MERRILL
A BANK OF AMERICA COMPANY

CHIEF INVESTMENT OFFICE

Investment Insights

The Potential Investment Impacts of Rising Individual Taxes

April 2021

The opinions are those of the author(s) and subject to change.

AUTHORED BY:

Chief Investment Office

It has long been stated that, over time, capital flows to the greatest risk-adjusted return. In our view, this is especially the case during periods in which capital is readily available, cheap and supported by above-trend growth in the economy. Sound familiar?

In 2021, the collective amount in absolute dollar terms of the government's fiscal stimulus plans and the central bank's liquidity programs could approach 50% of U.S. gross domestic product this year. This does not include the much-discussed infrastructure bill proposal (American Jobs Plan). Needless to say, the world looks to be awash in liquidity, and many assets have been rising in value since the lows in March of 2020.

As the sharp V-shaped rebound took hold in both the economy and the equity capital markets over the past year, bond yields have, and those who managed assets have been adjusting their exposure higher to risk assets in general and to more cyclical or economically sensitive areas. We expect this to continue throughout this year and into 2022. This portfolio rebalancing wave has supported the broad equity markets, which are now at or close to record-high levels in the U.S. as of mid-to-late April 2021, in our view.

As equity markets have rebounded, there have been various concerns or small roadblocks that have pressured prices from time to time but that have not been large enough to halt the broader uptrend. Our view still remains that there are two positive surprises developing in 2021 that should support equities further: sharply positive U.S. economic growth and much-higher-than-consensus S&P 500 earnings. We believe this trend could also filter into 2022, which supports our overweight to Equities overall and relative to Fixed Income and our preference for U.S. Equities relative to non-U.S. markets in general.

However, we should begin to consider the potential portfolio and overall capital markets effect from the proposed higher tax environment, notably capital gains taxes. We examine both history and current developments as a guide in assessing the potential effect on asset prices in the foreseeable future. The bottom line: We do expect the proposed capital gains tax to be raised near term but not to the proposed headline figure of 43.4%. As in previous episodes, the hike in the tax rate may precipitate some profit-taking among investors but the overall effect on the equity markets would be minimal. Indeed, history shows that tax-related market declines are short-lived and followed by reversals and significant market gains.

We outline below our overall view and address the top questions on investors' minds as more details begin to emerge from President Biden's proposed various tax hikes and adjustments.

Merrill Lynch, Pierce, Fenner & Smith Incorporated (also referred to as "MLPF&S" or "Merrill") makes available certain investment products sponsored, managed, distributed or provided by companies that are affiliates of Bank of America Corporation ("BofA Corp."). MLPF&S is a registered broker-dealer, registered investment adviser, Member SIPC and a wholly owned subsidiary of BofA Corp.

Investment products:

Are Not FDIC Insured	Are Not Bank Guaranteed	May Lose Value

Please see back page for important disclosure information.

Capital gains tax: What's expected to be proposed?

Based on a White House summary of the American Families Plan and Biden's campaign promises, the administration will propose raising the federal long-term capital gains tax from 20% to 39.6%; this, along with the Obamacare 3.8% surcharge on net investment income, will increase the total tax rate from 23.8% to 43.4%.[1] The proposed changes will also apply to qualified dividends, which are currently taxed as the same preferential rate as long-term capital gains.

Which investors would be targeted?

Households (which means both couples and individuals) earning over $1 million a year in gross income—or a relatively small segment of the domestic investor base considering that roughly 80% of the U.S. equity markets are owned by institutions (U.S. and foreign) not subject to capital-gains taxes.

What are some other individual income tax changes being targeted by the Biden administration?

Also proposed: 1), eliminating the step-up in cost basis on inherited assets, which would result in a deemed gain triggered on death on appreciation exceeding $2 million for couples ($1 million for individuals); 2), cutting the estate-tax exemption from $11.7 million to $3.5 million; 3) raising the top marginal income tax rate to 39.6% from its current 37% along with curtailing the benefit of itemized deductions for taxpayers making more than $400,000; and 4) imposing Social Security taxes on wage income over $400,000 at current rates (6.2% for employee and employer).

What does history suggest—what happened prior to and after previous tax hikes?

We believe a capital gains tax hike will provide a tailwind for selling appreciated assets in 2021. Some sales will be brought forward, creating a potential drag on equities, although the downside effects are expected to be minimal and limited. Per history, the Tax Reform Act of 1986, signed October 22, 1986, raised the tax rate from 20% to 28%, triggering a surge in the collection of capital gains taxes ahead of the tax increase that went into effect in 1987. A similar result occurred in 2012 prior to the jump in capital gains rates from 15% to 23.8%. Momentum stocks—because they had the highest gains to be generated—suffered the most.

That said, the relationship between changes in capital gains tax rates and the performance of the U.S. stock market are tenuous, at best. Over the long run, market returns beat to the tune of earnings growth/momentum, the cost of capital, and real economic growth, etc. Yes, equities do tend to consolidate and decline in the run-up to a tax hike. But not only are these declines short-lived but also have been followed by reversals and significant market gains. Case in point: In 2013, following a near-nine-percentage-point increase in the capital gains tax that year, the S&P 500 returned 29.6%.

As Goldman Sachs notes, "*In 2013, although the wealthiest households sold 1% of their assets prior to the rate hike, they bought 4% of starting equity assets in the quarter after the change and therefore only temporarily reduced their equity exposures in order to realize gains at the lower rate. Total household equity allocations demonstrated a similar pattern around the two preceding capital gains tax hikes.*"[2]

What are the odds of Congress passing the president's proposed tax changes in their entirety?

We believe the odds are slim. The proposed tax changes will be part of Biden's "American Families Plan", and the proposed corporate tax changes will be part of his "Made in

[1] whitehouse.com, Fact Sheet: The American Families Plan, as of April 28, 2021; The Biden-Sanders Unity Task Force made several tax recommendations in a report issued July 8, 2020. The task force represents the campaigns of President-elect Joe Biden and Senator Bernie Sanders and generally calls for higher taxes on the wealthy but stops short of more radical tax reforms such as a wealth tax.

[2] Goldman Sachs Research, US Weekly Kickstart: "Capital gains tax rate hike represents only a minor speed bump for the upward trajectory of stock prices", October 23, 2020.

America Tax Plan." The consensus is that, in the end, Congress will pass a scaled-back version of his plan, with 28% to 30% the expected range for the capital gains rate (exclusive of the 3.8% surcharge). That is roughly halfway between the current rate and Biden's opening bid. Democrats can enact such a change without any Republican support via the budget reconciliation process; however, the challenge for Democrats will be getting sufficient votes since without any Republican support, they will need all 50 Senate Democrats (with Vice President Kamala Harris casting the tie-breaking vote) and about 98% of House Democrats, a fair number of whom are from affluent suburban districts that lean Republican.

Regardless of the ultimate capital gains rate, what are the possible effective dates?

There has been a history of not imposing capital gains tax rate increases on a retroactive basis. Past changes were generally effective at the beginning of a subsequent tax year or on the date of introduction or enactment of the tax bill. Sentiments shared by Treasury Secretary Janet Yellen and other senior appointees of President.

Biden indicated a preference to refrain from a retroactive change. This could mean such a change could take effect January 1, 2022. However, forecasting a tax rate change over an extended period may give taxpayers an opportunity to decide whether accelerating sales is a prudent option. It also may give business owners and businesses an opportunity to close their deals and recognize a gain in a lower capital gains tax environment. Both could pull revenue into the more favorable tax period and dramatically decrease revenue within Congress' budget window. For this reason, it is conceivable that an effective date could be upon "date of enactment" or "date of introduction" of the tax bill.

What are the potential broad portfolio implications if capital gains taxes are raised to the proposed levels?

The need for ongoing tax-efficient investment management across taxable accounts may be more important than ever. Where possible, tax-efficient strategies with low taxable turnover and municipal bond strategies can help to reduce recognition of taxable capital gains and investment income. Further, strategies that deliver index-like performance while harvesting capital losses have the potential to become attractive in a higher capital gains tax environment than in most recent history. Income-oriented solutions, high turnover tax-inefficient strategies and taxable bond strategies may be attractive in tax advantaged accounts such as individual retirement accounts (IRAs), 401(K)s, 403(b)s and nonqualified tax-deferred accounts. Rebalancing portfolios by changing the mix in tax-advantaged accounts may help to be more tax efficient than rebalancing in a taxable account.

Year-end tax planning strategies will also be important. In years where income is unusually higher, deferring capital gains to years where income is lower, accelerating charitable deductions, and gifting appreciated securities to charities may help offset higher taxes rather than selling the appreciated securities in your own name and gifting cash.

Maximizing contributions to tax-advantaged accounts and nonqualified tax-deferred accounts could help investments grow tax-deferred and in some cases tax free until distributions are taken in retirement. At retirement, if income is lower, one's income tax rate would accordingly be lower. A change in tax domicile in retirement may also help to reduce state and local tax burdens.

What could a near-doubling of the capital gains tax mean for Fixed Income?

In general, the net effect on Fixed Income assets is expected to be limited; however, to the extent that common and preferred stocks are marginally less attractive due to the higher capital gains tax rate, some investors may look to increase their allocation to debt instruments, depending on a variety of factors, including current yields and duration. Trading Fixed Income securities could also potentially incur the new capital gains rate, but would be far less of a consideration when compared to Equities. Changes in individual ordinary income tax rates could be considered far more meaningful to the Fixed Income market, particularly the relationship between taxable bonds and munis.

What effect could higher capital gains taxes have on mutual funds overall and relative to exchange-traded or index funds?

Since a mutual fund establishes its own cost basis, capital gains are distributed to owners each year, while losses are accumulated in the mutual fund and not distributed. Thus, a newer participant in a mutual fund may take on a tax burden for which they may not have received the investment benefit. When, and if, the tax rate on the capital gains rate is increased, it may be productive for investors in mutual funds to review portfolio holdings and consult with their tax and investment advisors on the best approach for dealing with built-up capital gains in held mutual funds within their taxable accounts. Note that, in a tax-advantaged account like a 401(k), 403(b), IRA and/or nonqualified retirement account, any distributions from a mutual fund are generally not subject to tax, only distributions from the tax-advantaged account may be subject to tax.

In taxable accounts, higher tax rates may make owning an exchange-traded fund (ETF) or a separately managed account (SMA) more attractive than owning a mutual fund. In an ETF or SMA, a taxpayer establishes his/her own cost basis and can recognize losses at any time. Tax-advantaged index strategies held in SMA form may be considered valuable for taxpayers in higher tax brackets because of the potential ability to harvest capital losses that can be used to offset capital gains from other investments.

A potential effect on mutual funds could be that more investors look to passive management[3] vehicles to gain exposure to broad market and thematic investing participation in order to limit the possibility of capital gains distributions in the future.

In addition, the use of tax-aware solutions, those which can potentially provide index like returns with constant harvesting of capital losses, is also likely to rise.

Should I consider selling now or later?

It depends. Like everything in life, there are tradeoffs. In this case, the tradeoff is between 1) locking in a lower rate now for the existing gain and losing the growth on the funds used to pay the tax, and 2) continuing to defer taxes but then paying the capital gains tax at a much higher rate later. When analyzing this tradeoff, the primary driver of decisions will likely be 1) anticipated investment return and 2) time horizon. Given the interrelationships of time and investment returns and the nuances of our tax laws, the “sell now or later” decision is unique to the individual taxpayer.

The bottom line

It is widely expected that the ultimate capital gains tax would be less than the recently announced 43.4%. The eventual higher rate overall, in our view, is not likely to materially pressure equity market prices in the long term. We expect some investor segments to take profits prior to any “kick-in” date of higher capital gains tax rates but the net effect to approximate a normal pull-back centered around 5%. This is due to our belief that investors are not likely to abandon the markets completely over an extended period of time; in addition, given where we are in the earnings and credit cycle, investors would continue to favor Equities over other asset classes. We believe a portfolio rebalancing or re-buying of prior “in the money” positions would develop, which could limit the potential downside to the broad equity indexes and potentially set the stage for future rallies.

[3] Passive management is an investing strategy that tracks a market-weighted index or portfolio.

Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in U.S. dollars.

S&P 500 Index is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States. It is one of the most commonly followed equity indices.

Important Disclosures

This material does not take into account a client's particular investment objectives, financial situations, or needs and is not intended as a recommendation, offer, or solicitation for the purchase or sale of any security or investment strategy. Merrill offers a broad range of brokerage, investment advisory (including financial planning) and other services. There are important differences between brokerage and investment advisory services, including the type of advice and assistance provided, the fees charged, and the rights and obligations of the parties. It is important to understand the differences, particularly when determining which service or services to select. For more information about these services and their differences, speak with your Merrill financial advisor.

Investing involves risk, including the possible loss of principal. Past performance is no guarantee of future results.

Bank of America, Merrill, their affiliates, and advisors do not provide legal, tax, or accounting advice. Clients should consult their legal and/or tax advisors before making any financial decisions.

The Chief Investment Office ("CIO") provides thought leadership on wealth management, investment strategy and global markets; portfolio management solutions; due diligence; and solutions oversight and data analytics. CIO viewpoints are developed for Bank of America Private Bank, a division of Bank of America, N.A., ("Bank of America") and Merrill Lynch, Pierce, Fenner & Smith Incorporated ("MLPF&S" or "Merrill"), a registered broker-dealer, registered investment adviser and a wholly owned subsidiary of Bank of America Corporation ("BofA Corp."). This information should not be construed as investment advice and is subject to change. It is provided for informational purposes only and is not intended to be either a specific offer by Bank of America, Merrill or any affiliate to sell or provide, or a specific invitation for a consumer to apply for, any particular retail financial product or service that may be available.

All recommendations must be considered in the context of an individual investor's goals, time horizon, liquidity needs and risk tolerance. Not all recommendations will be in the best interest of all investors.

Asset allocation, diversification and rebalancing do not ensure a profit or protect against loss in declining markets.

Exchange Traded Funds are subject to risks similar to those of stocks. Investment returns may fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost.

Mutual funds are subject to investment risks, including possible loss of the principal amount invested. Investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. For a discussion of the risks specific to a particular mutual fund, please refer to the fund's prospectus.

Investments have varying degrees of risk. Some of the risks involved with equity securities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration. Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. Bonds are subject to interest rate, inflation and credit risks. Historically, municipal bonds have been high-quality investments relative to other fixed income securities. However, not all municipal bonds are high grade, and when deciding whether to invest in municipal bonds, investors should consider: default risk, market risk and liquidity risk. Income is generally exempt from federal taxes and state taxes for residents of the issuing state. While the interest income is tax-exempt, capital gains, if any, will be subject to taxes. Income for some investors may be subject to the federal Alternative Minimum Tax (AMT). Investing directly in Master Limited Partnerships, foreign equities, commodities or other investment strategies discussed in this document, may not be available to, or appropriate for, clients who receive this document. However, these investments may exist as part of an underlying investment strategy within exchange-traded funds and mutual funds.

© 2021 Bank of America Corporation. All rights reserved.