Six Tax Reduction Strategies to Enhance Portfolio Performance


Tax planning requires attention throughout the year.

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>> Physicians in the highest income tax brackets may have been presented with an unpleasant surprise in the last few years when they learned of their investment tax liability. A prolonged period of strong domestic stock performance from 2009 to today, combined with the implementation of The American Taxpayer Relief Act of 2012 may have resulted in significantly higher taxes for you. The top ordinary income tax rates were raised, while the top capital gains rate was increased by more than 58 percent. While the 2017 Tax Cuts and Jobs Act reduced the top marginal rate from 39.6 to 37 percent, capital gains rates were not changed and several itemized deductions were either capped or eliminated. Writing a large check to the IRS serves as a harsh reminder that tax planning requires attention throughout the year and is not a technique you can properly manage one week out of the year.

The US stock market is in the midst one of the longest bull markets in the history of our country, however investors have been provided numerous tax loss harvesting opportunities during this period. In 2015, oil prices declined more than 75 percent from peak to bottom. The pricing pressure experienced by energy companies impacted multiple industries and contributed to an equity sell-off for the first time in years. Healthcare stocks experienced a sharp decline in January 2016. The Dow Jones Industrial Average declined more than 1,800 points over two trading days in February 2018.

Proper tax planning becomes more critical in an era of higher returns. Nine years of a rising stock market resulted in many traditional investment vehicles holding large amounts of unrealized gains that can become realized gains if you are not careful. Short-term investment losses may be frustrating; however, volatility does create a planning opportunity for astute investors and their advisors. In this article, we will provide you with six suggestions that could save you thousands of dollars in investment taxes over the next several years.

1 Account Registration Matters

If you are reading this article you likely have a reasonable amount of investment experience and have become familiar with the benefits of security diversification in your portfolio. However, a common mistake made by investors is failure to implement a tax diversification strategy. Brokerage accounts, Roth IRAs, and qualified plans are subject to various forms of taxation. It is important to utilize the tax advantages of these tools to ensure they work for you in the most productive manner possible. A properly integrated approach is critical during your accumulation phase. Further, it is just as important when you enter the distribution period of your investment life cycle. Investment vehicles paying qualified dividends are preferred in a brokerage account, while it is generally preferable for qualified accounts to own high yield bonds and corporate debt taxed at ordinary income rates. There are countless additional examples we could discuss, but the lesson is it is important to review the pieces of your plan with an advisor who will consider both tax diversification and security diversification as they relate to your specific circumstances.

2 Consider Owning Municipal Bonds in Taxable Accounts

Most municipal bonds are exempt from federal taxation. Certain issues may also be exempt from state and local taxes. If you are in the highest federal tax bracket, you may be paying tax on investment income at a 2018 rate of 40.8 percent. Under these circumstances, a municipal bond yielding three percent will provide a superior after-tax return in comparison to a corporate bond yielding as high as five percent in an individual or joint registration, a pass-through LLC, or in many trust accounts. Therefore, it is important in many circumstances to make certain your long-term plan utilizes the advantages of owning certain municipal bonds in taxable accounts.

3 Be Cognizant of Holding Periods

Long-term capital gains rates are much more favorable than short-term rates. Holding a security for a period of 12 months presents an opportunity to save nearly 20 percent on the taxation of your appreciated position. For example, an initial investment of $50,000, which grows to $100,000, represents a $50,000 unrealized gain. If an investor in the highest tax bracket simply delays liquidation of the position (assuming the security price does not change), the tax savings in this scenario would be $8,500. Although an awareness of the holding period of a security would appear to be a basic principal of investing, many mutual funds and managed accounts are not designed for tax sensitivity. High income investors should be aware that the average client of most advisors is not in the highest federal tax bracket. Therefore, it is generally advantageous to seek the advice of a financial professional who is aware of holding periods and has experience executing an appropriate exit strategy.

4 Proactively Realize Losses to Offset Gains

As mentioned in the opening paragraphs of the article, the last several quarters presented investors with an opportunity to realize losses in domestic stocks for the first time in four years. Clients with a diversified portfolio likely had this opportunity in prior years. One benefit of diversifying across asset classes is that, if the portfolio is structured properly, the securities typically will not move in tandem. This divergence of returns among asset classes not only reduces portfolio volatility, it creates a tax planning opportunity. Domestic equities have experienced a consistent upward trend from the depths of the financial crisis in March 2009; however international stocks, commodities, and multiple fixed income investments experienced down years. Astute advisors were presented with the opportunity to save clients thousands of dollars in taxes by performing strategic tax swaps prior to year-end. It is important to understand the rules relating to wash sales when executing such tactics. The laws are confusing, and if a mistake is made your loss could be disallowed. Make certain your advisor is well versed in utilizing tax offsets.

5 Think Twice About Gifting Cash

This is not to discourage your charitable intentions. Quite the opposite is true. However, a successful investor can occasionally find themselves in a precarious position. You may have allocated five percent of your portfolio to a growth stock with significant upside. Several years have passed, the security has experienced explosive growth, and it now represents 15 percent of your investable assets. Suddenly your portfolio has a concentrated position with significant gains, and the level of risk is no longer consistent with your long-term objectives. The sound practice of rebalancing your portfolio then becomes very costly, because liquidation of the stock could create a taxable event that may negatively impact your net return.

By planning ahead, you may be able to gift a portion of the appreciated security to a charitable organization able to accept this type of donation. The value of your gift can be replaced with the cash you originally intended to donate to the charitable organization; and, in this scenario, your cash will create a new cost basis. The charity has the ability to liquidate the stock without paying tax, and you have removed a future tax liability from your portfolio. Implementing the aforementioned gifting strategy offers the potential to save thousands of dollars in taxes over the life of your portfolio.

6 Understand your Mutual Fund's Tax Cost Ratio

The technical detail behind a mutual fund's tax cost ratio is beyond the scope of this article. Our intent is to simply bring this topic to your attention. Tax cost ratio represents the percentage of an investor's assets that are lost to taxes. Mutual funds avoid double taxation, provided they pay at least 90 percent of net investment income and realized capital gains to shareholders at the end of the calendar year. But, all mutual funds are not created equally, and proper research will allow you to identify funds that are tax efficient.

A well-managed mutual fund will add diversification to a portfolio while creating the opportunity to outperform asset classes with inefficient markets. You do need to be aware of funds with excessive turnover. An understanding of when a fund pays its capital gains distributions is a critical component of successful investing. A poorly timed fund purchase can result in acquiring another investor's tax liability. It is not unusual for an investor to experience a negative return in a calendar year, yet find himself on the receiving end of a capital gains distribution. Understanding the tax cost ratios of the funds that make up portions of your investment plan will enable you to take advantage of the many benefits of owning mutual funds.

UNDERSTAND YOUR UNIQUE PORTFOLIO

The above steps are by no means the only tax strategies experienced advisors can execute on behalf of their clients. This article highlights several strategies you should discuss with your advisor to determine if implementation is appropriate for your unique portfolio and overall financial situation. Successful investing requires discipline that extends beyond proper security selection. While gross returns are important and should not be ignored, the percentage return you see on your statements does not tell the full story.

In today's tax environment, successful investors must choose an advisor who helps them look beyond portfolio earnings to focus on strategic after-tax asset growth.

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