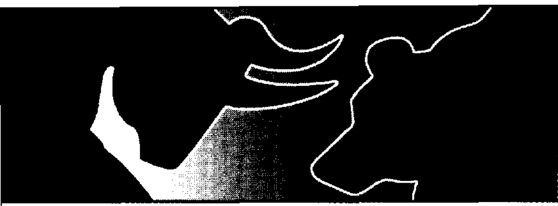

Investments

Charles P. Boinske, CFA

Taxes: Much More Than Meets the Eye

Coauthors of this column are Daniel J. Esquirell, James D. Brown, and Thomas C. Post.

The tax-filing season is, unfortunately, the only time of year that many Americans pay much attention to taxes. Many investors with sizable portfolios pay more taxes than necessary, primarily because of their (or their adviser's) lack of understanding of the complexities of the tax code or because they are following the "exciting" stock-of-the-day forecasts rather than focusing on "boring" concepts like tax-efficient investing. While the majority of affluent Americans recognize the need to carefully prepare their tax returns, far fewer recognize the need for a professional to manage the tax liability associated with their investment portfolios. The primary reason your clients should carefully consider taxes in their investment decisions is that they'll be wealthier if they do!

After-Tax Returns

The marketing "gurus" of the investment world do not pay much attention to after-tax returns. Given the lack of education and direction on these matters, individual investors, in turn, have been slow to understand and demand information regarding the taxation of their investments. The returns that are advertised and the incentives given to money managers are rarely on an after-tax basis. But they should be. After all, it's what they keep that matters most. While pension plan monies have dictated most of the investment "product" development over the years, individual taxable monies have grown and will continue to grow at a faster rate, thereby finally capturing the attention of Wall Street's selling prowess. While the financial services industry is still dominated by marketing machines that try to pitch products rather than provide objective, wealth-enhancing advice, there have been significant improvements in the availability of tax-efficient investment vehicles in recent years. Examples of these improvements can be seen in the increasing number of separate accounts and mutual funds dedicated to tax-efficient strategies.

Recently, even the Securities and Exchange Commission (SEC) has gotten into the act by requiring investment managers to report both before- and after-tax returns in their prospectuses and annual reports stating, "We are concerned that the millions of mutual fund investors who are subject to current taxation may not fully appreciate the impact of taxes on their fund investments..." In our view, this is quite an understatement considering that the SEC also states "...it is estimated that investors in diversified U.S. stock funds surrendered an average of 15 percent of their annual gains to taxes."

To illustrate the point, an investor with $1,000,000 in taxable assets and a 10 percent annualized pretax return would have generated roughly $1,600,000 in investment earnings over 10 years. However, after paying the typical 15 percent in taxes, the portfolio would increase in value by only approximately $1,250,000 or 8.5 percent. Our experience has shown that building and managing a tax-efficient portfolio will allow such a portfolio (with the same 10 percent annualized pretax return over 10 years) to increase in value by approximately $1,500,000, thereby only giving up 5 percent to taxes. In essence, an investor can choose to pay the tax later and continue to generate investment returns on this deferred tax money. As Figure 1 illustrates, this makes a huge difference in the expected growth of one's portfolio.

Following are several strategies that have proven to be effective at increasing after-tax investment returns.

Tax Deferral

One way to generate higher after-tax returns is to defer paying tax on portfolio gains for as long as possible. Investments in qualified retirement plans like 401(k)s and IRAs have this powerful benefit built in, because taxes are not levied until the money is withdrawn from the account. Table 1 illustrates how deferring taxes creates greater wealth.

Most investors are familiar with the power of tax deferral as it relates to retirement accounts. Far fewer understand that the tax benefits of qualified retirement accounts can be simulated to a certain degree in taxable accounts through the selection of tax-efficient investment vehicles and loss harvesting.

Loss Harvesting

It is financially beneficial to accelerate deductions and postpone income

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when possible. The process to accomplish this in an investment portfolio is called loss harvesting. This entails selling investments that are at a loss and investing the proceeds into a similar investment. Swapping from one large growth stock selection to another, for example, will not change the overall structure or allocation of a portfolio and has nothing to do with market timing. It is simply an intentional decision to use the tax benefit of the loss as either a current or future reduction in taxes. It is rooted in the concept of the time value of money.

The financial benefits of loss harvesting are huge. Most academic studies estimate that disciplined loss harvesting of a portfolio will add 40 to 50 basis points **per year** (.40 percent to .50 percent) to the expected after-tax return of the portfolio. In spite of the evidence, many wealth managers are not actively pursuing this strategy. In fact, many are not even familiar with it.

Even if they are familiar with loss harvesting, many investors (including professionals) are reluctant to realize losses because of the emotional stress and the belief that unless you have gains to offset the losses, it doesn't make sense to continue to loss harvest. A taxpayer can deduct net capital losses of up to $3,000 per year against ordinary income. But what if an investor has losses far in excess of $3,000? Does it still make sense to harvest these losses? The answer is clearly yes. For example, an investor with a $1 million portfolio who has net realized losses of $50,000 in 2001 could only deduct $3,000 in 2001. But the excess loss of $47,000 **can be carried forward indefinitely** to offset gains to be taken in future years. It may not take very long to use up the tax loss carryforward, as the portfolio only has to increase in value 4.7 percent to create the $47,000 in gains that could be utilized to offset the losses. Clearly individuals who invest in stocks can and should expect their portfolios to gain significantly more than this over the years.

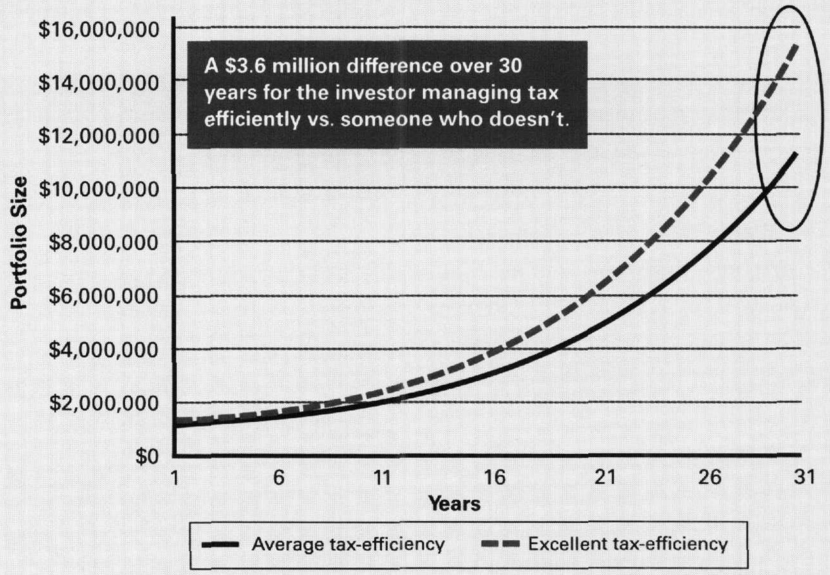
Tax-Efficient Investment Vehicles

Over the past couple of years much attention has been focused on the tax inefficiency of mutual funds as they are required to pass on the capital gains and dividend income they produce each year. In large part the criticism aimed at the typical mutual fund is fair, given that most equity mutual fund managers are not seeking tax efficiency. Their focus is on pretax return. The result is often unpredictable taxable distributions that serve only to increase the tax bill of the shareholders. Mutual funds that are not tax-sensitive should not be considered for taxable accounts. The tax burden of such investments cannot be justified, considering that tax-sensitive investment vehicles now exist that generate similar investment returns while reducing the current taxes. Table 2 illustrates the huge difference in taxes paid (for a starting portfolio of $1,000,000) between a tax-sensitive equity portfolio and the typical equity portfolio. Over a 10-year period, the typical portfolio would pay over $115,000 more in taxes than a portfolio managed for tax efficiency.

With this in mind, investors should seriously consider passively managed investments (commonly known as index funds) for their taxable accounts.

FIGURE 1

The Impact of Taxes on a Portfolio



Passively managed investments usually try to replicate the performance of a specific index (such as the S&P 500, Russell 2000 etc.). The passive approach generally has far less trading activity, and therefore, far smaller capital gains distributions. The best measure of trading activity is the portfolio turnover rate. A portfolio with a turnover rate of 100 percent means that the average stock is held for one year, a 50 percent turnover rate means that stocks are held an average of two years. Amazingly, according to Lipper Inc., the average portfolio turnover for domestic equity funds is 113 percent! So, the average fund holds its stocks for less than a year.

TABLE 1

The Power of Tax Deferral
(starting value of $1,000,000, 10% pretax return, and 30% tax rate)

Years	Value If Currently Taxable	Value If Tax-Deferred
10	$1,967,151	$2,115,620
15	$2,759,032	$3,224,074
20	$3,869,684	$5,009,250
25	$5,427,433	$7,884,294
30	$7,612,255	$12,514,582

Asset Placement

Another key element to minimizing the erosion of wealth due to taxes is asset placement. Asset placement deals with the issue of where to hold the various components of a portfolio. For example, is it better to hold the fixed income allocation in a taxable or tax-deferred retirement account? This issue demands a thorough understanding of the differences in taxation between retirement accounts and taxable accounts. Retirement accounts have the advantage of tax-deferred growth, but the withdrawals from retirement accounts are taxed as ordinary income (with federal rates up to 38.6 percent currently). Taxable accounts must pay taxes on interest, dividends, and realized gains each year, but long-term realized gains are taxed at lower rates (with federal rates up to 20 percent currently). Taxable accounts also benefit from the possibility of a stepped-up cost basis upon death, meaning unrealized gains would never be taxed.

Elements such as age, time until retirement, cash flow projections, taxable income, and purpose of the portfolio all factor into the issue of asset placement. A related issue is where to withdraw funds when they are needed in retirement. In general, it is best to wait as long as possible to tap retirement accounts.

Investors sometimes wrongly conclude that they must have an income stream equal to the withdrawals they are making in an account from which they are withdrawing funds. Not only is it not

TABLE 2

Taxes Paid: Efficient vs. Average Portfolios

Year	Taxes Paid by Typical Portfolio	Taxes Paid by Tax-Efficient Portfolio
1	$14,000	$6,000
2	$15,204	$6,564
3	$16,512	$7,181
4	$17,932	$7,856
5	$19,474	$8,594
6	$21,148	$9,402
7	$22,967	$10,286
8	$24,942	$11,253
9	$27,087	$12,311
10	$29,417	$13,468
Cumulative Totals	**$208,683**	**$92,916**

Table 2 Assumes:

- a 10% portfolio return for both portfolios with a 2% dividend yield and 8% capital appreciation
- half the capital appreciation is paid out to shareholders each year in the typical portfolio
- the tax-efficient portfolio pays out no capital gain distributions
- capital gains taxed at 20 percent and dividends at 30 percent

Conclusion:
The tax-efficient investor has saved $115,767 more money than the typical (tax-inefficient) investor.

necessary to match a portfolio's income to the withdrawals, but the income that is part of the portfolio need not be in the same account from which the money is being withdrawn. For example, an investor who needs to withdraw $50,000 per year from a taxable account may best be served with a taxable account that is all equities, which produces very little income. The $50,000 can be raised in a tax-efficient manner through sales of securities at a loss or those in a long-term gain position where tax rates will be only 20 percent or less, as opposed to ordinary income with tax rates up to 38.6 percent. The **overall portfolio** will still be managed to maintain the appropriate asset allocation target. The fixed income component may be better invested in a retirement account where the interest is not currently taxed.

Estate Taxes

Another area needing careful consideration is estate planning. The Economic Growth & Tax Relief Reconciliation Act of 2001 brought sweeping changes to the estate tax code. The good news is that the amount a client can leave to his or her heirs free from estate tax has increased, while the top estate tax rates have decreased. The bad news is that the tax structure changes frequently over the next decade, which will require many to revise their estate plan several times. Congress chose to set up a tax matrix that changes every few years until 2009, repeals the estate tax altogether for 2010, then returns us to the present for 2011 and beyond (see Table 3). Undoubtedly, at some point in the next decade Congress will again tackle the estate tax structure.

These changes will allow many more Americans to escape the "death tax" altogether. With good planning, a married couple can now shield up to $2 million from this lofty tax. The changes should also impact the way many look at gifting (now up to $11,000 per year per person) as well as the titling of assets. Credit shelter trusts (which generally transfer an amount equal to the estate tax exemption amount from personal assets into a trust) should also be reviewed given the sweeping and ongoing changes in the estate tax system.

Is It Getting Simpler Yet?

With The Economic Growth & Tax Relief Reconciliation Act of 2001 we weren't insulted with the legislation being called "The Tax Simplification Act of 2001," as was the case with several previous tax law changes. We all know that the tax system is now more complex than ever.

A few of the recent tax changes actually make life easier though, and have also provided more opportunity for tax deferral. One significant improvement can be seen in the calculation of required mandatory distributions (RMD) from IRA accounts. IRA accountholders are required to begin taking withdrawals by April 1 of the year following the year in which they turn age 70½. Prior to 2001, there was a complex maze of rules and choices to sort through. The selection of IRA beneficiaries also figured into the old RMD calculation. The new RMD guidelines allow everybody to use a simple table that generally requires significantly smaller distributions to be made. (The only exception is a married person with a spouse who is more than 10 years younger.) Congress has also requested the IRS to update the life expectancy tables, which are nearly 20 years old. In addition, the selection of beneficiaries no longer impacts the RMD.

These changes will allow people to keep IRA assets within the tax-deferred IRA account for a much longer time. In

TABLE 3

Revised Estate Tax Matrix

Year	Estate Tax Exemption Amount	Top Estate Tax Rate
2001	675,000	55%
2002	1,000,000	50%
2003	1,000,000	49%
2004	1,500,000	48%
2005	1,500,000	47%
2006	2,000,000	46%
2007	2,000,000	45%
2008	2,000,000	45%
2009	3,500,000	45%
2010	Tax repeal	0%
2011	1,000,000	50%
2012	1,000,000	50%

addition, now it's easier for beneficiaries of IRA accounts to withdraw the assets based on **their** life expectancy. This may allow for the IRA assets to remain tax-deferred for many decades (which is referred to as a *stretch-out IRA*). This is a very significant wealth preservation and transfer issue.

Thus, focusing on after-tax returns, maximizing tax-deferral opportunities, utilizing loss-harvesting techniques, identifying tax-efficient investment vehicles, determining optimal asset placement strategies, and staying abreast of estate tax law changes are *all* absolutely critical for the investor interested in comprehensive wealth management. In many, if not most cases, the combination of these tax-related issues is more important to building wealth than the Wall Street-induced focus on investment returns. The "cost" of not addressing each of these areas is far more than most understand or have been led to believe. It is the equivalent of playing good defense in sports. Professional wealth management allows the client's resources to be deployed as efficiently as possible, with an eye toward preserving the client's wealth from the erosive power of taxes. ■

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Mr. Boinske is a pioneer and a nationally recognized expert in the application of Monte Carlo simulations to retirement planning and other complex financial issues. He has published articles and spoken at industry conferences on the subject. He is a member of the Financial Analysts of Philadelphia, the New York Society of Securities Analysts, the Association of Investment Management and Research, and the NASD Board of Arbitrators. He earned a BS in economics from the Pennsylvania State University in 1984 and received the designation of chartered financial analyst in 1994. Mr. Boinske can be reached at cboinske@independenceadvisors.com.

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From Kidder Peabody, Mr. Brown moved to The Vanguard Group, where he was director of corporate asset management. He created a national initiative, concentrating on consulting with existing institutional pension clients on their corporate investment needs.

Prior to founding Independence Advisors, he was president of an investment advisory firm that manages individual portfolios for high-net-worth individuals.

Mr. Brown received his undergraduate degree in psychohistory from Denison University and his masters in education administration and counseling from Fairfield University. He is a member of the Financial Planning Association, Institute for Certified Investment Management Consultants, and former Institutional Advisory Board member, Charles Schwab & Co.

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Mr. Post gained his experience at Merrill Lynch where he worked in the Private Client Group. Preceding his employment with Merrill Lynch, Mr. Post was with a real estate development firm. Prior to this, he was a yacht broker with Sparkman & Stephens in New York City.

Mr. Post is a certified financial planner. He earned a B.A. in history from Cornell University in 1984.