## Tax-Efficient Investing Can Help Investors Stay Ahead of Pending Tax Increases

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What happens in Washington over the next four years will affect how much taxpayers can pocket from investments after taxes. In this article, we will briefly examine the budget proposal that President Obama issued in February 2009. Then we will explore an important investment category that can help investors to weather the tax storm in store for them and their advisors.

Taxes are going to increase in coming years—on that most Washington observers agree. Increased tax revenue will be needed in the years ahead to contend with a budget deficit swollen by economic stimulus measures, financial bailouts, wars, proposed new social programs, and the escalating costs of Social Security and Medicare.

### Tax Proposals

The administration’s budget makes good on President Obama’s campaign promise to retain current tax rates for families with incomes of less than $250,000 per year and to increase taxes on families with taxable incomes of more than $250,000 per year. The Obama proposal would permit the Bush tax cuts to expire in 2010 for high-income taxpayers. The top rate would increase from 35 percent to 39.6 percent; the top rate on long-term capital gains would increase from 15 percent to 20 percent; and the top rate on dividend income would increase from 15 percent to 20 percent.

Furthermore, the administration proposes locking in the 2009 estate tax rules permanently. This proposal would set the estate tax exemption at $3.5 million per person and the top estate tax rate at 45 percent. If Congress is unable to complete permanent estate tax reform this year, it likely will extend the current rules to 2010 and address a permanent solution next year.

The proposal contains bad news for some members of the middle class: It would continue the alternative minimum tax (AMT) in its current form. This tax originally was aimed at wealthy taxpayers who did not pay a fair share of taxes. Over the years, it has crept deeper into the middle class and become an important source of revenue for the government. Reforming the AMT permanently would put an additional burden on the budget and thus is unlikely to be attempted in the near future. (The Obama administration assumes that Congress will continue its annual practice of exempting from the AMT taxpayers with taxable income below about $71,000, adjusted for inflation.)

Although the president’s budget is merely a proposal, given the Democrats’ control of Congress this proposal serves as an initial blueprint. Even with changes, an increase in tax rates taking effect in 2011 is a foregone conclusion, provided the country is safely out of the recession by the time the new rates are scheduled to go into effect.

### A Solution for Taxpaying Investors

Investors need not wait for Washington’s decisions about the budget to arrange their portfolios with an eye toward reducing the effects of taxes. In fact, making adjustments now offers two types of investors—two types of funds.

**Mutual fund investors** fall into two categories—those who pay taxes on distributed income and gains and those who don’t. The latter group consists primarily of investors in qualified retirement accounts, such as individual retirement accounts (IRAs) and 401(k) plans, in which all fund returns regardless of source are tax-deferred until fund shares are redeemed. Of course, investors in qualified accounts can choose to move their assets to taxable accounts, as long as they are willing to pay any penalties and taxes caused by their exiting a qualified plan. However, according to the Investment Company Institute, over 53 percent of mutual fund assets are held in taxable accounts. Investors holding funds in taxable accounts must pay taxes on fund distributions of income and realized gains in the year the distributions are made. Because they are taxed differently, the interests of qualified plan investors and taxable investors in the same fund may not always be fully aligned. Taxable investors may be best served by investing in tax-managed funds that are managed with an objective of after-tax returns.
How Taxes Can Hurt Fund Returns

Consider this hypothetical, but realistic example. If a conventionally managed equity fund returns 10 percent in one year and derives 2.5 percent of that return from nonqualified dividend income (QDI) and short-term gains distributions, 5.5 percent from qualified dividends and long-term gains distributions, and 2 percent from price appreciation, its real return could be only 8.3 percent after federal income taxes. In other words, 17 percent of the fund’s total return could be lost to taxes. And that’s before state and local taxes.

| TAX-EFFICIENT INVESTING CAN HELP INVESTORS STAY AHEAD OF PENDING TAX INCREASES |
|---------------------------------|----------------|----------------|----------------|
|                                | Pre-Tax Returns | Tax Rate | After-Tax Returns |
| Non-QDI and Short-Term Gains Distributions | 2.5% | 35.0% | 1.6% |
| Qualified Dividends and Long-Term Gains Distributions | 5.5% | 15.0% | 4.7% |
| Price Appreciation | 2.0%* | 0.0% | 2.0% |
| Total Return | 10.0% | 8.3% |
| 17% of Total Return Lost to Taxes |

* Tax is deferred until appreciation is realized.

Source: Eaton Vance. This chart is for illustrative purposes only and uses the highest applicable federal income tax rates. State and local taxes and all taxes due upon redemption are not considered. The chart is not meant to represent or imply returns from any particular mutual fund.

immediate benefits that investors can observe under today’s tax structure. In addition to the old standbys of tax planning, such as tax-exempt income from municipal bonds and tax-free funds, investors can turn to an important class of investments called tax-efficient funds.

These funds employ a strategy that is favored by high-net-worth investors and has been practiced for decades to preserve wealth. The portfolios are managed with strict oversight of the tax implications of every transaction including the tax costs of dividends, realized short-term gains, and interest payments. In short, they take into account applicable federal and state taxes to surrender as little to tax collectors as allowed by law. These tax-efficient techniques have been refined over the years and first were adopted by retail funds launched in the 1990s.

Relatively few equity funds are tax-efficient. Most equity funds are managed to maximize pre-tax performance rather than after-tax returns. But many mutual fund investors increasingly are recognizing that a fund’s tax management can be an important contributor to their long-term success. To meet this concern, tax-managed funds are designed and managed to meet the needs of taxpaying investors. Unlike other types of equity funds, a tax-efficient fund’s objective is to maximize after-tax returns.

Tax-efficient equity funds really have a dual objective: balance investment and tax considerations. Portfolio management decisions are aligned with the perspective of shareholders who are assumed to care about both the level of the fund’s pre-tax returns and how tax-efficiently those returns are achieved.

Tax-Reduction Strategies

The following summarizes major tax-reduction strategies and the rationale for applying them to a portfolio:

1. Buy stocks for the long term, i.e., with the expectation of holding them for at least several years. This strategy can lead to a potentially low capital gains realization rate and a mix of realized gains skewed toward more-favorable long-term tax rates.

2. Generally, maintain a relatively low turnover of stocks with appreciated gains. Like the first strategy, this technique minimizes capital gains distributions and trading costs.

3. Invest primarily in lower-yielding stocks and/or stocks that pay qualified dividends, because qualified dividend income currently is taxed at long-term capital gains rates rather than as ordinary income.

4. Attempt to avoid net realized short-term gains and nonqualified-dividend income in excess of fund expenses.

5. When appropriate, sell stocks trading below cost to realize losses; realized losses can offset realized gains, thereby reducing capital gains distributions. Systematic “tax loss harvesting” provides losses that can offset capital gains taken elsewhere in the portfolio for up to seven years.

6. In selling appreciated stocks, select the most tax-favored share lots, generally the highest cost, to minimize capital gains distributions.

7. Make selective use of tax-advantaged hedging techniques to reduce risk exposure without realizing large capital gains.

A typical strategy for a tax-efficient portfolio manager is to be more patient with highly rated stocks and attempt to own them over multi-year holding periods. If the entry point was not optimal, a tax-efficient manager will
“harvest” the short-term loss and then look to buy the stock back after 30 days (the minimum period allowed to avoid a “wash sale” that would negate the benefit of the loss). Given the short-term volatility of the market, it is rare that a great five-year investment will not give an investor multiple buying opportunities.

A tax-managed strategy seeks to limit the number of taxable events within a fund’s portfolio—thereby significantly reducing the impact for investors. Using these simple techniques, a tax-managed equity fund potentially can keep 200 basis points or more per year of performance compared to a fund with a high turnover rate and no regard for tax-efficiency.

Tax-efficient investing can provide solutions to investors with a variety of tax-related concerns, such as the impact of unexpected capital gains distributions, limits on funding retirement plans, and inflation protection. Many investors in conventionally managed funds have been unpleasantly surprised by capital gains distributions (see figure 1). These investors have an incentive to invest in funds specifically structured to avoid such costly events. Retirement investors have the need to shelter assets for their post-work years but many have exhausted the funding limits of their qualified plans. With tax-efficient alternatives, they have a useful complement to 401(k)s, IRAs, 403(b)s, and other plans. For those heavily invested in municipal bonds and municipal bond funds, there is a need for capital growth to offset the effects of inflation. Historically, equities have been the ideal counterweight to inflation and many people have moved a portion of their muni assets to these funds for growth with minimal tax exposure.

Conclusion

Changes in tax rates are inevitable; it’s only the specifics that are unknown to us. Faced with this reality, investors and their advisors can begin a portfolio re-

configuration that minimizes exposure to taxes while continuing to pursue long-term growth, inflation protection, and income. By choosing funds now with managers who have the motivation and mindset to maximize after-tax returns, investors can mitigate the effect of future tax changes while also lessening the effects of current taxes. These funds monitor after-tax implications of pre-tax decisions, optimizing returns using strategies fine-tuned for the benefit of high-net-worth investors. We may be unable to influence tax policy in Washington, but investors can influence their own tax situations. It is not unpatriotic to arrange our affairs to minimize Uncle Sam’s bite.

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