INVESTMENTS & WEALTH MONITOR

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The After-Tax Advisor

By David Gordon, CFA®, CPWA®

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Taxes are something of a third rail for financial advisors. We don't want to touch them because we're not professional tax advisors. But unless our clients are nontaxable pension plans or foundations, taxes impact our clients' ability to achieve their financial goals.

We cannot simply cross our fingers and hope somebody else will provide good tax advice that aligns with our investment strategy. That's too risky, both for our clients and for us.

We have to step into the tax arena. We need to become after-tax advisors. Here we address three tax tenets your taxable clients need to understand:

1. Taxes can be a client's easiest investment "fee" to reduce.
2. Asset location can be as important as asset allocation.
3. Uncle Sam can be a coach, not just a referee.

THE OPPORTUNITY

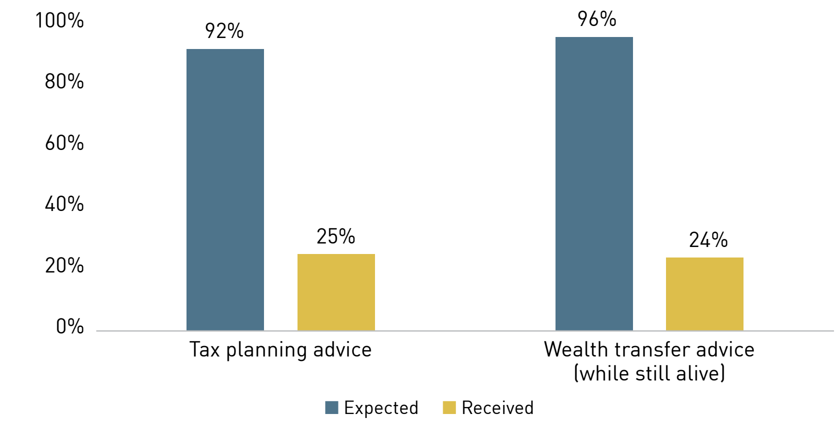
Ask yourself a few pointed questions:

- What are you doing about fee compression?
- How are you differentiating yourself from other advisors?
- How are you becoming attractive to high-net-worth (HNW) and ultra-high-net-worth (UHNW) investors?

Taxes matter. Taxes can reduce the investment return clients experience. Taxes reduce the amount of income available for your clients to spend, save, and invest.

Figure 1

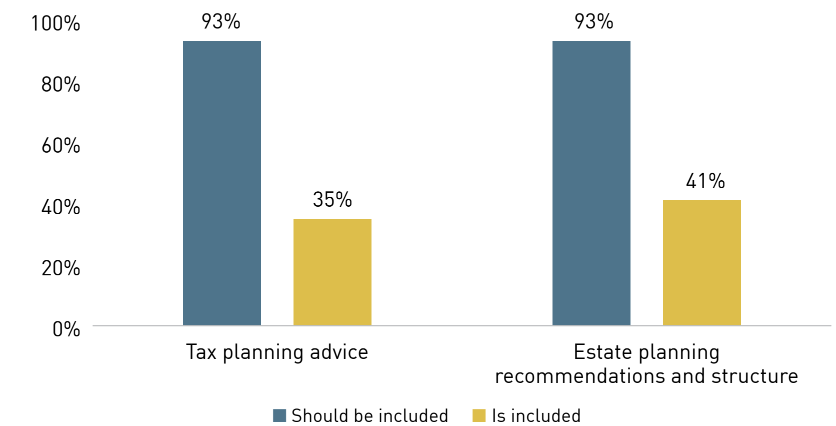
GAP BETWEEN SERVICE HNW/UHNW EXPECT FROM THEIR WEALTH MANAGERS AND WHAT THEY ACTUALLY RECEIVE



Source: Spectrem Group, "Defining Wealth Management" (2018a, p. 14)

Figure 2

GAP BETWEEN WHAT SHOULD BE INCLUDED IN A FINANCIAL PLAN VS. WHAT IS ACTUALLY INCLUDED IN A FINANCIAL PLAN



Source: Spectrem Group, "Defining Financial Planning" (2019, p. 28)

However, tax planning is an investor need that is going largely unmet by wealth managers (see figure 1). Financial planners do only slightly better in delivering the tax and estate planning advice their clients expect (see figure 2).

Increased wealth is often accompanied by increased tax complexity. Whether your clients complete their own tax returns using off-the-shelf software or hire accountants to do the work, they still want and need your help.

After Congress passed the Tax Cuts and Jobs Act of 2017, a majority of wealthy investors thought their taxes would stay the same or decrease (see figure 3). Think about your wealthier clients' actual experience upon filing their 2018 tax returns in early 2019: How many actually saw their taxes stay the same or decline? Most advisors we know report the opposite.

Whose job is it to help clients weather changes in the tax code? Professional accountants deserve to be at the top of the list, of course, but whom do you suppose clients would turn to next? You, their financial advisor (see figure 4).

That's good news for you, especially in a fee-compression environment, because clients attach more value to tax management than to almost any other service advisors provide (see figure 5).

So, what does it mean to become an after-tax advisor? What simple ideas can we incorporate into our practices so we can deliver what clients expect?

THREE TAX TENETS FOR THE AFTER-TAX ADVISOR

When it comes to tax planning for your clients, you need to think ahead—far ahead. Only then can you capitalize on opportunities to help them grow tax-smart wealth throughout the year—a key proof point of the value you provide as their advisor.

Providing year-round, tax-aware forward planning boils down to the client-specific application of a few general tenets. Because (in most cases) neither you nor your clients regularly speak in the language of the tax code, you can best communicate these tenets in your daily interactions using the normal language clients use every day. In this article, we explore three key tenets your taxable clients need to understand.

TAXES CAN BE A CLIENT'S EASIEST INVESTMENT 'FEE' TO REDUCE

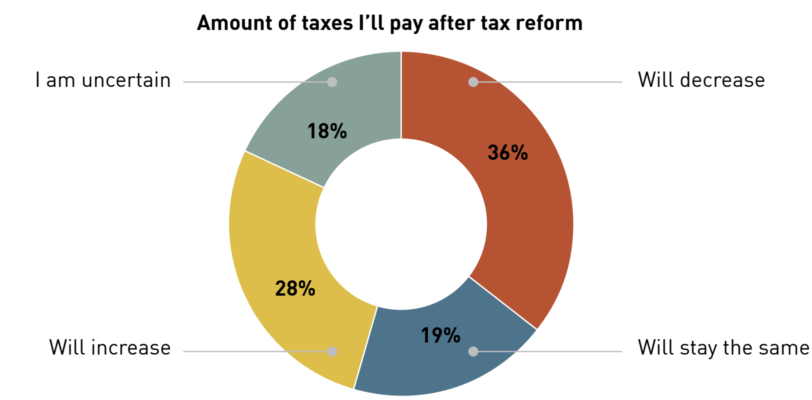
Our industry faces relentless fee pressure, and you may have clients who question every small charge or who want to bargain over basis points. It is as if they think advisor fees are the biggest drag on their investment performance. But the larger erosion of wealth, by far, occurs at Uncle Sam's hands, making taxes almost act like the largest "fee" a client typically pays. The after-tax advisor is keenly aware of the corrosive effects of taxes and earns a full-service fee by providing tax-aware investment advice.

Have you ever considered how explaining the cost of taxes puts your fee into perspective? If your fee is, for example, 1 percent, how does that compare to saving 20 percent or more through careful tax planning? What is the long-term effect of taxes on a client's returns?

Unless a client is nontaxable or invested entirely in assets generating tax-exempt income, taxes on income may reduce investment returns. Tax rates are not static, and neither are tax brackets and filing status. Many investors migrate

Figure 3

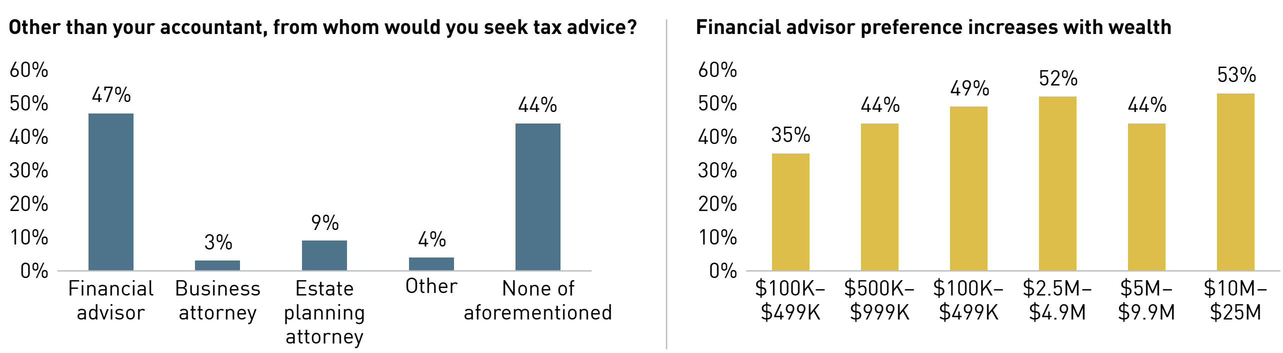
WHAT WEALTHY INVESTORS EXPECTED FROM THE TAX CUTS AND JOBS ACT (BEFORE THEIR FIRST POST-REFORM TAX FILING)



Source: Spectrem Group, "Politics, Taxes, and Investors' Changing Attitudes" (2018b, p. 19)

Figure 4

WEALTHY INVESTORS' PREFERENCE FOR RECEIVING TAX ADVICE (OTHER THAN ACCOUNTANT)



Source: Spectrem Group, "Politics, Taxes, and Investors' Changing Attitudes" (2018b, p. 19) from one filing status to another or from one tax bracket to another every few years, which can make their tax liability unpredictable.

Factor in changes in tax law and you have a recipe for tax volatility, a portion of which is illustrated in figure 6.

The implication for advisors and investors is that assumptions based on a previous year's tax experience may not be accurate for the current year. Smoothing this tax volatility is the subject of the section below.

Questions you might ask a client to stimulate discussion:

- What do you think detracts more from investment performance: fees or taxes?
- What do you think taxes cost you in investment returns each year?
- Do you typically look for ways to reduce the amount you pay in taxes each year?

ASSET LOCATION CAN BE AS IMPORTANT AS ASSET ALLOCATION

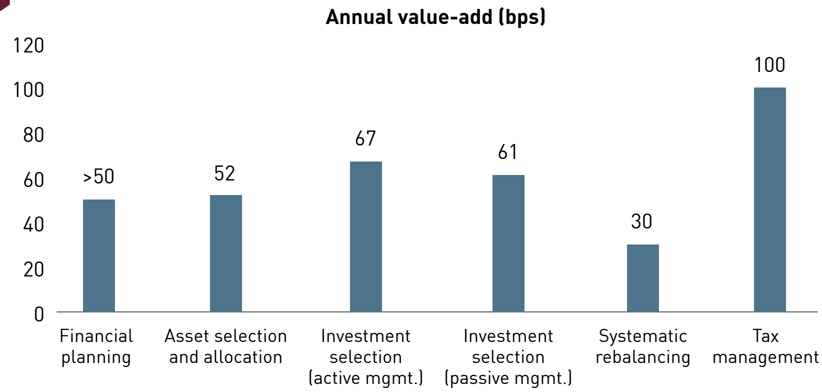
Choosing the right asset class at the right time—asset allocation—is certainly important because your return on any asset class you don't own is zero. Unless you're a big believer in market timing, you probably do what most advisors do and invest in multiple asset classes and multiple management styles so that some part of the portfolio is always doing well even if other parts are not.

In its landmark work on quantifying "advisor alpha," Vanguard estimates that asset location contributes up to 75 basis points of added value for clients (Kinniry et al. 2019; see figure 7).

Vanguard also notes that spending strategy—which is all about the tax consequences of sales and redemptions, which vary by asset location—contributes up to an additional 110 basis points. Together, that can be up to 185 basis points of added value from making good location and spending decisions.

Figure 5

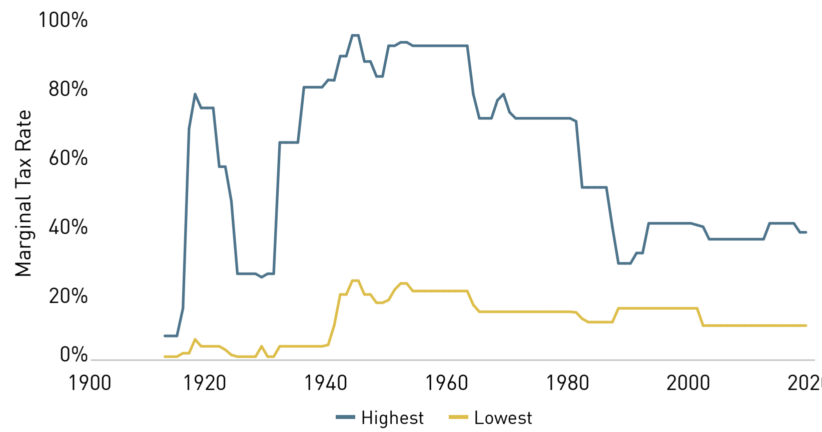
ENVESTNET PMC'S CAPITAL SIGMA BREAKDOWN



Sources: Envestnet, Morningstar, Vanguard; as cited in Envestnet PMC, "Capital Sigma: The Advisor Advantage" (2019, p. 3)

Figure 6

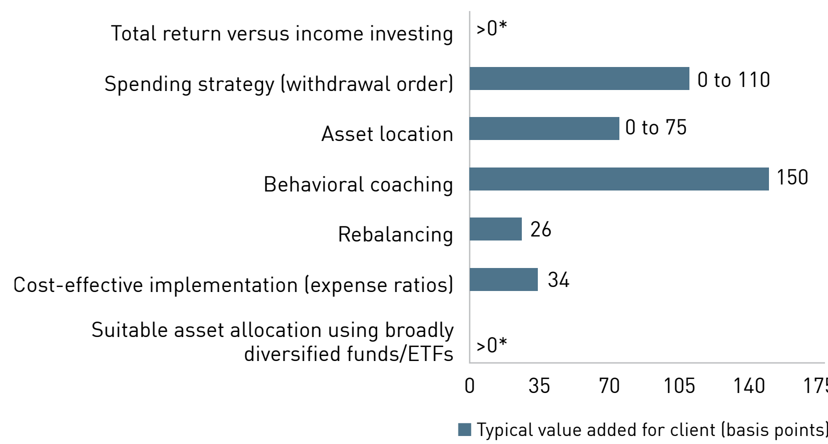
TAX VOLATILITY—HISTORICAL MARGINAL TAX RATE FOR HIGHEST AND LOWEST EARNERS



Source: National Taxpayers Union Foundation, "How Have the Top and Bottom Income Tax Brackets Changed Over Time?" (2019), https://www.ntu.org/foundation/tax-page/how-have-the-top-and-bottom-income-tax-brackets-changed-over-time

Figure 7

VANGUARD QUANTIFIES THE VALUE-ADD OF BEST PRACTICES IN ASSET MANAGEMENT



**Value is deemed significant but too unique to each investor to quantify.*
Source: Vanguard, "Putting a value on your value: Quantifying Advisor Alpha" (February 2019, p4)

Asset allocation was made much easier, in a way, by the Employee Retirement Income Security Act of 1974. Pensions were at risk of overconcentration by style, so the style box approach was born as a way of making sure pensions did not miss out on the best-performing area of the market. The style box shown in figure 8 can represent domestic equity, for example, and a pension plan might invest in each of the boxes.

Many popular approaches to diversifying sources of risk and return in portfolios trace their roots to style box diversification. Like style boxes, they can become a little lopsided over time. Prudent advisors rebalance periodically by selling some of the largest allocations—the allocations that have performed best over the past year—and moving the proceeds into one or more underperforming areas. It is an elegant solution because it puts into practice the age-old wisdom of buying low and selling high.

But there is often a catch. Rebalancing can be very costly in taxable accounts because rebalancing can trigger capital gains taxes. That's why asset location is so important for taxable investors. Vehicles that distribute capital gains each year or are used in style box allocations may be better suited for tax-deferred accounts (see figure 8).

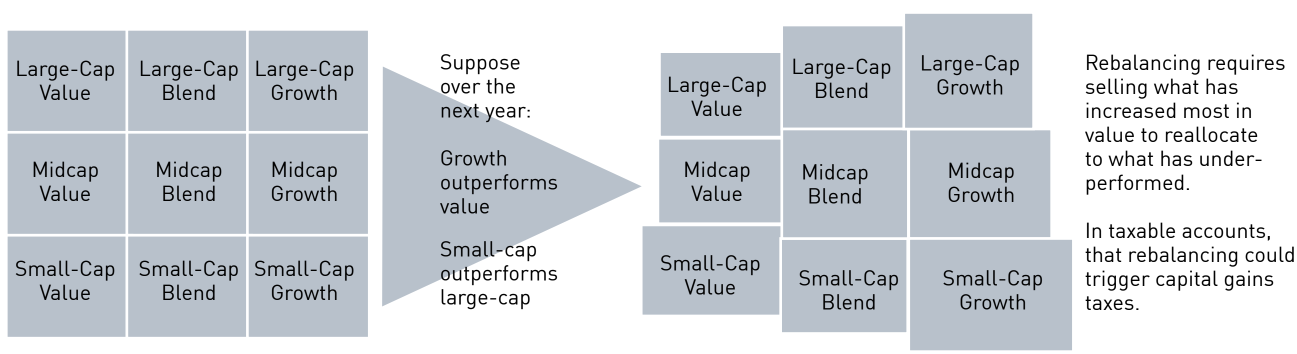
One of the first duties of the after-tax advisor is to consider asset location. Asset allocation decisions may explain the majority of a client's pretax returns, but asset location will strongly influence what remains after taxes. There are three main considerations to determining optimal asset location:

1. The type of account, for example:
   a. Tax-exempt Roth IRA
   b. Tax-deferred employer-sponsored qualified plan, such as a 401(k)
   c. Fully taxable brokerage account
2. The tax efficiency of the investment assets
3. The type and frequency of taxable events the investment(s) will experience

Location decisions, in turn, may influence investment vehicle selection. Classic examples involve the location of bond portfolios: Most municipal bonds can only benefit from their tax-free status

Figure 8

PORTFOLIO REBALANCING CAN BE COSTLY



For illustrative purposes only.

Figure 9

TAX HIERARCHY AND ASSET LOCATION

The level of taxes imposed ...	... and the type of tax ...	... suggest an asset location preference
Highest	Ordinary income Taxable interest Nonqualified dividend income	Roth IRA or Roth 401(k) Traditional IRA or 401(k)
Moderate	Short-term capital gains Long-term capital gains Qualified dividend income	Can work almost anywhere with a forward-looking, tax-aware approach, such as using capital losses to reduce taxable capital gains
Lowest	Tax-free (certain types of municipal bond income) Exchanges Charitable donations	Taxable brokerage account

outside of tax-deferred or tax-exempt retirement accounts, whereas fully taxable corporate bonds may be best positioned inside accounts that are shielded from annual taxation of income. The power of compounding is most pronounced inside tax-exempt and tax-deferred accounts because all of the annual income can be reinvested (see figure 9).

Taxes are not just an issue in portfolio rebalancing and account selection. They can also be a factor within an account by affecting strategies with high turnover (see table 1).

To address these challenges, more advisors today are structuring taxable portfolios using a core-satellite model. Core investments are strategic, long-term allocations that rarely change in weight or composition, such as domestic broad equity market exposure and municipal bond exposure. Satellites include tactical allocations to sectors, regions, styles, and alternative assets that typically are not highly correlated to the core. The core-satellite model is most effective when the core provides tax efficiency to offset the tax inefficiency inherent in tactically reallocating among satellites (see figure 10).

The after-tax advisor sees a special opportunity to communicate these benefits to the emerging wealth of Generation X and millennials. Many younger investors have enjoyed a kind of "free ride" if they have selected their own securities successfully after the Great Recession of 2008–2009. Younger self-directed investors may not fully appreciate the tax bill they will face when realizing their gains, and they may welcome the benefits of a systematic tax-loss harvesting strategy.

Questions you might ask a client to stimulate discussion:

Table 1

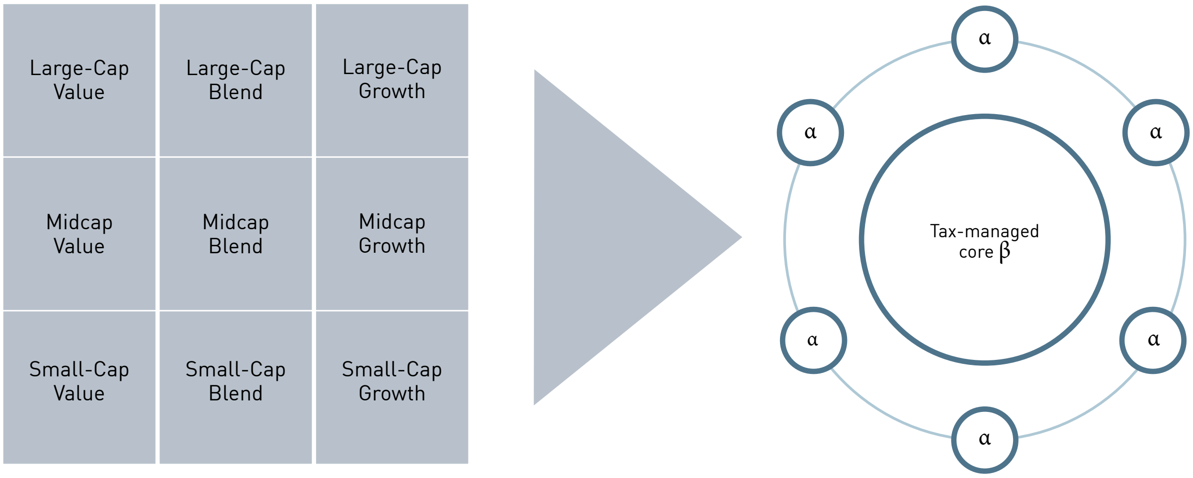
ESTIMATED ADDITIONAL ANNUAL PRETAX GROWTH REQUIRED TO OFFSET FEDERAL TAXES

Turnover	Market Growth				
	4%	6%	8%	10%	12%
5%	0.35	0.48	0.58	0.68	0.76
10%	0.61	0.84	1.05	1.23	1.39
25%	1.12	1.60	2.04	2.45	2.83
50%	1.68	2.48	3.23	3.97	4.67
60%	1.89	2.80	3.67	4.52	5.36
75%	2.21	3.28	4.33	5.37	6.40
100%	2.76	4.14	5.51	6.89	8.27

Source: Parametric, 2018. Based on the model proposed in Jeffrey and Arnott (1993). For illustration purposes only. Assumptions: Hurdle determined by setting after-tax preliquidation market value for an active manager with realized gains on turnover equal to a buy-and-hold exchange-traded fund, both gross of fees; 20-year horizon; short-term capital gains tax rate of 40.8 percent, long-term capital gains tax rate of 23.8 percent; and pro-rata gain realization (e.g., for a 50-percent turnover manager, half of Year 2 gains are short term and half are long term). A taxable investor with 50-percent annual turnover over 20 years would need pretax growth of 8.48 percent to experience the market's 6-percent growth after taxes.

Figure 10

EVOLUTION FROM STYLE BOX TO TAX-MANAGED CORE-SATELLITE IN THE PRESENCE OF TAXES



For illustrative purposes only. α indicates alpha-generating satellite investments. β indicates broad-market beta exposure.

- What do you think is more important: asset allocation or asset location?
- Do you make use of tax-exempt and tax-deferred accounts? How do you invest inside them?
- What has been your history with taxable distributions from mutual funds? From separately managed accounts (SMAs)?

UNCLE SAM CAN BE A COACH, NOT JUST A REFEREE

There are several tax filing categories. As income rises, various additional taxes kick in. Advisors should be familiar with these tax-filing categories so clients are not surprised at tax time. Do not wait until tax season to have these conversations—tax considerations require year-round diligence.

Deferring taxable events also can benefit from a reduced tax bracket, such as when a client transitions from highly compensated employment to retirement at a lower level of income. Even paying the same tax rate in the future may be preferable to paying the tax today because the time-value of money renders a unit of money, such as a dollar, less valuable in the future than it is today. Clients generally understand the corrosive effects of even mild inflation, just as they understand that they would rather retain custody of their money, with all the possibility of investment growth that ownership entails, for as long as possible.

"Realized capital gains" are gains that happen when investors sell an asset in a taxable account for more than they originally paid for it. That gain may be subject to short-term or long-term capital gains tax, depending on how much time has passed between the original purchase and the sale. If the asset is sold for less than the original purchase price, the investor may have a realized capital loss.

Most advisors are aware that investors can reduce the taxable amount of capital gains by first subtracting any unused capital losses. An investor without realized gains can even use a capital loss to shield a small amount of ordinary income from taxation, an opportunity that may be more valuable to higher-income investors. A client who has losses but no gains can carry the losses forward to one or more future tax years during which there might be gains to offset. This is known as a "tax-loss carryforward."

Beneficial tax losses are not just available in down markets, but also, perhaps surprisingly, in up markets.

Talking with clients about harvesting tax losses can go off the rails quickly because the only thing many clients hear is "loss." Different word choices can inspire more intentional outcomes. From a client's perspective, isn't harvesting a tax loss really about capturing an opportunity today to keep more of the client's money at some future tax time?

Beneficial tax losses are not just available in down markets (see figure 11), but also, perhaps surprisingly, in up markets (see figure 12). By shielding some gains from taxation, tax losses can reduce the amount of tax investors pay and increase the amount remaining in their pockets. That is when losses are gains.

Questions you might ask a client to stimulate discussion:

- What is your current tax filing status? Do you expect that to change?
- Do you plan to sell your business in the next 5–10 years? Have you planned for the large tax implications of that sale?
- Do you expect your taxable income to increase or decrease next year? By how much?

BECOMING AN AFTER-TAX ADVISOR

You can begin by addressing the concerns already discussed. Check client portfolios with an eye to asset location. Are the investment vehicles you have recommended located in the most tax-favorable accounts? What other available strategies might be appropriate for the unique tax situation of each client? Do you have all the information you need to make the most tax-optimal recommendations for each client? Can you identify and express how the changes you recommend can reduce the drag that taxes exert on portfolio performance?

Next, consider what other resources might be available to you. These could include:

- Each client's tax advisor and legal advisor
- Statements illustrating assets you do not administer, such as 401(k) plan assets or equity incentive compensation
- Expertise within your firm, such as tax advisory teams
- Expertise available from third-party solutions

Finally, consider how you will maintain this new advantage. Tax planning is not just a tax-season or year-end activity. Opportunities are available year-round, and advisors capitalize on them by thinking ahead.

YEAR-ROUND DISCUSSION IDEAS

JANUARY–MARCH

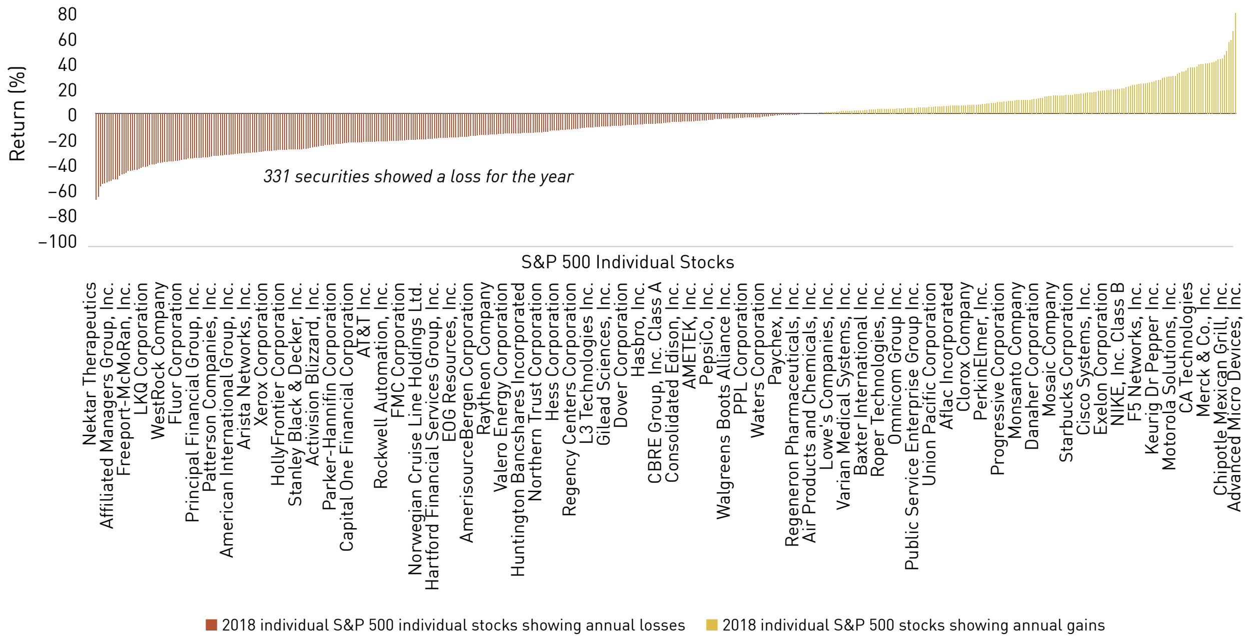
- Contact clients who receive equity incentive awards to review vesting schedules and plan for option exercise. Offer to review incentive compensation statements. Clients with incentive stock options (ISO) might wish to exercise early in the tax year because an ISO exercise is an alternative minimum tax (AMT) preference item unless the shares are disposed of before year-end. If the stock price declines during the year, a disposition before year-end could eliminate AMT concerns and capture a valuable short-term capital loss.[1]
- Contact clients' CPAs to be sure long-term assets have correct cost

Continued on page 17 →

Figure
11

BENEFICIAL TAX LOSSES CAN BE AVAILABLE IN DOWN MARKETS (S&P 500, 2018)

The S&P 500® Index returned –4.38% and 98% of the stocks in the Index experienced a maximum drawdown of 10% or more at some point during the year.

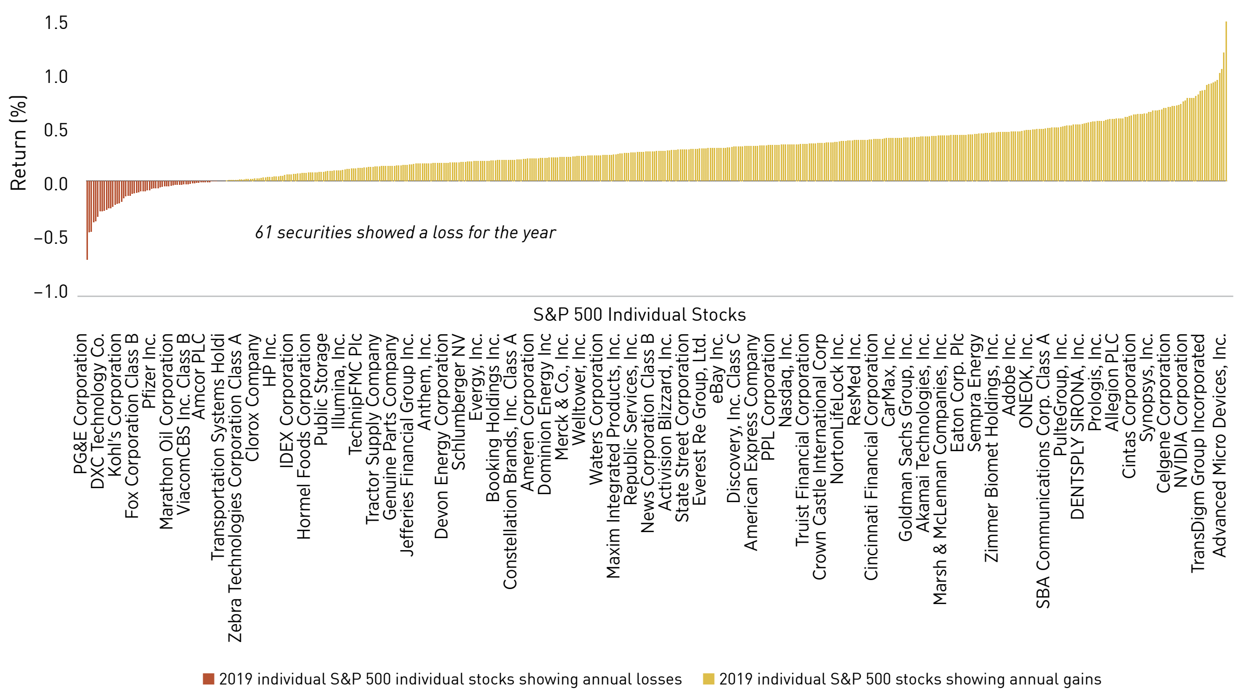


Sources: FactSet, Eaton Vance, as of December 31, 2018. For illustrative purposes. Not a recommendation to buy or sell any security. It is not possible to invest directly in an index. Past performance is not indicative of future results. 2018 was selected for presentation because it is the most recently completed negative calendar year. All investments are subject to risk of loss. Not all index constituents are named above.

Figure
12

BENEFICIAL TAX LOSSES ALSO CAN BE AVAILABLE IN UP MARKETS (S&P 500, 2019)

The S&P 500® Index returned 31.49% and 84% of the stocks in the index experienced a maximum drawdown of 10% or more at some point during the year.



Sources: FactSet, Eaton Vance, as of December 31, 2019. For illustrative purposes only. Not a recommendation to buy or sell any security. It is not possible to invest directly in an index. Past performance is no guarantee of future returns. 2019 was chosen to illustrate our observation that loss harvesting opportunities are available during years of high market returns. Actual tax loss harvesting experience may vary by account and depends on additional factors such as market return, volatility, and appreciation level of the account. Not all index constituents are named above.

THE AFTER-TAX ADVISOR

Continued from page 11

basis information. Help gather and review all tax-related forms (W-2s, 1099s, K-1s, etc.) before clients send them to their tax professionals.

- Raise questions for clients to submit to their CPAs. Identify possible planning areas to review after taxes are filed.

APRIL–JUNE

- Help clients adjust withholding to align more closely with next year's expected tax liability. Remember that clients will have only 7–8 months to make up 12 months of potential under-withholding.
- Communicate with clients' CPAs as needed.

JULY–SEPTEMBER

- Midyear evaluation and course correction (possibly combined with estate plan review):
  - Are we taking appropriate deductions? Could we improve our strategy?
  - Are there any unrealized capital losses we can capture and stockpile?
  - Is our investment income tax-efficient?
  - Are we addressing concentrations and other potential tax problems?
- Heading into elections (typically every even-numbered year), what adjustments should we make to reflect potential policy changes at local, state, and national levels?

OCTOBER–DECEMBER

- Year-end has shorter trading months due to holidays. What last-minute opportunities can we identify to reduce an anticipated tax bill before the tax year ends? Communicate any loss carryforwards to clients' CPAs.
- Help clients who receive annual bonuses before year-end pay additional estimated taxes to avoid a penalty (because most bonuses are only withheld at the supplemental income rate).
- Consider whether to sell shares obtained through an ISO exercise (if at a loss) to avoid AMT. If AMT is likely or assured, consider accelerating future ISO exercises to this year.

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ENDNOTE

1. Internal Revenue Service, Instructions for Form 6251, 2019, p.4 (Line 2i - Exercise of Incentive Stock Options).

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