TIME TO BOOST YOUR PORTFOLIO'S TAX-EFFICIENCY?

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There is much speculation that the current administration will enact new tax hikes on both corporations and the wealthiest individual taxpayers. One potential scenario might be that tax legislation would roll back the 2017 tax cuts for the wealthiest taxpayers, including joint filers earning more than $400,000. In that case, the top tax brackets may again be pushed toward 40%. The value of deductions could also be cut. In addition, there is ongoing discussion about a substantial increase in the capital gains tax rate for the wealthiest taxpayers. Other potential measures could target such provisions as the step-up in basis upon death and the estate tax rate and exemption.

While there is considerable uncertainty about the exact areas to be affected, as well as the timing and magnitude of the changes, there is virtually unanimous agreement on the overall direction of taxes, and that direction is "higher." For that reason, now is a good time to assess your portfolio's tax efficiency in light of anticipated larger tax bills.

How does a portfolio get to be tax-efficient? There are a number of considerations and techniques, some of which are well known to the general investing population. For example, a tax-efficient portfolio might be invested in municipal bonds rather than taxable bonds. Index exchange-traded funds (ETFs) can be more tax-efficient than mutual funds, as index ETFs generally distribute no or limited capital gains each year. Strategies with high turnover (frequent trading, or portfolio "churn") can produce short-term gains, as opposed to long-term gains that are taxed more favorably, not to mention higher transaction costs.

In addition, portfolios can be invested in tax-aware or tax-managed equity strategies. Tax-aware strategies include actively managed strategies that constrain portfolio turnover in order to minimize short-term gains. A tax-managed strategy may be an index-like separately managed account strategy that actively pursues tax efficiency in order to lower an investor's overall tax bill. Some basic principles of a tax-managed strategy might include the following:

- Avoidance of short-term gains
- Deferral of gains
- Active tax-loss harvesting

It's easy to understand how the first two principles listed above might work. Short-term gains can be avoided by waiting to sell a stock until it is held in the portfolio for at least a year. Deferral of gains can be achieved through low turnover over time, especially if the turnover might produce gains.

The third technique, active tax-loss harvesting, can take considerably more skill but can provide a noticeable reward to the investor. The strategy may be structured to be index-like, with the goal of providing the same risk and return characteristics of an index, while owning considerably fewer stocks than the index at any given time. This allows the strategy to harvest losses while maintaining the risk/return profile of the index, ultimately producing a better after-tax return from the strategy than from the index.

Here's how it can work: Let's say a strategy is benchmarked against the Russell 1000 Index, but the actual portfolio may only own half of the total large- and mid-capitalization stocks traded. The stocks held are selected so that the total portfolio looks like and provides returns similar to those of the larger universe of stocks. For example, the portfolio may intentionally own half the stocks in all industries. The other half are used as replacements when a stock is sold to harvest losses. If the portfolio owns, for instance, Coca-Cola and not PepsiCo, and the entire beverage industry drops on some bad news, the strategy may sell Coca-Cola at a loss and buy PepsiCo, still maintaining a risk/return profile in line with the index. When the beverage industry recovers, PepsiCo is likely to recover as well. The loss from Coca-Cola can be used to offset gains elsewhere in the client's portfolio, perhaps in other asset classes. In the end, tax-managed strategies can achieve index-like returns and reduce near-term tax bills at the same time.

Tax-managed strategies aren't for everyone. First of all, the portfolio must be large enough to hold a considerable number of stocks in order to maintain the profile of the index. Also, it's best to fund the portfolio with cash, or with other stocks that have an unrealized loss or a stepped up cost basis—you certainly wouldn't want to be forced into selling stocks at a gain in order to fund a tax-managed portfolio. Also, an investor would want to be able to offset other gains in the investor's total portfolio in an effort to optimize the advantage of the harvested tax losses.

It is important to note that many strategies advertised as "tax managed" may not have all the bells and whistles. Some may only limit turnover. On the flip side, a robust offering should be able to track individual tax lots so that there is more flexibility in taking losses. Also, it would be important to be able to avoid wash sales in connection with stocks in other parts of the investor's portfolio.

Clearly, a tax-efficient portfolio can reap benefits to the investor. Gains that are offset or deferred for five or 10 or more years can allow greater compounding of the portfolio and increase an investor's wealth.

Clients who wish to discuss employing more tax-efficient strategies on their investment portfolios are welcome to reach out to their Commerce Trust Company wealth management advisors.

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