2000

Investing for After-tax Returns: An Overview

Anne B. Shumadine

Repository Citation
https://scholarship.law.wm.edu/tax/192

Copyright c 2000 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.
https://scholarship.law.wm.edu/tax
Investing for After-tax Returns
An Overview

Anne B. Shumadine, Esq.
Susan R. Colpitts, CPA/PFS
Mark R. Warden
Weyman Gong

Signature Financial Management, Inc.
999 Waterside Drive, Suite 2220
Norfolk, VA 23510

www.sigfin.com

Copyright 2000 by Signature Financial Management, Inc.
I. The problem: Current income taxes may reduce dramatically the after-tax return of an investment portfolio.

A. Investors often are wary of tax considerations when diversifying concentrated holdings, but they don't pay much attention to taxes in a diversified portfolio so long as "performance" beats, or is close to, the market.

B. In 1993, Robert H. Jeffrey and Robert D. Arnott published what is often considered the seminal article on tax managed investing. The article, titled "Is your Alpha Big Enough to Cover Its Taxes?" stated that "for many investors taxes are clearly the largest source of portfolio management inefficiency, and thus of mediocre investment returns." ¹

C. As of July 31, 2000, there were 1616 large cap mutual funds which had at least a 3 year history. The average mutual fund in the group had annualized pretax return of 14.18% over a three-year period ending July 31, 2000; the after-tax return was 11.85%. The tax efficiency of the average fund was 83.57%.²

D. When the effect of compounding is taken into account, the results are dramatic, even with such a small differential.

Example: The investment of $100,000 at an annualized return of 14.185% nets $376,772.15 at the end of 10 years; if the tax efficiency is that of the average mutual fund (83.57%), the after-tax amount is $306,391.53 after 10 years. After 20 years the effect is even greater; $1,419,572.54 versus $938,757.67.

¹ Jeffrey, Robert H., and Robert D. Arnott. "Is Your Alpha Big Enough to Cover Its Taxes?" Journal of Portfolio Management, Spring, 1993, p.15. Alpha is a measure of economic benefit to an investor of holding an actively managed account over a passively managed account, such as an index fund. In other words, alpha measures the amount by which a manager beats (or fails to match) an appropriate benchmark.
² Source: Morningstar; Signature Financial Management calculations
E. Funds with tremendous positive returns can suffer from tax inefficiency, although the effect is masked by the return.

1. For instance, Pimco Mid Cap Equity Institutional showed a pre-tax return of 51.81% for 1999; its after-tax return was 25.17%.

2. Index Funds generally are more tax efficient, since they are passively managed. However, even index funds are not 100% tax efficient. The Vanguard 500 Index Fund had a pretax return of 21.17% and an after-tax return of 20.32% (with a tax efficiency ratio of 96.44%); however, Vanguard's Small Cap Index Fund had a pretax return of 23.13%, with an after-tax return of 20.32% (giving it a tax efficiency ratio of 87.85%).

3. The fact that a fund tracks an index does not guarantee tax efficiency. For instance, Northern Institutional Equity Index Fund (which tracks the S&P 500 Index) had a tax efficiency of 85.58%, substantially lower than Vanguard's similar product.

---

3 Source: Morningstar.
4 Source: Morningstar.
5 Source: Morningstar.
II. The Environment: The emphasis in the investment industry has been on pre-tax returns, and until recently, investment managers rarely distinguished between taxable and non-taxable accounts. More tax managed funds have appeared, but the total number of funds claiming to be tax managed is still less than 1% of all the funds covered by Morningstar.6

A. There are challenges inherent in reviewing investment alternatives from the standpoint of after-tax return.

1. Although the Association for Investment Management and Research (AIMR) has been studying the issue, no particular standard for measuring after-tax performance has been uniformly accepted.

   a) Appendix A describes four methods of measuring after-tax performance.

   b) Measuring performance on a pre-tax and pre-cost basis gives a homogenous result; it is the same from the viewpoint of every investor. When taxes are considered, performance cannot be interpreted in the same way for every investor. Each investor’s particular tax situation will have an effect on how performance is interpreted.

2. Managers and mutual funds measure their performance against indices that do not take taxes into account.

   a) After-tax performance doesn’t look as good as pre-tax performance and therefore is rarely reported in the popular press (or as part of marketing information). However, the Vanguard Group has announced that it will begin reporting after-tax returns for its funds.

   b) Managers who report after-tax performance that is below the performance of the “market” may be punished by the market place.

3. The media and most industry commentators have focused their articles on the choice between taxable and non-taxable accounts, particularly retirement accounts.

4. The industry focus has been on tax exempt investing; in fact, investment management as a discipline came about largely as a response to the needs of tax-exempt institutions such as pension plans.

5. Investors have been slow to demand accountability for after-tax performance.

B. Completely avoiding taxes is difficult, if not impossible, but taxes are a cost of investing and should be managed like other costs.

---

6 Source: Morningstar; Signature Financial Management calculations
1. As early as the 1980's, commentators had focused on taxes as an investment expense. "Taxes are the biggest expense that [many] investors face- more than commissions [and] more than investment management fees." 7 "R[eturn is likely to depend far more on the risk the fund assumes and more on its tax liability than on the accuracy of the analysts' forecasts." 8

2. Reducing current income taxes on investments has a tremendous compounding effect.

   a) Most commentators agree that the focus in managing for after-tax performance should be on reducing realized capital gains.

      (1) Capital gains generally have greater impact on after-tax return than dividends. Taxes reduced the performance of the average mutual fund by about 3% over the period from 1984-93; most of the tax cost was attributable to capital gains (2.4%), with only .7% attributable to dividends. 9

      (2) Avoiding dividends and interest skews asset allocation and changes risk parameters. Avoiding interest results in an all equity portfolio. Avoiding dividends results in a growth orientation. The tax effects of interest can be managed through the correct choice of municipal bonds or taxable bonds.

   b) In the case of unrealized capital gains, the liability for deferred taxes can be referred to as an "interest free loan from the Treasury" that becomes due only at the borrower's option; i.e., when the investor chooses to sell the stock. 10

      (1) Pretax growth compounds geometrically, while deferred tax liability does not. When the recognition of gain is deferred, the tax that is also deferred continues to earn an investment return.

3. Completely avoiding taxes may produce a less than optimal return.

4. Likewise, minimizing taxes through a buy and hold strategy can result in a portfolio with so much unrecognized gain that further trading makes no sense from a tax standpoint. The portfolio will have no losses that can be used to offset gains, and stocks that are no longer in favor cannot be sold without incurring substantial tax liability. The portfolio is likely not to produce excess

---

10 Jeffrey & Arnott, at p.16.
returns because of the out of favor stocks, and it is exposed to increasing risk over time.

C. **Modern Portfolio Theory is the standard for investing institutional money.**

1. Modern Portfolio Theory (MPT) was proposed by Harry Markowitz in 1952. MPT provides an investment approach based on a statistical analysis of historical returns and volatility. MPT quantifies the relationship between risk and return and assumes that investors must be compensated for assuming risk.

   a) Diversification is key to MPT. By properly combining securities, an investor can increase the rate of return per unit of risk on the portfolio above that which can be achieved on any individual security or inadequately diversified portfolio. It also is possible to reduce the risk of a portfolio below the risk of the least risky security in the portfolio and earn a higher rate of return than that of the least risky individual security.

   b) MPT shifts the emphasis from analyzing individual investments to determining the statistical relationships among individual securities that comprise the entire portfolio. The risk of any individual security is relevant only insofar as it contributes to the risk of the portfolio as a whole. No investment is per se too risky if it fits into the portfolio and increases return while reducing risk.

   c) Risk is the possibility that an investor will not receive the desired return at the time the funds are needed. It is alternatively described as the volatility around the mean or the inherent uncertainty in the future performance of an investment. Risk is measured by a statistical measure called standard deviation. **Standard deviation reflects the average deviation of observations from their sample mean and measures how wide the range of returns typically is.** The wider the range of returns, the higher the standard deviation and the higher the portfolio risk. If returns are normally distributed, then approximately \( \frac{2}{3} \) of the returns would occur within plus or minus one standard deviation from the sample mean.

   d) The return and volatility of stocks and bonds over the past 50 years is shown on the chart below:
Optimal portfolios, those that theoretically provide the highest return for a given level of risk, are plotted on a graph called the "efficient frontier."
e) MPT is based on pre-tax returns and standard deviation. The introduction of taxes as a third variable affects not only the return of an asset class, but also its standard deviation. As a result, the asset allocation for a taxable account theoretically should be different from the asset allocation for a non-taxable account with the same risk and return objectives.

2. Modern Portfolio Theory has become the accepted investment process for institutional investors as well as individual investors. The Uniform Prudent Investor Act adopted in Virginia and effective January 1, 2000, accepts the principles of MPT as a standard for fiduciaries in Virginia.

D. Applying MPT to taxable accounts raises interesting issues that have not been answered by the industry or academia.

1. Optimal asset allocations are built using historical returns and measures of risk. When taxes are considered, unrealized gain might be a necessary third variable.

   a) The Efficient Frontier could become three dimensional instead of linear.

   b) Unrealized gain may be different for every investor, since it depends on the starting portfolio positions. The tax effect of unrealized gain would almost always differ from investor to investor.

2. Industry commentators have suggested various ways to allocate assets in taxable accounts.

   a) Some have suggested that taxable investors avoid dividend paying stocks and invest only in growth stocks which do not pay dividends. However, academic research has shown that on a long term basis, dividend paying stocks as a group have outperformed low or non dividend paying stocks. Additionally, investing only in growth stocks skews the risk profile of a portfolio, which may or may not be suitable for a particular investor.

   b) Investors who have both taxable and non-taxable (retirement) accounts have been urged to put all fixed income investments in their taxable accounts, or all fixed income investments in their non-taxable accounts. At least one commentator has suggested an overall asset allocation approach for taxable and non-taxable portfolios. The commentators agree that each approach is subject to various assumptions.

---

(such as equal account sizes, for one thing) that may not hold true in all cases.\textsuperscript{13}

c) Many of these studies fail to take into account the benefits to be derived from the permanent tax avoidance mechanisms of basis step-up at death and charitable giving.

3. Dampening volatility has been the goal of MPT. For taxable accounts, however, volatility may present opportunities to harvest offsetting losses and increase basis.

a) Higher volatility is acceptable in the tax exempt world only if it produces higher expected returns or if it can be diversified away, or both. In the taxable world, volatility is good when it offers options to shelter realized gain; such volatility may offer the opportunity not only to choose better securities, but also to diversify or rebalance across asset classes.

b) Taxable investors may have to accept the proposition that riskier investments (which are also more volatile) may have a different role in taxable accounts. A higher risk investment may be purchased not to produce higher expected return, but rather to offer the opportunity for greater tax efficiency.\textsuperscript{14}

4. MPT assumes that a portfolio will be rebalanced from time to time to keep the asset allocation in sync. Rebalancing theoretically allows the investor to “sell high and buy low” as he sells excess holdings in an asset class that has performed well and buys additional holdings in a class that has performed poorly.

a) For taxable investors, rebalancing should be done sparingly. The tax costs associated with rebalancing make it uneconomical except when a portfolio is substantially over-allocated in a particular class or when offsetting losses can be harvested. A portfolio can also be rebalanced in a tax efficient manner by utilizing cash infusions.

5. Consultants hire managers to perform certain specified functions that generally are tied to benchmarking indices. A manager who lets his “winners run” risks being fired if those winners take him outside the parameters of the benchmark and the function for which he was hired. At the same time, letting winners run is one method for deferring taxes and increasing after-tax return.


6. Measuring success is difficult, since benchmarks generally do not take taxes into effect and the effect of tax liability will vary from investor to investor.

   a) Even when benchmarks show after-tax return, the impact of taxes may be different for each investor.

   b) The tax impact will depend not only on the portfolio holdings, but also on other extraneous factors affecting the investor's overall tax situation.

7. Numerous questions remain unanswered.

   a) How long should the horizon be for measuring performance?

   b) Should absolute returns be considered as an alternative to benchmarked performance?

   c) How does one balance investment performance (the need to sell underperforming stocks with low basis) against the compounding effect of tax deferral?

   d) What time frames are important?

III. Solutions for taxable investors are available, but they require careful planning and portfolio management. Most of the solutions fall into three categories: choosing the appropriate savings vehicle; designing portfolios; and managing portfolios to produce optimal after-tax returns.

A. Choose the appropriate savings vehicle.

1. Few high net worth clients have a substantial portion of their wealth in retirement plans. However, on a purely after-tax return basis, investing tax deductible contributions in a qualified plan almost always produces better returns (even after the income tax hit for withdrawals) than investing non-tax deductible amounts in a taxable account. If contributions are matched by the employer, the effect is a home run.

   a) Example: Assume an employee has a choice of investing $1,000 in a savings account or $1,000 in a 401(k) plan where the employer matches each contribution by $.50 for each $1.00 contributed. If the plan earns 8% a year for the entire 20 years and the employee withdraws the entire amount at the end of 20 years and pays taxes immediately, the after-tax value of his 401(k) plan after 20 years is $6,991 (assuming that the employee's tax rate is the same on the date of contribution and withdrawal). If the employee invests $1,000 in a savings account that earns the same 8% on an after-tax basis, the amount that he has at the end of 20 years is $4,661. That result is unlikely, since he is unlikely to
find an after-tax return equal to the tax sheltered return inside the pension plan.\textsuperscript{15}

b) If the employee qualifies to invest in a Roth IRA with the same 8% return, the amount at the end of 20 years is the same $4,661 as he would have in a savings account.

c) The difference is attributable the tax deductibility of the contribution and the employer match. Because the contributions are tax deductible, the employee can contribute $1.54 (in a 35% tax bracket; $1.75 in a 43% tax bracket) of before tax dollars for every $1 of after-tax dollars. Even without the employer match, the after-tax distribution from the pension plan is the same as the amount in the Roth IRA.

2. Private foundations are also a vehicle for tax-exempt investing for those who are charitably inclined. The investor avoids permanently capital gains tax on the appreciated securities contributed to the foundation and then permanently avoids income tax on the investments inside the foundation (although the foundation is subject to certain excise taxes on income).

B. Design asset allocated portfolios that accomplish the investor's goals and offer tax management opportunities.

1. The proper asset allocation depends on the facts and circumstances affecting the investor. In some circumstances, an investor may be wise to allocate all fixed income to retirement accounts and equity to taxable accounts, or vice versa. Treating taxable and tax exempt accounts as a whole also may work for some investors. Problems arise because investors rarely have equal amounts in both places, and even if they did, they cannot move freely between the two types of accounts to keep the allocation in balance.

2. Taxable accounts may be managed for optimal after-tax return on a stand-alone basis. In a taxable account (as well as a tax exempt account) most investors want a balanced portfolio that will produce the optimal return for the risk that they are willing to take. That usually (but not always) means a blend of assets, including some fixed income (domestic and international), equities (large and small cap, and domestic and international) and sometimes alternative investments, such as private equity, hedge funds, real estate and timber, and other opportunities.

3. Fixed income investments are those for which income generation is a goal. Income generally represents a large percentage of the total return produced by the investment. Bonds are a good example of fixed income investments.

a) Fixed income investments are used in a portfolio to produce income and reduce volatility (risk).

b) U.S. Bonds are not perfectly correlated to U.S. stocks and therefore reduce the overall volatility of a portfolio.

c) If income generation is a goal, a mix of taxable and non-taxable bonds may be the best solution.

(1) Municipal bonds often produce the best after-tax yield for investors in high tax brackets.

(2) Exceptions occasionally occur. It is wise to calculate and compare the tax-equivalent yield on municipal and taxable bonds, using the investor’s top tax bracket.

(3) Investors who are often in alternative minimum tax situations often are better off using taxable short-term bonds and money markets because of the variability in their top tax bracket. In a year in which the investor’s top tax bracket is the AMT rate of 28%, municipal bonds may not provide the greatest after-tax return.

d) Sales of bonds produce capital gains and losses. Bonds can be traded like stocks and produce not only long term capital gain and loss, but also short term capital gain and loss.

e) Bond funds bear the same capital gains risks that equity mutual funds have; an individually managed bond account will give an investor more control of the tax consequences.

4. Choose equity managers that invest for after-tax return.

a) A tax efficient manager usually focuses on reducing the rate of realized capital gains, not on completely avoiding dividend paying stocks. Turnover is an important statistic, but the rate at which net capital gain is realized, and whether that gain is short-term or long-term, is more crucial to after-tax performance.

b) Tax efficient managers employ different strategies or combinations of strategies to reduce taxes. Those strategies include harvesting losses to offset gains, using tax lot accounting, and considering tax liability when deciding whether to sell an underperforming stock.

5. Consider whether mutual funds or individually managed accounts should be used. Individually managed accounts have been the choice historically for taxable
investors and currently are being marketed as the ultimate solution. However, mutual funds may be used efficiently in taxable portfolios.

a) A mutual fund is a shared portfolio of stocks or bonds (or both) in which individuals can invest by purchasing shares from the investment company.

b) Many funds are tax efficient, even though they may not have a stated objective of being tax managed.

(1) Tax efficiency often has resulted from the style of investing and sometimes, substantial cash flows into the fund. A fund that does not have a stated objective of being tax managed may not be tax efficient when cash flows into the fund slow, or stop altogether.

(2) The tax efficiency of a fund can be measured by dividing the fund's after-tax return by the pre-tax return. For instance, a fund that has after-tax returns of 8% and pre-tax returns of 10% has a tax efficiency ratio of 80%.

c) Mutual funds have benefits:

(1) Mutual funds allow investors to diversify their investments, obtain professional management of their holdings, and enjoy economies of scale without committing very large amounts of capital.

(2) Because mutual funds are required to distribute all of their net investment income and net realized gain each year, no income tax is due at the fund level. A fund offers the benefits of diversification and professional management without exposing investors to an added layer of taxation.

(3) Expenses of the fund (management fees, brokerage commissions, custody, etc.) are deducted against income within the fund instead of as a miscellaneous deduction on an individual's tax return.

d) Mutual funds have disadvantages, particularly for taxable investors:

(1) An investor in a mutual fund gives up a good deal of his control over the timing and character of tax obligations associated with investing in the fund. Mutual funds distribute realized gain and income every year. However, mutual funds cannot pass out the benefits of a net realized loss in a particular year.
(2) Buying a mutual fund immediately before a capital gain distribution creates unnecessary tax liability. When the distribution is paid, the net asset value (“NAV”) of the fund is reduced by the amount of the distribution, with the result that the NAV plus the distribution is the same as the investment in the fund before the distribution. In other words, the shareholder is no more or less wealthy, but if he is a taxable investor, he owes income tax on the amount of the distribution.

(3) A mutual fund may have large accumulated unrealized capital gains — embedded gains. An investor purchasing shares in such a fund is buying someone else’s capital gains. So long as cash flow into the fund is stronger than distributions out, embedded gains are not particularly troublesome; in fact, the fund may appear to be very tax efficient, since gains are theoretically spread out among more and more investors. When redemptions from the fund exceed purchases of shares in the fund, the fund may be forced to sell appreciated positions to satisfy the redemptions. Those sales will trigger realized gains and distributions to the remaining shareholders — even at times when the NAV of the fund has decreased.

(4) With the exception of institutional shares, mutual funds generally do not offer expense reductions for large accounts. Institutional shares can reduce expenses slightly (generally about 20 basis points).

e) There are several planning opportunities for taxpayers invested in mutual funds.

(1) Mutual funds may be transferred to charities; those gifts avoid the tax liability of accrued and undistributed capital gains in the same manner that gifts of appreciated stocks would do so.

(2) When a shareholder redeems shares in a mutual fund, he incurs a taxable gain or loss equal to the net proceeds from the redemption less the shareholder’s adjusted basis in the shares. Redeeming shares in a mutual fund before a distribution of capital gain may avoid short term gain inherent in a forthcoming distribution and result instead in long term capital gain of the same amount or sometimes a lesser amount.

6. Individually managed accounts historically have been the choice of taxable investors. Individual accounts offered directly from a manager require minimum investments ranging from $1 million to $100 million.
a) Individually managed accounts with smaller required minimum investments typically are offered through brokerage wrap accounts or through firms that aggregate accounts for specified managers. Technology makes it possible to offer some customization, but those accounts run the risk of being clones of mutual funds or all other smaller accounts. The trade off for access at a lower minimum investment usually is a larger fee that does not decrease as rapidly as the fee that would be charged by going directly to the manager. However, some aggregators offer individually managed accounts that actually have lower fees (particularly at a lower level) than those that would be incurred by going directly to the manager.

b) Management fees for individually managed accounts are deductible but are subject to the 2% floor for miscellaneous deductions.

c) Individually managed accounts offer several benefits over mutual funds for taxable investors. An investor normally can control the timing and characterization of his tax liability for the account by directing the manager to avoid short term gains wherever possible, to postpone sales until the following calendar year, to transfer appreciated securities to charities, to recognize losses, etc. The most compelling benefit, however, is that the investor in an individually managed account will not incur tax liability that might result from redemptions by other investors, particularly during a market decline.

7. Consider whether passive or active management is the best strategy for tax managed accounts.

a) Passive management has benefits of low cost, low turnover and generally higher tax efficiency than active management.

(1) Exchange traded funds should be more tax efficient than passive index mutual funds, since the investor will not be purchasing tax liability of other investors. Exchange traded funds will not be completely tax free, however, since gains may be recognized when the underlying index changes.

(2) There are certain periods in which passive management will perform better than active management. The last five years has been such a period.

b) Passive management has disadvantages.

(1) The underlying index may not reflect the risk tolerance of an investor. For instance, the return of growth indices in 1999 reflects the return of a small number of stocks. Accordingly, the
investments are concentrated more than an investor may actually desire.

(2) Passive management generally is more effective in the U.S. large cap arena, where the market is more efficient (knowledge is more uniformly available). Passive management has not been as effective in the small cap arena or the international arena, where information is not as readily, or uniformly, available. In those areas, active management (where the manager uses fundamental analysis to choose sectors and/or stocks) may reward investors with better returns.

8. Other investment vehicles are being developed. For instance, some investment firms offer access to professional investment through limited partnerships. Like mutual funds, investment partnerships offer diversification and professional management at lower minimums, but they don’t carry the risk of incurring other investors’ tax liability.

C. Manage the portfolio as a whole for after-tax performance.

1. Let winners run. A strict (tax-insensitive) approach to Modern Portfolio Theory results in regular selling of asset classes that have outperformed and of individual securities that have grown out of their original asset class. The result is the possibility that a manager might sell a stock that no longer fits his portfolio parameters (such as a small cap stock that had grown into a mid-cap or large cap stock), while another manager may be simultaneously purchasing the same stock. In tax-sensitive portfolios, these rules can be relaxed with less regular rebalancing and accounts that allow “asset class creep.”

2. Routine tax projections and constant communication among managers can optimize tax results. Particulars about an investor’s tax situation, such as excess short term gains or losses or an AMT situation, can make a difference to managers in their decision making models.

a) Be aware that a large amount of long-term capital gain and a relatively small amount of ordinary income, coupled with significant deductions either from large taxes or even charitable contributions, can result in the application of the alternative minimum tax (AMT). The consequences of being in AMT are a top tax bracket of 28% and a loss of a bulk of one’s itemized deductions.

(1) AMT offers some planning opportunities. For instance, one might choose to defer deductions, if possible, until a later year, since the benefit will be lost. Charitable gifts are not added back for AMT purposes, but the deduction will produce only a 28% benefit (instead of a 39.6% benefit under normal tax circumstances).
(2) The fact that the highest AMT rate is 28% may also offer opportunities to accelerate ordinary income or short term capital gains.

b) Money managers often are not aware of a investor's overall tax situation. Without better information, a manager who recognized losses early in the year might choose to offset them with gains later on unless informed that there are other gains elsewhere in the portfolio. When made aware of the whole picture, they can make better decisions for the investor.

3. Track tax basis of assets (and unrealized gains and losses)

a) Use tax lot accounting methods that are tax beneficial. If taxes are of no concern, a custodian or manager will likely use the easiest method of identifying tax lots sold: FIFO or average cost. However, the IRS also allows the use of a specific identification method which can frequently offer better tax results in accounts where stock positions are added to and subtracted from over time. The rules governing its usage are quite specific regarding the identification of tax lots at the time of sale, so it is important that the custodian of the securities be notified of which tax lot is being sold.

b) The highest cost basis is not always the appropriate lot to sell. Make sure that a sale does not produce short-term capital gain that is more costly than long term gain from the sale of lower basis lots. For example, if a stock is sold and there are two lots, one 11 months old and one 13 months old, it may be preferable to sell the 13 month lot to get the lower long term gain rate, even if the cost basis is somewhat lower than that of the 11 month lot.

c) Be aware that the cost basis of stock acquired in a merger becomes the average of all bases before the merger. The individual tax lots are lost, which can be disadvantageous, but unavoidable, for tax purposes.

4. Consider selling mutual funds to harvest losses or to avoid short term gains

a) Selling a mutual fund immediately before a capital gain distribution may be more beneficial than receiving the distribution, particularly if a significant portion of the dividend is to be short-term.

b) Selling an underperforming mutual fund to produce a capital loss can be beneficial, particularly if it can be replaced with a similar fund at a lower cost.

c) The wash sale rule prohibits losses unless the investor is out of the security for 31 days on either side of the loss.
(1) Mutual funds are treated like securities for wash sale rule.

(2) Wash sale rules do not prohibit purchase of a similar (but not identical) security.

5. Use appreciated stocks for charitable gifts

   a) Appreciated mutual funds can also be given to charities without recognition of gain.

6. Transfer assets in kind to managers. When changing managers, an investor can realize significant tax savings and avoid transaction fees by transferring securities from existing accounts to the new manager. The new manager generally will agree to review a list of existing holdings to see what should be kept in the new portfolio. (Be aware also that the transaction costs in the old account may not be as good as you can get elsewhere, as generally the broker or manager already knows he is being “let go” and has no incentive to keep the commissions down.)

7. Look for mutual funds that redeem large positions in kind. There is no tax saving for the redeeming shareholder, but the fund avoids sales that could result in gains for remaining shareholders.

8. Manage cash flows into and out of the portfolio

   a) Keep cash reserves for short term needs to avoid untimely sales. For example, when a client sells a security that represents a significant gain, set aside the funds needed for taxes. If cash is not set aside for short term needs, the investor may experience a cycle of selling, often at inopportune times.

   b) Rebalance portfolios using cash flows. As discussed above, the tax inefficiency of regular rebalancing often tips the cost-benefit analysis scales away from regular rebalancing. But for a portfolio that has flows into or out of the fund, such flows can be applied or taken “closer to target,” to bring the portfolio back into alignment with the optimal asset allocation.

IV. Managing the tax consequences of stock options is vital to wealth maximization for many “New Economy” millionaires, as well as the “Old Economy” employees, executives and board members.

   A. Qualified (“Incentive”) Stock Options (ISO’s) have traditionally had better tax consequences for the issuing companies and for the option holders and, therefore, have been the preferred route for designing stock options plans.
1. At the date of grant, the ISO recipient has no tax consequences. Vesting also has no tax implications for the option holder.

2. Generally, the ISO holder recognizes no income at the time of exercise.
   
a) That rule does not apply if an employee exercises an ISO more than 3 months after termination of employment.

3. The basis of the stock will be the amount paid to purchase the stock at the time of exercise.
   
a) However, for purposes of the AMT, the difference between option price and fair market value at the time of exercise is reportable income, taxable at AMT rates. The basis for AMT is therefore different than the basis for regular tax and must be tracked. At best, the AMT effect is reversed when the stock is sold in a subsequent year, but whether a real tax offset will be achieved is affected by other income and deduction factors. Unfortunately, once AMT is paid, tax planning tools, such as charitable donations of securities, do not provide the usual tax benefits.

4. The ISO holding period is the later of 2 years after the date of the grant or one year after the date the shares were transferred to the employee upon exercise. The tax treatment upon sale of the underlying stock depends upon whether the stock has been held for the ISO holding period.
   
a) If the stock is sold after the ISO holding period expires, the disposition generates capital gains.
   
b) If the stock is disposed of before the expiration of the ISO holding period, the disposition is called a “disqualifying disposition.” In a disqualifying disposition, the employee recognizes as compensation income the difference between the exercise price and the fair market value at the time of exercise. That compensation income is then added to the employee’s basis (which is usually the exercise price) for purposes of determining gain on disposition.
   
   (1) If the value at disposition is greater than the value at exercise, the difference is capital gain.

   (2) If the price received in a disqualifying disposition would result in a loss if the rules regarding disqualifying dispositions were applied, then the amount of compensation income is the excess, if any, of the amount realized on sale over the basis of the ISO stock.
5. A holder of ISO faces a tension between the desire for favorable tax treatment and the risk created by holding the stock for the required time. The greatest tax benefits go to the option holder who can afford to hold the options for 2 years. Avoiding unfavorable tax treatment may not be the best investment decision.

   a) In addition, the AMT treatment at time of exercise can create a less than desirable situation - tax liability at exercise with no wherewithal to pay.

B. Nonqualified stock options (NQSO's) carry fewer restrictions and offer less favorable tax treatment.

   1. Generally, the value of a NQSO is not included in the option recipient's income at the time of grant unless the option has a readily ascertainable fair market value at the time of the grant.

      a) Only options traded on an established market or options that meet the requirements under IRC Section 83(b) (where the option has a fair market value that can be measured with reasonable accuracy) are considered to have a readily ascertainable market value. See Reg. 1.83-7(b)(2) for the specific requirements.

   2. Exercise of the option triggers taxation. The taxpayer will recognize compensation income on the difference between the exercise price and the fair market value of the stock at the time of exercise.

      a) The shareholder's basis is the fair market value of the stock at the time of exercise.

      b) There are no AMT consequences to the exercise of a NQSO.

      c) A subsequent sale will generate capital gain. If the option lapses unexercised, a capital loss is recognized to the extent of the previously recognized income.

C. The taxation of stock options is an area that includes many technical details, which this outline does not cover. Many exceptions arise in the application of these rules. Some of those exceptions follow:

   1. There are exceptions for estates and persons going through bankruptcy, as well as for those who are disabled.

   2. Rules differ for disqualifying dispositions if the stock price drops below the value at exercise.
3. Stock options that would otherwise be ISO's are treated as if they were non-qualified to the extent that the value of the stock covered by the options exercisable in any one year exceeds $100,000.
APPENDIX A
METHODS OF MEASURING AFTER-TAX RETURNS

Full Liquidation:

Full liquidation Method assumes that all investments are sold by the end of the holding period. Such assumption exaggerates the negative tax impact. It ignores other non-tax-triggered ways of liquidation and penalizes the portfolio manager's performance by taxing the unrealized gains.

AIMR Method:

AIMR Method is very similar to the Full Liquidation Method, except it assumes no liquidation by the end of the holding period. Though it does not penalize manager's performance, it ignores the potential tax impact of the unrealized gain.

Cash Flow Basis:

It assumes that all taxes are paid out of the portfolio itself. In computation, it treats tax payments as expenses rather than normal cash withdrawal. However, taxes are often paid out of other accounts. And a client's tax liability is affected by many factors.

Full Cost Equivalent Value:

If a portfolio starts with existing securities instead of cash, the above three methods will not be able to accurately reflect the tax effect under the new management. FCE tries to standardize the starting value by computing a FCE under a set of assumptions. However, the calculation is very tedious and the assumptions are very restricted.
Louise is a Vice President of TVS, Inc. TVS, Inc. is a large, closely held company that is about to be acquired by Risco, Inc., an even larger public company. The transaction will be in the form of a stock for stock merger. Because of TVS' generous employee stock purchase plans, Louise has thousands of shares of stock in TVS, Inc., and if the transaction goes as planned, Louise will hold 466,000 shares of Risco, Inc., each share having a value of $15 and a basis of $.25. The value of her stock will be approximately $7 million.

Louise also holds qualified stock options in TVS, Inc. After the merger, she will have the right to purchase 1,000,000 shares of Risco, Inc. at $.50 a share. Those options will be exercisable for 6 to 10 years after the transaction closes.

Louise is married and has two children, ages 10 and 8. She is 40 years old, and her husband is 45 years old. Her husband is a family doctor who is dedicated to medicine and cannot imagine retiring. Louise has been offered a position in Risco, Inc. after the merger, but she has decided to take some time off and see what other things life has to offer. Louise and her husband have saved and invested wisely in the past; they each have personal investment accounts (including retirement accounts) worth $500,000 each and a home that has equity of approximately $150,000. Each child also has a college savings account of $25,000 and $18,000, respectively. They live modestly and despite the windfall that Louise expects, have no plans to change that lifestyle dramatically. They expect that college funding will no longer be a great worry, but they haven't thought much beyond that one issue.

Louise has been learning as much as she can about Risco and its prospects. She thinks the company has good long term prospects if certain things happen in its industry, but she doesn't want to bet most of her net worth on that one company's success or failure. Risco's stock has been very volatile in the past; its price has ranged from $1.25 a share to $17 a share in the last year alone. Getting out at $15 a share seems to be a desirable proposition if she can do so without paying a huge tax.

Louise's father has impressed on her the benefits of considering taxes along with investment decisions. Louise is aware that tax considerations may affect her decisions about selling or holding on the Risco. She also is aware that some restrictions may apply to her stock and perhaps to her stock options. At the same time, she doesn't want taxes to rule over prudent investment decisions.
Case Study
Rick

Rick is 50 years old and has just become a millionaire. In fact, he is slightly (although just slightly) more than a millionaire; his total net worth is $1.5 million. Most of that net worth ($1.2 million in cash) is an inheritance from his father, who passed away six months ago. The remaining $300,000 includes his home ($200,000), his 401(k) account ($40,000) and various property and investments, such as an automobile, a boat, some interests in real estate and a small brokerage account.

Rick is a partner in a small law firm. He enjoys his work and has no current plans to retire, although retirement in about 10 years might be an attractive alternative. That is, retirement would be attractive if Rick could continue to live the lifestyle to which he has become accustomed. Rick makes a good living as a lawyer, and he spends almost every penny. He is divorced and has one child who has just graduated from college. Rick has not seen a compelling reason to cut his spending, particularly since he has anticipated this inheritance for some time. Rick realizes that in order to continue his lifestyle, his inheritance nest egg will have to grow substantially by the time he retires. Unfortunately, Rick has never paid much attention to investments, since he figured he would learn about investments after he received the inheritance.

Rick has read about hitting investment home runs by investing in hot new ventures, stock in internet companies, even day trading (which is not really an option if he is going to continue practicing law). Hitting an investment home run has some appeal to Rick, but even with his limited investment experience, Rick knows that these options might be risky. Rick wants to safeguard his inheritance even more than he wants to hit that investment home run. After all, this inheritance nest egg is his sole hope for retirement, and Rick has no prospects for additional windfalls in the future. Currently, his inheritance is sitting in money market in his brokerage account, and given the volatility of the markets in the past year, Rick wonders whether money markets might be the right investment for him for the foreseeable future. Rick also knows, however, that his inheritance will not grow the way he wants it to if he invests solely in money markets.

Because of his law firm income, Rick pays income taxes at the highest federal and state rates. He has few deductions and no easy way to reduce his taxable income without actually reducing his cash flow. His accountant has warned him about impact on taxes of investment income and has suggested that Rick look at tax efficient investments such as municipal bonds. Rick also has met with some brokers, money managers and financial planners to get advice about how to invest his inheritance. Rick listens carefully to everyone, since he wants to know what his options are and what is realistic to expect for his inheritance. The problem, however, is that every professional that Rick consults seems to have a different approach to what he should do.

Rick is confused. He wants some advice on what to expect from his inheritance, what impact taxes will have, and how and where to invest.