Increasing after-tax returns in wealth management - Tax Optimization

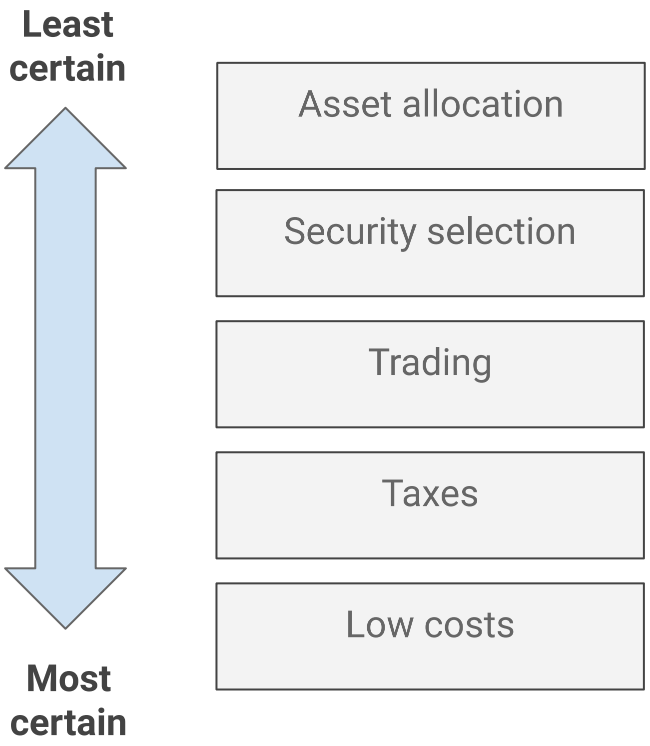
Agenda

1. Leveraging tax incentives
2. Avoiding tax bombs
3. Tax uncertainty
4. Case study

Taxes are a huge consideration for investors

- Taxes can be a 0.5% - 2.0%+ annual drag on returns depending on portfolio turnover and tax bracket
- Presents additional opportunities to generate outperformance for investors
- Easier than “beating the market”

Determinism in investment management



Leveraging tax incentives built into the system

Deferral of taxes on appreciated assets

- Appreciated assets have a deferred tax liability
- Akin to a loan with a zero percent interest rate
- The longer the asset is held the greater the opportunity for compounding at an exponential rate

How to leverage

- Be aware of deferral forgone when making trading decisions
- Consider trade-off of old investment to new investment
- Recognize that high portfolio turnover requires substantially higher returns to offset the tax drag

Long-term gains and qualified dividend reduced tax rates

- Long-term gains have a reduced tax rate to incentivize risk taking
- Qualified dividends have a reduced tax rate to partially mitigate double taxation of C-Corporation profits
- 0%, 15%, 20% plus 3.8% rates for high income earners

How to leverage

- Be aware of holding period when making trading decisions
  - Long-term requires a holding period of 1 year and 1 day or longer
  - Qualified dividends generally require a holding period of 61 days surrounding the ex-dividend date
- If close to meeting the holding period, ask the question “Does it make sense to wait X days?”

Tax exempt municipal bond income

- Municpal interest income is generally exempt from federal income tax
  - Certain types of bonds are subject to the AMT (alternative minimum tax)
- States (with an income tax) generally tax out of state municipal interest

How to leverage

- Analyze the after-tax returns of municipal vs taxable bonds
- Analyze the after-tax return of in-state vs out-of-state municipals

Roth type accounts (IRA and 401k/employer plan)

- One of the most powerful tax advantaged savings vehicles as the government does not share in investment success
- Qualified Roth distributions are retirement are tax and penalty free
  - 5 years holding period + age 59.5, disability or death

How to leverage

- Use the back door Roth IRA contributions when available
- Use the mega back door Roth 401k contributions when available
- Identify opportunities to convert pre-tax retirement funds during periods of low tax rates (unemployment, early retirement etc.)

Capturing investment losses

- Losses have a value to the extent they can reduce current or future tax liability
- Offset gains first, up to $3,000 in ordinary income, and carryforward until used or deceased

How to leverage

- Consider selling to capture losses to the extent there are recognized gains and $3,000 of other income
- Avoid wash sales by using similar (but not substantially identical) investments

Step-up in basis at death

- Unrealized capital gains at death are erased as the cost basis is reset to the market value on the date of death
- All inherited property is treated as long-term regardless of actual holding period

How to leverage

- Avoid selling highly appreciated positions for elderly clients
- Attempt to find cash from other sources to meet expenses which have substantially lower tax cost
- Recognize that all capital gains taxes are really “pre-death” taxes

Investment sale sequencing

- The IRS allows the taxpayer to choose which investments to sell and among those investments choose which specific lots to sell
- If no choice is made, the lot that is held the longest is sold first
    - Why let the government choose for you especially when its likely (but not always) to be the higher tax cost?

Avoiding tax bombs

Wash sales

- Buying substantially identical replacement securities within 30 days before or after sale at loss will generate a wash sale
- Loss is typically deferred until replacement investment is sold
    - IRAs wash sales permanently lose the loss

Early retirement plan distributions

- Making a withdrawal from a retirement plan before age 59.5 is designed to be punitive and incentive taxpayers to avoid them
- Generally, the withdrawal is subject to ordinary income tax and a 10% penalty
  - Certain exceptions apply to the 10% penalty

Large capital gains distributions from mutual funds/ETFs

- Mutual funds/ETFs are required to distribute capital gains from their underlying investments
- This creates an additional tax burden for investors who have not sold their shares
- Actively managed funds are more likely to be in this situation due to high turnover

Large gains in December and large losses in January

- An investor recognizes capital gains or $100 million in December and the recognizes $100 million capital in losses in January of the nest year
- Even though the investor is an economic break even, taxes are still due on then gains as losses cannot be carried back

Constructive sales of appreciated assets

- Investors who have large appreciated financial positions (especially in individual stocks) have a tendency to get skittish during times of market volatility
- Hedging (shorting, buying puts, selling in-the-money calls) all create risks that the IRS will “deem” the appreciated position as being sold at the time the hedge is put on

Cost basis/purchase date is not properly tracked

- Cost basis/purchase date tracking has improved substantially since 2011
- However, many investors hold assets that were acquired pre-2011 where the basis is unknown due to poor recordkeeping and firm transfers
- The IRS assumes that the cost basis is zero and it is short-term

Tax uncertainty

Legislative risk

Some tax proposals in recent years that never got passed

- Eliminating specific identification
- Eliminating Traditional retirement accounts
- Reclassifying carried interest as ordinary income

Uncertainty of future tax rates

- Tax loss harvesting
- Asset location
- Lot sorting

Case Study

How would you create an algorithm/decision matrix to sequence sales?

- Order -> Short-term gains, Short-term losses, Long-term gains, Long-term losses
- What additional constraints would you apply?
- What are the tradeoffs?

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