You Don't Have to Pay Taxes

While taxes are a natural by-product of the investment process, they have a material impact on the investor's experience and deserve constant consideration by asset managers and their clients. Taxes can be managed; taxes should be managed.

Clients typically meet with their Advisors in January/February and review the performance of their portfolios for the previous year. The Advisor will often measure account performance on absolute and relative bases but there may not be enough data to draw informed conclusions on the performance in the account(s). What about taxes? How did they impact returns? While not an issue in retirement accounts (until making distributions in anything but a Roth IRA/401k) taxes are a drag and must be accounted for.

Consider the following three hypothetical scenarios for equity portfolios where an investor pays 45% federal/state tax on income (which includes short-term capital gains) and 25% federal/state tax on long-term capital gains.

- **Manager A (Short)** - *all realized gains are short-term; all dividends are non-qualified*
- **Manager B (Long)** - *all realized gains are long-term; all dividends are qualified*
- **Manager C (Deferred)** – *has no realized gains; all dividends are qualified*

Each Manager's portfolio appreciates by 6% and yields 2% in dividend income. Starting with a balance of $3,000,000, the appreciation of $180,000 and income of $60,000 result in a year-end balance of $3,240,000[1].

($ Thousands)	**Manager A (Short)**	**Manager B (Long)**	**Manager C (Deferred)**
December 31st Statement	**3,240**	**3,240**	**3,240**
Less: Capital Gains Tax	(81)	(45)	(0)
Less: Income Tax	(27)	(15)	(15)
Equals After-Tax Value	**3,132**	**3,180**	**3,225**
After-Tax Return	*4.4%*	*6.0%*	*7.5%*

The December 31st statements would all (correctly) reflect account values of $3,240,000 in each of the above…but, after taxes are considered, investors with these three managers had different experiences. Consider a client with Manager C. While she started with the same balance as the client with Manager A and had the same pre-tax return, the client with Manager

[1] For more detail on the calculations, please see the table at the end.

C ended up with $93,000 more[2]. And that's just after one year…what about the long-term implications? The compound effect of annual, after-tax differences like the above would make a meaningful impact on an investor's portfolio; over ten years, Manager B's portfolio would be worth over $750,000 more than Manager A's[3]. When the client meets with each of the managers, the performance is identical on a pre-tax basis but what they end up is very different. The differences can be explained by the following:

- Investors don't pay taxes on portfolio gains, they pay taxes on realized gains

- Short-term gains have holding periods of one-year or less and are taxed as income (in these scenarios at an average rate of 45% which is a reasonable estimate for those in the highest tax brackets that live in states with an income tax); long-term gains have holding periods of more than one year and receive relatively favorable tax treatment (in these scenarios at an average rate of 25%, also a reasonable estimate for those in the highest tax bracket living in states with an income tax.)

- Non-qualified dividends are taxed as income (at 45% in the scenarios) and qualified dividends are taxed like long-term capital gains (at 25% in the scenarios). While the difference between qualified and non-qualified dividends can be complex, at a high level, qualified dividends are paid by US companies, have certain holding period requirements and do not come from Real Estate Investment Trusts or Master Limited Partnerships (please consult your tax advisor for more detail).

For many managers, the biggest difference between their solutions for taxable and tax-exempt/deferred investors is the use of municipal bonds instead of taxable bonds. The industry can do better on this front. Given the advantages illustrated above, a manager can materially improve client outcomes by being mindful of short-term versus long-term gains and qualified versus non-qualified dividends. *(There is also real value in realizing short-term losses and deferring gains which we will explore in a future blog entry.)*

The higher the tax bracket, the bigger the tax impact. For most people, the bulk of their assets are in retirement accounts so the illustrations/points above don't have a significant impact. However, for High Net Worth clients, the marginal tax rate is higher and the bulk of their assets are in some form of taxable account so the subject is very relevant. It's interesting to note that I don't recall ever being asked about my firm's turnover and tax efficiency in the sixteen years I've been in wealth management. Investors seem to think taxes are an inevitable outcome. Look beyond the "headlines" and understand the numbers. Investors simply can't evaluate their advisors/managers until they have a complete picture – and that won't be until they can assess the tax bill their advisors/managers generated. Ask your Advisor to calculate your after-tax, net of fee returns; they have the data, you deserve the answer.

It's not what you make in your portfolio; it's what you keep that matters. At 7258, our clients experience the difference.

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[2] Taxes cannot be deferred in perpetuity; the purpose of this illustration is simply to underscore the need for investors to understand the tax implications of returns.

[3] $3,000,000 compounded at 4.4% over ten years would grow to $4,614,517; $3,000,000 compounded at 6.0% over ten years would grow to $5,372,543.

Calculation Details

($ Thousands)		Manager A (Short)	Manager B (Long)	Manager C (Deferred)
	January 1st Value	**3,000**	**3,000**	**3,000**
Plus: 6% Appreciation	Short-Term Realized Gains	*180*	*0*	*0*
	Long-Term Realized Gains	*0*	*180*	*0*
Plus: 2% Dividends	Non-Qualified Dividends	*60*	*0*	*0*
	Qualified Dividends	*0*	*60*	*60*
	December 31st Statement	**3,240**	**3,240**	**3,240**
Less: Taxes	Short-Term Capital Gains Tax	*(81)*[4]	*0*	*0*
	Long-Term Capital Gains Tax	*0*	*(45)*[5]	*0*
	Income Tax on Non-Qualified Dividends	*(27)*[6]	*0*	*0*
	Income Tax on Qualified Dividends	*0*	*(15)*[7]	*(15)*[8]
	Equals After-Tax Value	**3,132**	**3,180**	**3,225**
	After-Tax Return[9]	*4.4%*	*6.0%*	*7.5%*

- **Manager A (Short) -** *all realized gains are short-term; all dividends are non- qualified*
- **Manager B (Long) -** *all realized gains are long-term; all dividends are qualified*
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[4] $180,000 Short-Term Capital Gain multiplied by a Federal/State Income Tax Rate of 45% = $81,000
[5] $180,000 Long-Term Capital Gain multiplied by a Long-Term Capital Gains rate of 25% = $45,000
[6] $60,000 of Non-Qualified Dividends multiplied by a Federal/State Income Tax Rate of 45% = $27,000
[7] $60,000 of Qualified Dividends multiplied by a Federal/State Income Tax Rate of 25% = $15,000
[8] $60,000 of Qualified Dividends multiplied by a Federal/State Income Tax Rate of 25% = $15,000
[9] (After-Tax Value Minus January 1st Value)/January 1st Value