Improving tax efficiency of investment portfolios

**The RSM difference**

At RSM US Wealth Management, our advisors are wealth managers, not portfolio managers. We manage your financial picture to help you live a great life. We work with you to address the two biggest drivers facing your wealth strategy—spending and saving.

Our investment approach is an important part of the overall wealth planning process. The RSM US Wealth Management investment philosophy states there are six primary drivers of returns: 1) asset allocation, 2) cost, 3) tax efficiency, 4) risk, 5) investor behavior and 6) time. Tax efficiency is a primary driver of return for the taxable investor because what matters is how much an investor gets to keep after taxes are paid.

When thinking about tax efficiency, it is important to remember that while taxes are an important part of an investment plan and strategy, they are certainly not the only factor that needs to be considered. In addition, it is important for your wealth management advisor and tax professional to collaborate in understanding your unique needs, as there is no singular solution that fits all investors. Providing for greater investor tax efficiency is an active, dynamic, ongoing and client-specific process.

**RSM US Wealth Management advisors work to maximize after-tax returns in a variety of ways**

RSM US Wealth Management advisors have a number of tools that help maximize after-tax returns.

**Collaboration between RSM US Wealth Management advisor and tax professional**

Most importantly, our holistic approach entails collaboration. Your wealth advisor and tax professional complement each other and work together to design, execute and implement your financial plan. Together, we aim to design tax minimization strategies intended to help grow and preserve your wealth.

**Viewing your investment plan from a total portfolio perspective**

To create a tax-efficient investment portfolio, it is important to consider the overall plan and investment portfolio, rather than each individual investment. One major component of maximizing after-tax returns in your investment plan is referred to as asset location. Asset location refers to the type of account (taxable, tax-deferred or tax-free) in which an investor should purchase and hold various types of investments. Asset location strategies can vary based on investor-specific factors, such
as investment timeline, liquidity needs and tax situation. In its simplest form, asset location recommends investors place their most tax–inefficient investments in their tax–deferred accounts whenever possible. This is often not a simple practice and needs to be reviewed for each individual situation. To learn more about maximizing after–tax returns through asset location, please refer to the following piece: Maximizing after–tax returns through asset location.

Steps an advisor can take to improve the level of tax efficiency for the taxable investor

There are several steps advisors can take throughout the year to improve tax efficiency for a taxable investor.

- **Tax loss harvesting opportunities**: This is a process where an investor sells a security that has fallen below its purchase price, or cost basis, thereby realizing a tax loss. This loss can then be utilized to offset realized gains. A replacement security is purchased in place of the investment being sold in order to maintain the appropriate asset allocation. When tax loss harvesting, there are a few items to think about. First, investors should be careful to avoid the wash sale (claiming a loss on a sale of a security when a “substantially identical” security is purchased within 30 days before or after the sale), which is prohibited by the IRS. If a wash sale does occur, the loss is added to the basis (purchase price) of the new shares. Second, be sure to look for tax loss harvesting opportunities throughout the year and not just at year–end.

- **Paying attention to tax lots when selling securities**: Trading systems have different accounting methodology capabilities. For example, with tax lot accounting, there are three main options: highest in, first out (HIFO); first in, first out (FIFO); and last in, first out (LIFO). At RSM US Wealth Management, we prefer the HIFO methodology for taxable investors, as it will generally reduce the tax impact of a sale and can therefore help to improve after–tax returns.

- **Avoiding short–term gains**: Capital gains from the sale of a security are taxed at ordinary income rates unless the security is held for a period longer than 12 months, which may qualify for a lower tax rate. At RSM US Wealth Management, we pay attention to holding periods in order to limit the amount of short–term gains generated for taxable investors.

- **Defer the realization of gains**: The U.S. government taxes investment gains only when an asset is sold; thus, the tax liability is deferred as long as the security is held. All else being equal, the longer the realization of gains can be deferred, the better.

- **Avoiding mutual fund purchases before ex–dividend dates**: Mutual funds are required to distribute their income to shareholders, resulting in a taxable event. The ex–dividend date is the date when the fund net asset value (NAV) is lowered by the amount of the dividend. Whether investors have held the mutual fund for one day or a thousand days, each investor who is a registered owner of the fund on record date receives the same pro rata distribution. Therefore, investors should know when the ex–dividend and record dates are and work to avoid any unnecessary taxable distributions. Similarly, if investors are looking to sell a particular mutual fund, it could be advantageous to sell the mutual fund just before the ex–dividend date as opposed to just after it. Mutual funds and exchange–traded funds (ETFs) have varying timing for when record dates and ex–dividend dates occur, so it is important to understand these differences.

- **Leaving shares for cost basis step–up**: In relation to the tax liability created from deferring the realization of gains, it is possible that the liability may never be repaid. In the case of death, the securities in an investor’s portfolio will have their cost basis reset at the current price and any tax liability stemming from deferring the realization of gains will not have to be repaid.

- **Donating appreciated shares to charity**: Similar to leaving shares for cost basis step–up, donating appreciated shares to charity is another potential way to improve an investor’s tax efficiency. A tax deduction may be taken for the full market value of any securities with unrealized long–term gains that are donated to a public charity. Donor–advised funds are a readily available way to easily facilitate the donation of appreciated securities.

- **Planning your income withdrawal during retirement**: The most common withdrawal strategy is to 1) take your required minimum distributions from retirement accounts, 2) take from your taxable accounts, 3) dip into any tax–deferred account, like a traditional individual retirement account (IRA) or 401(k) and 4) finally to take the money from tax–exempt accounts, like a Roth IRA. However, this may not be the correct strategy for you. Having a wealth advisor collaborating with your tax professional can be important in planning your income withdrawal strategy during your retirement years.

- **Maintaining a disciplined investment approach**: RSM US Wealth Management takes a long–term, strategic view when it comes to investment management. This approach allows us to take advantage of several of the points made above. In contrast, if an investor were to rebalance his or her allocation too frequently or were to place many trades in an attempt to time the market, these actions would likely increase the investor’s overall tax burden.

The importance of investment product and vehicle selection

There are a number of different products and vehicles that advisors and investors have to choose from when looking to maximize after–tax returns.

- **Municipal bonds**: Municipal bonds tend to be a preferred fixed income investment for taxable investors for the simple reason that under current federal income tax
Mutual funds: Dividends, interest and realized capital gains from mutual funds are distributed pro rata to mutual fund holders each year and are taxed accordingly. Mutual fund managers can actively harvest losses, but those losses may only be used within the fund or carried forward to the next year. When thinking about actively managed mutual funds, it is important to remember that most portfolio managers are compensated on the pre-tax returns they generate and not the after-tax returns. In addition, as there are so many investors in each mutual fund, all of whom have their own tax issues, it is impossible for portfolio managers to create strategies that help all of their fund investors. Therefore, active mutual fund managers, in general, pay little to no attention to tax consequences.

Tax-managed mutual funds: There are some mutual funds that have tax management specifically listed as part of their mandate. The goal of these funds is to maximize after-tax returns. These funds work to obtain this goal by holding securities longer than one year to avoid short-term gains, harvest losses, observe wash sale rules and minimize dividend yields. On a positive note, these types of funds have generally been very good at limiting tax cost and therefore have a high amount of tax efficiency. However, keep in mind that high tax efficiency does not necessarily equate to higher after-tax returns (i.e., there may be investments in the same asset class that are less tax-efficient, but actually have higher after-tax returns).

ETFs: ETFs are mainly different from mutual funds in that they trade intraday. Most ETFs were originally created to replicate an index and with the low turnover of such products, there is an inherent amount of tax efficiency that stems from that. In addition, the structure of how ETFs trade through their creation and redemption process also provides for a certain level of tax efficiency. Recently, newer ETFs have been created that are not structured as pure or traditional index funds and may trade more frequently, making them less tax-efficient. In addition, some ETFs are not established as standard ETFs and therefore investors may receive a Schedule K-1 for tax purposes and not a simpler IRS Form 1099.

Separately managed accounts (SMAs): Different from a mutual fund, SMAs are owned by a single taxpayer and therefore provide the most flexibility when it comes to tax management. Investors have the flexibility to ask for the acceleration of the realization of gains, to transition assets to other managers without tax consequences or to gift specific tax lots to charity. When employing separate accounts, tax efficiency can often be improved with consistent cash inflows in order to purchase different tax lots over time. SMAs can also be provided in a unified managed account (UMA) structure, where there is one overlay manager, providing the potential for even greater tax efficiency. Similar to active managers of mutual funds, separate account managers are compensated on their ability to generate higher pre-tax returns. Therefore, it is necessary for your advisor to communicate with your separate account manager if tax efficiency is important.

Tax complexity: A variety of investments, including hedge funds, oil and gas partnerships, in addition to some ETFs, report their taxable income to investors via a K-1. This can lead to more complexity for tax preparers and higher tax preparation costs for investors. The increase in tax complexity and costs needs to be considered when making investments in these types of securities.

Of course, not all mutual funds, ETFs or SMAs are managed, invested or traded in the same manner, and these differences can all affect levels of tax efficiency. It is important to understand these differences when investing in these various products and vehicles.

**Way to calculate and measure tax efficiency**

There are multiple ways to measure and evaluate tax efficiency of investments. We will review several of the more common methodologies, while remembering each has a number of embedded assumptions, which may be different from your unique circumstances. It is also important to remember that each of these calculations is backward-looking and reflect the historical market environments being measured. Finally, each of these measurements is return-focused and does not include any discussion on the riskiness of the investments being measured.

Tax cost ratio: This is a calculation used by Morningstar to calculate tax efficiency for the mutual funds in their database. It helps investors estimate how much of a fund’s return is reduced by the impact of taxes. Mutual funds regularly distribute stock dividends, bond dividends and capital gains to their shareholders. Investors then must pay taxes on those distributions during the year when they were received. As an example, let’s say a fund shows a tax cost ratio of 2 percent. This means if that fund has a pre-tax return of 8 percent over a three-year period, its after-tax return over the same time period was 6 percent. A key benefit of the tax cost ratio is that it isolates the impact of taxes, allowing investors to compare the effect of taxes independently of the level of return (which is helpful when comparing investments in the same asset class or across asset classes). Per Securities and Exchange Commission (SEC) guidance, the highest tax
rates prevailing at the time of distribution are utilized in the calculation. Investors in a lower tax bracket would not feel the full impact of the tax cost ratio calculated. Overall, a lower tax cost ratio is preferred to a higher one.

- **Tax burden:** The calculation for tax burden is simple: it is just the pre-tax return minus the after-tax return. It measures how much of a fund’s pre-tax return is lost to taxes in basis points terms. While this calculation is certainly simple, it does have its drawbacks. For example, this calculation is best utilized as a vertical measure of comparison, comparing funds in the same asset class for the same time period.

- **Tax alpha:** Tax alpha can be thought of as the difference between pre-tax excess returns (or alpha) and after-tax excess returns, where the excess return equals an investment’s return minus its benchmark return. By subtracting pre-tax alpha from after-tax alpha, the value a manager adds through tax management can be calculated. However, tax alpha, while simple in its calculation, is actually very hard to calculate in practice. This is because it requires the use of an after-tax benchmark return, which is not often readily available.

**Summary**

Taxes play an important role in the investment process for taxable investors. Providing a better after-tax experience for investors is an active, dynamic and ongoing process that needs to incorporate each individual’s distinct needs and circumstances. At RSM, we aim to design tax minimization strategies intended to help grow and preserve your wealth. We believe this a major benefit of having your wealth advisor and tax professional collaborating on behalf of your best interests.