INVESTMENT-RELATED TAX SERVICES

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With an increase in the marketing of investment services—including tax planning—by private bankers and brokerage firms to high-net-worth individuals, CPAs and tax lawyers are at risk of losing some of their best clients. The question is how to prevent this from occurring.

The Threat: Private Bankers and Brokerage Firms

Financial brokers have been offering additional products specially designed to target high-net-worth clientele. In general, a high-net-worth individual is considered a prime target when assets reach the $10 million range, and might be targeted with as little as $500,000. Major financial institutions offering expanded brokerage services (private banking) are listed in the *Exhibit*.

Private banks and brokerage firms have shown an increased interest in offering new products because of the potential for sizable fees. Generally, an annual fee of 1–2% of the account's assets applies. Additional charges also apply and are often hidden. Fees in general are highly negotiable.

At the higher end of the fee range, a client gets personal attention and expanded investment advice. Tax services are often a critical selling point, and this is a direct threat to tax professionals that service high-net-worth clients. Tax planning can range from estate and charitable planning to suspect offshore accounts and hedge funds.

Bank customers often fail to realize that investment fees are subject to numerous deductibility limitations. Proper tax planning can help preserve more of the tax benefits of these fees. More importantly, tax professionals can help investors avoid both these excessive fees and the inherent conflict of interest they create.

Questioning Excessive Fees

Individuals that deduct high investment fees will increase the likelihood of an audit. Tax professionals that fail to fully disclose not only do their clients a disservice, but also fail to meet their professional obligation. Given current market conditions, the trade-off between fees and performance is likely to be more acute.

Comparing the performance of index funds to managed funds highlights the impact of fees on total performance. As of November 2001, low-cost index funds were outperforming most managed funds since September 21, 2001. Many investment advisors, however, contend that managed funds have significant advantages in down markets. But over the long term, an index fund's annual fee of 0.28%, compared to a managed fund's fee of 1.42%, means that managed funds have an inherent cost disadvantage. In addition, index funds have considerable built-in tax efficiencies; this alone can have critical investment ramifications.

Many tax professionals are reluctant to encroach on an investment advisor's business; however, ongoing market conditions will force a discussion of the issues. It is not unusual for investment advisors to recommend that a client take aggressive and sometimes incorrect positions on a tax issue, meaning that many tax professionals will be forced to address this somewhat awkward situation. Nevertheless, it offers an excellent opportunity to market additional services in an area that has high fee potential.

Marketing Expanded Tax Services

Tax professionals attempting to expand into investment advising can use this typical tax situation to their advantage. Even tax professionals not looking to expand into investment services can use it to engage the client in more frequent tax planning. CPAs can offer complete objectivity, independence, neutrality, and tax competence in this process. If a strict, no-commission fee policy is maintained, tax professionals are in a superior position to offer advice over commission-based brokers.

Evaluating the full impact of brokers' collar recommendations (where a taxpayer sells a call option and buys a put option with a lower strike price) is one situation where independent tax professionals need to guard their clients' interests. For clients with most of their net worth invested in one stock, a collar may be advisable. However, there are significant downsides, and a broker trying to sell this product may not be inclined to inform the client of the potential problems. A tax professional, however, can be of invaluable assistance in the process. A taxpayer is often sold this multi-year product on the basis that it has no direct, upfront cost. Although no money changes hands initially, the strike prices at which the collar is exercised are negotiable, effectively resulting in a fee.

For example, take an individual with most of her wealth in one stock. When

EXHIBIT
MAJOR INSTITUTIONS OFFERING BROKERAGE SERVICES

Private Wealth Providers	Assets Under Management	Minimum Account	Median Account	Clients Per Manager	Contact
Merrill Lynch	$900B	$1M	$8M	275	(800) MERRILL
Fidelity	369B	0.5M	0.9	200–400	(800) FIDELITY
Goldman Sachs	200B	25M	*	*	(800) 323-5678
J.P. Morgan	225B	25M	100M	50	(212) 464-1555
Bank of America	119B	1M	*	*	(800) 863-9500
Morgan Stanley	100B	10M	*	30	www.morganstanley.com/pwm
Wells Fargo	76B	0.5M	*	125	(800) 981-9063
Mellon Private	76B	1M	5M	75	(800) 867-4010
US TRUST	60B	2M	7M	*	(800) USTRUST
Credit Suisse	60B	1M	2.5M	75	(212) 892-8255

Source: Barron's Online, November 5, 2001 (some numbers are estimates).
** Not reported.*

Editor:
Melody Wachtel
The CPA Journal

the stock is trading at $100, a collar is placed. If the stock falls below $90 (put price), the investor is protected (in essence, selling at $90). If the stock goes above $145 (call price), the stock is called away (in essence, selling at $145).

One major tax issue is that the collar is potentially subject to short-term capital gains treatment. Strike prices also contain hidden and often undisclosed fees. If an investor decides on a collar, then one should negotiate these prices aggressively by contacting several brokers. There are other alternatives, ranging from using regular put options or forward contracts, to simply selling part or all of a position, which usually results in favorable long-term capital gains treatment.

The full and independent assessment of a collar is only one example of how tax professionals can participate in planning. Tax professionals can offer high-net-worth individuals services ranging from independent evaluations of potential investment products to many of the services that private bankers provide.

Competitive Advantage

Tax professionals have several easily exploitable marketing opportunities. For example, when tax returns are prepared, the tax professional can initiate a serious discussion about the tax implications of various investment scenarios. Tax professionals can follow up the annual tax process with more frequent tax and investment discussions.

Recommendation

High-net-worth taxpayers generally make quarterly estimated tax payments. A policy of making quarterly tax payment reminder calls to clients can lead to more aggressive tax planning, as well as expanded engagements for the tax professional.

Investment fees are subject to an array of regular and Alternative Minimum Tax (AMT) rules. Appropriately trained tax professionals can offer alternatives to individuals considering the use of a private banker. Services can range from simply negotiating lower fees, to actually competing with private bankers and brokerage firms. These private bankers and brokers may be selling products that do not benefit their clients. While a good broker is generally worth the fee, the expenses become harder to justify as they increase. Additionally, the broker relationship contains many inherent conflicts of interest. CPAs and other tax professionals, such as lawyers, can offer greater professionalism. The fee environment means tax professionals can not only protect their tax planning and compliance practices, but also expand their practices by offering investment-related services to high-net-worth individuals. ❑

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