden tax changes being implemented in 2021. The other actions will only be relevant if the tax code changes go through. The implications there are that compounding untaxed unrealized gains should be the hallmark of the most tax efficient strategy, combined with the establishment of estate planning legal structures such as PPLI. In addition, the relative attraction of high alpha asset classes such as hedged equities and absolute return hedge funds increases and may warrant higher allocations, especially in light of the unattractiveness of traditional safety net asset classes in the form of government bonds. Finally, at the right moment in time, you may consider a gradual increase in overall portfolio risk level given the after-tax volatility of returns decreases with higher tax rates. If these tax changes do come to pass, this will call for a re-evaluation of your overall asset allocation to reflect any change in overall portfolio risk budget and in light of the change in after tax expected returns for each asset class as shown in Exhibit 2.

Exhibit 6: The Impact of Not Crystalizing Long-Term Unrealized Gains Before Biden Proposals Enacted



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