Increased Tax Rates and Investment Strategy

By Peter Melcher, JD, LLM, and Robert Keebler, CPA, MST, AEP®

The American Taxpayer Relief Act of 2012 (ATRA) increased the top tax rate on dividends and long-term capital gains from 15 percent to 20 percent and the top rate on ordinary income and short-term capital gains from 35 percent to 39.6 percent. For single filers, the increased rates apply to income more than $400,000 and for married taxpayers filing jointly, to income more than $450,000.

In addition, the 2010 Affordable Care Act added a 3.8-percent Medicare surtax on the net investment income of high-earning taxpayers. This tax, which applies to gross income from interest, rents, dividends, annuities, royalties, nonbusiness capital gains, and passive activities, can increase the total tax rate to as much as 23.8 percent for long-term capital gains and 43.4 percent for ordinary income.

How do these increased tax rates affect investment strategy for high-income taxpayers? The answer is that they make tax-aware investing more important than ever. Focusing on after-tax returns will affect the following: (1) what assets are selected for a portfolio, (2) the timing of gain and loss recognition, (3) portfolio design, (4) asset allocation, and (5) asset location.

**Tax-Aware Investing**

Tax-aware investing is rapidly gathering momentum. There has been a growing realization among investors in recent years that what counts is not what you earn, but what you keep after taxes. Apelfeld et al. (1996) concluded that when after-tax returns are compared, tax-aware portfolios have a 200-basis-point advantage over portfolios that ignore taxes.

This should not be surprising. The Internal Revenue Service (IRS) takes its share off the top and taxes can make a dramatic difference in wealth accumulation over time. To illustrate, suppose that a taxpayer (T) has $100,000 to invest for 30 years. The investment will grow at a pre-tax rate of 10 percent. Table 1 compares how much T would have at the end of the 30-year period given various tax rates.

In this article we suggest the following five tax-aware planning strategies that may help investors improve after-tax returns in response to increasing tax rates.

1. **Increase investment in tax-favored assets.**
2. **Manage income, gains, losses, and tax brackets from year to year.**
3. **Consider changes in portfolio construction.**
4. **Do asset allocation on an after-tax basis.**
5. **Manage asset location.**

**Increasing Investment in Tax-Favored Assets**

Tax-favored assets could be (1) assets that produce tax-exempt income, (2) assets that are taxed at lower rates, or (3) assets that produce greater tax-deferral.

**Tax-Exempt Bonds**

Investors clearly could save on taxes by switching from taxable corporate bonds to tax-exempt municipal bonds. It is important to remember, however, that the goal is not to minimize taxes, but to maximize after-tax return. Consider the following example.

**Example 1.** Chuck, a single taxpayer in the 39.6-percent marginal tax bracket, owns $2 million in corporate bonds that pay 5-percent interest ($100,000/year). Chuck could switch to tax-exempt bonds paying 3-percent interest and avoid both income tax and the surtax. Would this be advisable?

Chuck’s after-tax return on the taxable corporate bonds is $100,000 – (0.434 × $100,000) = $56,600. This makes the after-tax return 2.83 percent. His after-tax return on the tax-exempt bonds would be $60,000 (0.03 × $2,000,000), or 3 percent. Thus, switching to tax-exempt bonds would produce a better economic result. If the tax-exempt bonds instead produced a 2.5-percent return, Chuck would be better off keeping the taxable bonds.

**Lower Tax-Rate Assets**

Following ATRA, most dividends and long-term capital gains continue to be taxed at the same rate. Moreover, dividends and capital gains on stock sales are both subject to the 3.8-percent Medicare surtax. Thus, there is no tax advantage to buying growth stocks over those that pay relatively high dividends.

On the other hand, for high-income investors, interest income is taxed at

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**TABLE 1: TERMINAL WEALTH GIVEN VARIOUS TAX RATES**

<table>
<thead>
<tr>
<th>Tax Rate</th>
<th>Final Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>$1,744,940</td>
</tr>
<tr>
<td>10%*</td>
<td>$1,326,768</td>
</tr>
<tr>
<td>20%</td>
<td>$1,006,266</td>
</tr>
<tr>
<td>30%</td>
<td>$761,226</td>
</tr>
<tr>
<td>40%</td>
<td>$574,349</td>
</tr>
<tr>
<td>50%</td>
<td>$432,194</td>
</tr>
</tbody>
</table>

* Note: The 10-percent tax rate reduces the annual growth to 9 percent after tax [10 × (1 – 0.10)].
43.4 percent while capital gains on stock sales are taxed at 23.8 percent, so stocks retain a higher percentage of their return after tax (76.2 percent vs. 56.4 percent). This makes stocks a more tax-efficient investment. Some commentators have suggested, however, that the recent tax increases could result in a moderate shift of wealth from stocks to bonds, at least until a new equilibrium is reached. The reason is that the percentage increase in the capital gains tax rate is much higher than the percentage increase in the ordinary income tax rate (58.7 percent vs. 24 percent).

**Assets that Produce Greater Tax Deferral**

In general, the lower a portfolio’s turnover ratio, the greater the after-tax returns will be. This suggests that passive buy-and-hold strategies should be employed. Tax-efficient mutual funds produce low taxes because they are managed to minimize capital gains and dividend distributions to shareholders. Index funds also reduce tax exposure because they have relatively low turnover. Exchange-traded funds (ETFs) are especially tax-efficient because they do not have to sell securities to meet investor redemptions.

It should be noted, however, that total turnover is not the best measure of tax efficiency. What counts is net turnover—capital gains that cannot be offset with capital losses. Some commentators have suggested that a portfolio with moderate turnover (e.g., 25 percent) might produce higher returns than a very low turnover portfolio provided that the gains can be matched up with losses. Such a portfolio might benefit from some active management without increasing taxes.

**Managing Gain and Loss Recognition**

This strategy involves managing asset holding periods, selling the highest-basis tax lots first (highest-in, first-out or HIFO accounting), loss harvesting, and managing tax brackets.

**Managing Holding Periods**

Long-term capital losses are taxed at a maximum capital gains rate of 23.8 percent, while short-term capital losses are taxed at ordinary income tax rates up to 43.4 percent (counting the 3.8-percent Medicare surtax). Thus, by holding assets for the long-term holding period (at least one year and one day), investors can save 19.6 percent on their tax bills. Conversely, short-term capital losses are more valuable than long-term capital losses.

**HIFO Accounting**

Investors often purchase shares of stock in a particular company over a period of time so some of the shares might have a much higher basis than others. Historically, investors generally used a last-in, first-out (LIFO) method to account for gains on the sale of stock. Assuming that stock prices were rising, this produced favorable results because the shares with the highest basis were sold first. Unfortunately, stock prices can go both up and down, making the HIFO method a better alternative now that computers are available to do the calculations.

**Harvesting Capital Losses**

Research indicates that loss harvesting can substantially increase after-tax returns. Arnott et al. (2000) conducted 400 Monte Carlo simulations on 500 stocks over a 25-year period. They concluded that the excess return from monthly loss harvesting was about 80 basis points annually and almost 2,000 basis points of alpha over the 25-year period. Loss harvesting is used commonly to reduce or eliminate capital gains realized during a tax year. In the typical situation, it is December and the investor is facing a large tax bill from assets sold at a gain during the year. To avoid this unfavorable result, the investor sells enough assets with capital losses to net out the capital gains, or at least to reduce them. Because the investor still likes the stock and only sold it for tax purposes, he waits 31 days to avoid disallowance of the loss under the wash sale rules and repurchases the stock.

Although the economic benefit of loss harvesting is substantial, it is often overstated. On the surface, it appears that the investor has created tax savings equal to the amount of the capital loss times the investor’s marginal tax rate. In reality, there is generally only a timing benefit, however. To see this, it is necessary to look at the overall transaction and not just the first step. The sale of the loss assets does create a current loss deduction, but it also gives the investor a lower basis in the replacement stock than she had in the original stock. This increases the future gain recognized by the amount of current deduction. If a significant time period passes between the first and second sale, however, the timing difference could be substantial.

**Example 2.** Alan, a high-income taxpayer, recognizes $100,000 of long-term capital gain in 2013. To eliminate the gain he sells 1,000 shares of XYZ stock with a basis of $300,000 for $200,000, recognizing a loss of $100,000. This saves Alan $23,800 in 2013 ($0.238 x $100,000).

Alan waits 31 days and repurchases 1,000 shares of XYZ stock at $20/share, giving him a total basis of $200,000 in the shares. The value of the XYZ shares
increases to $400,000 in 2017 and Alan sells the stock. Alan recognizes a long-term capital gain of $200,000 and pays tax of $47,600 (0.238 × $200,000).

If Alan had not harvested the loss in 2013 and sold the original shares in 2017, he would have recognized a $100,000 gain in 2013 and a $100,000 gain in 2017 ($400,000 – $300,000).

Assume that Alan has a 6-percent opportunity cost of capital. Combining the tax consequences for 2013 and 2017, we get the results shown in tables 2 and 3.

By loss harvesting, Alan pays $6,247 more tax in future value terms than he would have paid without loss harvesting ($53,847 – $47,600). Note that the amount of the tax savings depends on the time period between the two sales. The longer the time period, the greater the value of tax deferral will be.

Two cautions should be noted for loss harvesting. First, the investor bears the risk that the stock price will increase during the 31 days he is out of the market. Of course, the price also could drop, creating an advantage. Second, if tax rates decrease significantly in the future, the taxpayer might pay more by harvesting losses now. If tax rates increased in the future, however, loss harvesting would produce even better results.

Managing Tax Brackets
By managing income from year to year, investors may be able to avoid the 3.8-percent Medicare surtax and/or avoid having income in the top tax brackets. One way to do this is by smoothing income—moving income from higher tax years to lower tax years. For example, if an investor is currently in the 39.6-percent marginal income tax bracket but expects to be in a lower bracket after retirement, he may be able to shift current income to the retirement years by purchasing deferred annuities. He also might be able to spread out a large capital gain by using a charitable remainder trust. Finally, an investor could invest income-producing assets in whole life insurance during high income years and later take policy loans in lower income years.

Another way to avoid high tax rates is to increase deductions in high tax years. Particularly high current deductions can be created by investing in oil or gas wells, for example. The upfront costs of a well (intangible drilling costs, etc.) can produce a current deduction of up to 85 percent of the amount invested.

Portfolio Construction
Constructing a portfolio to maximize after-tax return may be quite different from constructing a portfolio to maximize pre-tax return. Brunel (1997) investigated the effects of volatility and correlation on the after-tax returns of portfolios that were rebalanced annually. He constructed four portfolios: (1) high-volatility, high-correlation, (2) high-volatility, low-correlation, (3) low-volatility, low-correlation, and (4) low-volatility, high correlation and compared after-tax returns first for portfolios that were not liquidated at the end of the test period and then for portfolios that were liquidated.

For portfolios that were not liquidated, he found that the high-volatility, high-correlation portfolio produced the highest after-tax return and that the low-volatility, low-correlation portfolio produced the lowest after-tax return. He reasoned that high volatility was an advantage because it created more opportunity for loss harvesting by creating larger gains and losses. Low correlation was an advantage because it minimized the need for rebalancing, which might create capital gains not offset by capital losses.

For portfolios that were liquidated, Brunel (1997) found the highest after-tax returns for high-volatility, negative-correlation portfolios. In this case, all gains and losses were recognized eventually, so the portfolio with the greatest potential for netting gains and losses produced the best result.

The research also suggests that a multi-manager, core-and-satellite approach can be effective in producing favorable after-tax returns. The core portfolio would be passively managed and include assets such as tax-efficient mutual funds and exchange-traded funds. The satellite portfolios, managed by other advisors, would include assets that the investor believes will produce positive alpha, such as actively managed single stocks.
Tax-Aware Asset Allocation

Research indicates that asset allocation is the most important factor in determining portfolio success (see e.g., Brinson et al. 1986). In tax-aware investing, asset allocation is done in the usual manner except that after-tax values are used for the assets instead of pre-tax values. The following simple example illustrates the concept.

Example 3. Rachel is an investor with $1 million in total assets who plans to retire in several years. She has $500,000 worth of bonds in a Roth individual retirement account (IRA) and $500,000 worth of stock in a traditional IRA. Rachel wants to have a 50/50 allocation between stocks and bonds and believes that her IRAs accomplish this result.

If she withdraws $1,000 from the traditional IRA, however, she will owe $300 in income tax and will have only $700 left to spend. In effect, she owns 70 percent of the value of the IRA and the government owns the remaining 30 percent. Thus, comparing after-tax dollars with after-tax dollars, her real asset allocation is $500,000 in bonds and only $350,000 in stocks, giving her a 59-percent allocation to bonds ($500,000 / $850,000) and a 41-percent allocation to stocks ($350,000 / $850,000).

If Rachel wishes to create a 50/50 allocation, she must increase the amount in her traditional IRA to $714,286 ($500,000 / 0.7). This will make the after-tax value of the traditional IRA $500,000 (0.7 × $714,286 = $500,000).

Similar calculations can be done with taxable accounts by factoring in unrealized gains and losses (see Reichenstein 2006).

Managing Asset Location

After the overall portfolio has been created, the investor must decide how to distribute the assets across taxable accounts, tax-deferred accounts, and tax-exempt accounts to minimize total taxes. This involves working through the following steps.

Step 1—Rank the Tax Efficiency of Each Asset in the Portfolio

Some assets are far more tax-efficient than others. At one end of the spectrum is corporate bond interest, which is taxed at ordinary income rates each year. At the other end are municipal bonds, which may not be subject to any tax at all. The basic asset-location rule in tax-aware investing is that the less tax-efficient an asset is, the more desirable it is to have the asset in a tax-deferred account. The list below provides a rough ordering of investments from least tax-efficient to most tax-efficient.

- High-yield (junk) bonds
- Real estate investment trusts (REITs)
- Actively managed stock or stock funds
- Investment-grade bonds
- Cash
- Tax-efficient mutual funds
  » Index funds
  » Exchange-traded funds (ETFs)
  » Standard & Poor’s Depository Receipts (SPIDERS)
- Passively invested individual assets
  » Precious metals
  » Raw land
- Tax-exempt (municipal bonds)

Step 2—Fill Tax-Exempt and Tax-Deferred Accounts with the Least Tax-Efficient Assets

Tax-exempt and tax-deferred accounts provide the most-favorable location for investment assets. The more tax-inefficient the asset, the greater the benefit it derives from being in these accounts, so investors should start funding with assets at the top of the list and work their way down until they reach their contribution limits. If the investor has a choice between a tax-exempt account (Roth IRA or Roth 401(k)) and a tax-deferred account (traditional IRA or 401(k)), it is probably better to transfer the fastest-appreciating assets to the Roth account because it is not subject to required minimum distributions. Moreover, contributions to a Roth IRA are generally more favorable than contributions to a traditional IRA unless the taxpayer expects to be in a substantially lower marginal tax bracket after retirement than at the time of the contribution.

Step 3—Fill Taxable Accounts

Any remaining assets are then transferred to taxable accounts. These typically will be tax-efficient assets from the bottom of the list, but if more tax-efficient assets are still available these assets might be even better because the cost of rebalancing will be lower.

Conclusion

Recent tax increases should provide further impetus for tax-aware investing. This article highlights the benefits of tax-aware investing and suggests strategies for maximizing after-tax returns.

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Endnotes

1 See Internal Revenue Code §1091.
2 A number of strategies can be used to hedge against the risk of being out of the market, but they are beyond the scope of this article.

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A Viable Alternative

By its nature, private capital investment contains a degree of risk. The returns on stocks and bonds obviously can go down as well as up. Opponents of personal accounts have suggested that this means, ipso facto, that seniors would be left in poverty. Of course, traditional Social Security is not without its own risks. Already, the Social Security system provides a rate of return well below historic rates of return from private market investment. Moreover, the system cannot pay the promised level of benefits given current levels of revenue. Because Social Security benefits are neither guaranteed nor contractual, those benefits are almost certain to be reduced in the future. Workers who chose to invest privately, rather than rely on traditional Social Security, therefore would be exchanging the political risks of an underfunded Social Security system for the market risks of private investment.

A fair comparison of actual investment returns over the past 40 years to the benefits provided under Social Security shows that a system of private investment will in fact provide significantly higher rates of return than the current Social Security system, meaning that the vast majority of younger workers would be better off switching to such a system. While there are limits to this type of analysis, it clearly shows that the argument that private investment is too risky compared to Social Security does not hold up. With Social Security running a cash-flow deficit today and facing a $25.7-trillion shortfall in the future that will make it impossible to pay promised benefits, private investment and personal accounts should be part of any discussion about reforming the troubled system.

The failure of President George W. Bush’s disastrous campaign for personal accounts is widely believed to have taken the idea off the table for the foreseeable future. None of the recent deficit commissions included personal accounts in their recommendations. However, given Social Security’s ongoing travails and the evidence that private investment provides a viable alternative, perhaps it is time to revisit such proposals.

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References


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