

Tax-Efficient Investing

J. Richard Joyner, CPA, CIMA, CFP, PFS, President, Tolleson Wealth Management

Overview

Taxes are the most significant single expense for most investors. The damage escalates further over longer time frames. To minimize the impact of taxes and maximize investment returns, you need to go beyond the simple measurement and tracking of after-tax returns to create a multi-generational, tax-sensitive investment strategy based on an all-inclusive understanding of your financial situation, needs, and goals. A well-crafted strategy can add up to 250 basis points to your portfolio's returns and give you an investment policy that you can stick with for the long term.

Tax-efficient investing has been the subject of numerous articles, presentations, and studies during the past few years. Most have focused on after-tax performance reporting standards for separate accounts and mutual funds. The skills and knowledge required to create, implement, and evaluate a long-term tax-efficient investment strategy, however, require much more than just the ability to measure after-tax returns.

There is no question that taxes create a significant drag on a portfolio. A recent study published by Lipper, a mutual fund research company, concluded that mutual fund investors give up between 1.3% and 2.5% of return per year in income taxes, or about 23% of their total returns. Other studies have found that mutual fund management fees average 1.25% annually. It is clear that taxes are a more significant cost to mutual fund investors than are management fees (up to 2.5 percent vs. 1.25 percent annually). That makes taxes the most significant single expense for most investors. The damage escalates further when you consider how taxes affect returns over longer time frames.

Determinants to Portfolio Tax Efficiency

To create the most effective after-tax strategy, it is important to evaluate separate "pockets" of wealth and consider the role for each in the overall strategy. Consider the following:

- Asset location. Which assets are right and where should they be owned for maximum impact?
- Trust construction. How can you maximize after-tax accumulation? Beneficiary needs. How do heirs' income requirements affect decisions about funding, and how can you maximize wealth after considering estate and income tax consequences?
- Minimum required distribution (MRD) rules. How do you integrate qualified plan assets into the overall plan to maximize tax deferral?

When evaluating specific investment managers or implementation vehicles, consider the following:

- Turnover. Seek managers who minimize bad portfolio turnover, which generates income taxes, and maximize good turnover, which harvests losses to generate tax savings.
- Tax lot tracking. Look for managers who specifically identify securities by tax lots to minimize adverse income-tax consequences.
- Specific identification of securities sold. Seek out managers who identify the most advantageous securities to sell instead of using the average-cost or first-in, first-out (FIFO) method of identifying securities to be sold.
- Character of income. If a manager sells a security owned for 360 days rather than waiting until one year has passed without a compelling reason to sell, watch out. Good managers pay attention to the character of the income they generate. The combination of tax-sensitive managers with effective strategies and regular oversight from tax-aware advisers can result in additional portfolio alpha.

New Legislation = Opportunity

Legislative changes in many states, along with some new rules proposed and issued by the Internal Revenue Service, may trigger an expansion of the current investment advisory model. Some of the changes include:

- Uniform Principal and Income Act (UPIA). Many states have broadened the concept of "income" to include capital gains, which can offer tremendous opportunities to develop highly tax-efficient investment strategies.
- IRS Proposed Rules on Trust Income. IRS rule changes may recognize the changes many states are implementing in defining trust income to include capital gains. This will enable the creation of trusts that maximize long-term growth and reduce taxes on earnings.
- Minimum Distribution Rules. New rules for minimum distributions from qualified retirement plans provide more flexibility to distribute retirement plan balances over longer time periods, which increases the plan's tax deferral value. The 2001 Tax Act also raised the limits for contributions to qualified plans.
- Changes to the Estate-Tax Law. While the elimination of the estate tax may not survive the sunset provisions Congress provided, many of the increased exemption amounts in areas such as the gift tax and generation-skipping tax provisions likely will. Thus, a growing percentage of assets gifted to trusts or to subsequent generations will be assets with carryover basis for income-tax purposes. Consequently, selection of assets to fund trusts or gifts to children could take on an added significance.

Investment Strategy: The Third Dimension

Investment strategy has taken a series of unusual turns in the past five years. The great bull market led many investors to think that investing was all about return—and that anyone could do it. The past three years have led that same group to conclude that risk is the only issue, and that no one can manage it well. In fact, both return and risk are clearly important, but tax efficiency is rapidly becoming the third—and equally prominent—dimension for taxable investors. A tax-effective investment strategy should incorporate the following elements:

- An understanding of your total financial picture. Explore your entire tax profile to understand non-investment assets (such as closely held business assets), estate and charitable planning entities and their taxation, carryforward attributes such as AMT credits, capital-loss carryforwards, etc. This information should be incorporated into decisions about asset allocation and investment vehicle selection (taxable versus tax-exempt, or fixed-income, for example).
- A multi-generational approach. Since many estate-planning entities are funded during an investor's lifetime and hold assets with a carryover income-tax basis for heirs, the investment strategy cannot be separated from the estate-planning process.
- An evaluation of investment vehicles' tax-efficiency. Recent volatility has led investors to spend more time evaluating risk, which has increased interest in hedge funds and other alternative investments, which may provide higher returns but are traditionally less tax efficient. New investment products such as exchange-traded funds (ETFs) are becoming commonplace, and traditional techniques for hedging concentrated-single stock positions are evolving. All of these strategies and techniques should be considered.

Conclusion

A multi-generational, tax sensitive approach based on an all-inclusive understanding of your financial situation, needs, and goals can help to create a truly integrated, tax-efficient investment strategy that can add up to 250 basis points to the portfolio's return. More importantly, a well-crafted strategy gives you an investment policy that you can stick with for the long term—even during the most difficult market conditions.

About the Author

J. Richard Joyner, President, Tolleson Wealth Management, specializes in providing financial advice to high-net worth clients, including senior executives of major U.S. corporations and individuals from the Forbes list of the wealthiest Americans. He has contributed to numerous publications including Smart Money, USA Today, The Dallas Morning News, Southwest Airlines' Spirit Magazine, Worth, and The Wall Street Journal.

Although information and opinions expressed reflect responsible points of view, they do not necessarily represent the opinions of the IMCA Board of Directors, the IMCA staff, or IMCA members.