Tax Management of Investment Portfolios ©

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For clients who are individuals or trusts (versus pension or other funds not subject to tax) tax management is a very important component of portfolio management. Taxes have a large impact on the accumulation of wealth over time. For example, $6,000 invested each year in a regular investment account for an individual in a 22% tax bracket who earns a 5% realized rate of return each year would result in ending wealth of $176,826 in 20 years. The same amount invested in a ROTH IRA which is generally non-taxable upon withdrawal would result in ending wealth of $198,396. 12% more wealth over time. There are a variety of ways to manage taxes;

- Choice of which basis method to use to measure capital gains on asset sales.
- Tax Loss Harvesting
- Account Choice - choosing the types of accounts to utilize for investment (such as IRAs or employer retirement accounts.
- Asset location/Asset Choice – choosing which accounts to place which types of investment assets in.

After a review of tax basics for investing we will discuss each of these tax management techniques.

Tax Basics for Investing

The United States has a progressive tax system. The higher your income the higher you the tax rate on your income. The table below shows the 2022 tax rate schedule for individuals using two filing statuses – single and married filing jointly – as examples:

Tax Rate	Single Filers – Level of Taxable Income	Married Filing Joint Returns
10%	First $10,275	First $20,550
12%	$10,275 to $41,775	$20,550 to $83,550
22%	$41,775 to $89,075	$83,550 to $178,150
24%	$89,075 to $170,050	$178,150 to $340,100
32%	$170,050 to $215,950	$340,100 to $431,900
35%	$215,950 to $539,900	$431,900 to $647,850
37%	$539,900 or more	$647,850 or more

Most income (called ordinary income) is taxed at the same rates. So, for a single taxpayer with taxable income from wages, interest, dividends, and similar income and with some permissible deductions totaling $10,275 would pay taxes of $1,027.50 (10% of $10,275). Another single individual with taxable income of $41,775 would pay taxes of $4807.5 (10,275 at 10% and $31,500 at 12%). Note that this is an effective average tax rate of 11.5%. This taxpayer's marginal tax rate, the rate on their next dollar of income, would be 22%. After $41,775 of income for single taxpayers and $83,550 for married filing joint taxpayers the tax rate rises dramatically. With the highest marginal rate of 37% for each additional dollar of income the taxpayer only keeps $0.63. If the taxpayer lives in a high tax state, the after tax income is considerably less.

Investment income is subject to some special tax rules, particularly the special treatment of long-term capital gains. It is important to understand these rules to maximize after tax investment returns. Internal Revenue Service Publication 550 is a great resource on the subject; however, I summarize the most important points here.

Investment income includes interest, dividends, short term capital gains, long term capital gains and mutual fund distributions. Other distributions may also be taxable depending on the nature of the entity and distribution. Generally, all of your investment income is included in your taxable income and taxed at your tax rates shown above. There are a couple of notable exceptions:

- Interest on municipal bonds (state or local government bonds) is generally non-taxable. Some of these bonds, however, are taxable, such as federally guaranteed bonds or those related to a private activity may be subject to ordinary tax or alternative minimum tax.
- Net long term capital gains are taxed at lower rates. Long term gains are gains on assets held more than one year. The rate depends on your filing status and level of taxable income. Capital gains are the difference between the selling price of an investment and the cost of that investment (known as the tax basis).

Tax Rate	Single	Married Filing Jointly
0%	Up To $41,675	Up to $83,350
15%	$41,676 to $459,750	$83,351 to $517,200
20%	Over $459,750	Over $517,200

Compared to the ordinary tax rates presented earlier, you can see that the tax rate on long-term capital gains presents a significant savings. For most individuals and extra dollar of long-term capital gains would yield $0.85 of after tax income (35% more than for ordinary income).

To determine the tax treatment of capital gains, you must net all capital gains and losses for a year. First, you net all short-term gains and losses together to get your net short term gain or loss. Then you net all long-term gains and losses together. If net long term gains are positive in both categories, you treat the two separately. The total short-term capital gain is taxed at ordinary marginal rates and the long-term capital gain is taxed at the lower rates.

If you have both short-term and long-term net capital losses, then up to $3,000 ($1,500 if married filing separately) of the net capital losses may be used to offset other ordinary income. Any additional losses are carried over to subsequent years retaining their short-term or long-term character.

If you have a net loss in one category (i.e. short-term or long-term) and a net gain in the other category you net the two to determine if is an overall gain or loss with the larger net-gain or net-loss determining the character. For example:

Example	Net Short Term Gain (Loss)	Net Long-Term Gain (Loss)	Overall Net Gain (Loss)	Tax Treatment
1	(10,000)	6,000	(4,000) Short-Term	$3,000 of the loss may be used to offset other income. The remainder is carried over as a short-term loss
2	(6,000)	10,000	4,000 Long-term	$4,000 net gain taxed at favorable rates
3	10,000	(6,000)	4,000 Short-Term	$4,000 net gain taxed at ordinary rates
4	6,000	(10,000)	(4,000) Long-Term	$3,000 of the loss may be used to offset other income. The remainder is carried over as a long-term loss

So, while long-term capital gains get favorable treatment this is offset to some extent by the limitation on the deduction of capital losses each year.

Tax Basis Selection

In computing investment capital gains and losses, you deduct the cost basis from the total selling price. This only matters when you have purchased the investment at various times and not all at once and are not selling all shares currently held. For most investments you have two possibilities in determining the tax basis for shares that you have sold. If you can specifically identify which shares/units were sold, you can deduct the actual cost of the precise shares that were sold. The investor would need to let the broker know which shares to sell if not all shares are being sold to use specific identification. If you cannot specifically identify the shares that were sold you must use the first-in, first-out method to determine basis. You assume you sell first the first shares that you acquired. Choosing specific identification allows you to manage tax impact by choosing the shares with the highest cost basis to sell – minimizing the current gain.

In the case of mutual funds, REITs and some dividend reinvestment plans there is a third option for determining basis. This is the average cost basis. As with individual stocks the specific identification method would allow you to minimize gains. Note however that once you have used the average cost method for a particular mutual fund you must continue to use that method and cannot change to the specific identification method.

Tax Loss Harvesting

Because of the favorable capital gains rules it is advantageous to examine an investors realized (from investments sold) and unrealized (from investments not yet sold) gains/losses as each year progresses. Note that in addition to the sales of investment directly by the investor, realized gains can also "flow through" to the investor from mutual fund distributions when the mutual fund sells investments during the year. These are passed through as short-term or long-term capital gain distributions. This normally occurs late in the year so you generally need to anticipate these distributions. If during the year the investor has net short term capital gains across all taxable accounts (e.g. not IRAs or other tax deferred accounts) is best to try to offset these by selling investment with unrealized losses (up to the amount of the gain plus $3,000). This avoids the unfavorable tax treatment on short-term capital gains. This is known as tax loss harvesting. Several research studies have show that tax loss harvestings can generate additional returns of anywhere from 0.30% to more than 1% per year depending on circumstances.

The same strategy can be employed for net long-term gains realized as the year progresses. In this case, however, you need to consider the advantage of paying the lower long-term rate now versus the advantage of tax deferral.

Tax loss harvesting is easiest when your are managing individual stocks and bonds. A large number of securities is likely to have some with gains and some with losses so that you can pick and choose. Beware of wash sale rules, however. If you sell a security at a loss and buy it back within 30 days you may not currently deduct the loss (this also applies if you buy more shares within 30 days before the sale and do not sell all shares held). Tax loss harvesting can also be done with ETFS and Mutual Funds when some increase in value while others decrease in value. Using ETFs and Mutual Funds can make it easier to avoid the loss sale rules as you can buy back another ETF with similar exposure as long as the IRS does not consider it "substantially identical."

Account Choice: To IRA or not To IRA? That is the question (or at least one of the questions)

The most important life objective for most people is saving and investing for retirement. Individual Retirement Accounts (IRAs) or employer retirement accounts are an important consideration in meeting this objective. Today we review the types of IRAs available and the differences in how much is accumulated for retirement in the various types of IRAs. The types of employer accounts are similar but with different contribution limitations (usually higher).

There are two basic types of IRAs:

- Traditional IRAs
- Roth IRAs

The maximum contribution to each of these is $6,000 per year if you are below age 50 or $7,000 per year if you are age 50 and above. Note that you or your spouse must have earned income (e.g. salary or self-employment income) to make any IRA contributions. If your earned income is less than $6,000 your contribution is limited to your earned income.

Traditional IRAs

There are two potential advantages to traditional IRAs:

- Your initial contribution may be deductible and save you taxes currently.
- Investment earnings accumulate on a tax deferred basis. Rather than being taxed each year, taxation is deferred until you take distributions from the IRA. This allows you to accumulate more wealth over time, reinvesting funds that would otherwise be paid in taxes currently.

We will explore how much this impacts the amount of wealth you will accumulate at retirement a bit later.

Traditional IRAs may be deductible or non-deductible depending on whether you have a retirement plan available through your employer and your level of income. If neither you nor your spouse are covered by a retirement plan at work, then traditional IRA contributions are fully deductible. If either of you are covered by a retirement plan at work, then the IRA is fully deductible if your adjusted gross income (a specific tax measure of income) is below certain levels depending on your tax filing status:

- Single $68,000
- Married filing jointly $109,000
- Married filing separately - not fully deductible in any case

If your income is above these levels an IRA contribution is partially deductible if your income is below:

- Single $78,000
- Married filing jointly $129,000
- Married filing separately $10,000

If your income is above these levels traditional IRA contributions are not deductible. Note, however, that if you have earned income of at least $6,000 you can always make a contribution to a traditional IRA. The only limitation is on deductibility.

Roth IRAs

Roth IRAs also have two potential advantages, even though contributions are not tax deductible:

- Investment earnings accumulate tax free in the Roth IRA.
- There is no tax on Roth IRA distributions provided certain requirements are met.

Regardless of whether you are covered by a retirement plan you may make a full contribution to a Roth IRA if your income is below:

- Single $129,000
- Married filing jointly $204,000
- Married filing separately - no full contribution in any case

If your income is above these levels but below the following levels, you can make a partial Roth IRA contribution:

- Single $144,000
- Married filing jointly $214,000
- Married filing separately $10,000

If your income is above these levels, you may not make a Roth IRA contribution.

Wealth Accumulation

So, depending on your circumstances you may have several possible investment alternatives among the following:

- Not invest in an IRA but invest in a regular taxable investment account
- Invest in a non-deductible traditional IRA
- Invest in a deductible traditional IRA
- Invest in a Roth IRA[1]

For comparison purposes we will assume you have $6,000 per year total to invest and that your investment return will average 5%. We will also use an investment horizon of 20 years until retirement. We assume you are currently in a moderate marginal tax

[1] There is another option which is to make a traditional IRA contribution and then covert or partially convert the traditional IRA to a Roth IRA. We will cover this in a later post.

bracket or 22% and will be in a 12% bracket in retirement. This assumes someone who is married filing jointly with income between about $80,000 and $180,000 currently and less than $80,000 during retirement (we will also show how results will change based on other tax rate assumptions). Note that while the numbers would change if your retirement horizon is less than or more than 30 years, the conclusions of the analysis would not change.

Regular Investment Account (not an IRA)

In the case of a regular account, you would invest the full $6,000 in a taxable investment account. Your wealth would accumulate after taxes (you would be paying tax on your 5% income each year if it is interest, dividends and realized capital gains). Your ending wealth at the end of your investment horizon in this case would be:

Circumstances	Cumulative Investment	Ending Wealth
$6,000 invested each year, 20 years to retirement, current tax bracket 22%	**$120.000 (20 years at $6,000 per year)**	**$176,826 (If all investment earnings are taxed each year)**

Note that the above calculations assume the full amount of investment income is taxed currently as interest, dividends and realized gains. If you invested in an index fund where some of the income is taxed each year and the rest is taxed when sold you would accumulate more. Let's assume that 2.5% is taxed each year (interest, dividends, some realized gains) and the balance of 2.5% (unrealized gains) is taxed when sold during retirement but at a favorable long term-gain rate of 15%. We adjust for the capital gains tax effect in year 20 although the tax on gains are paid as the wealth is used (you do not sell the entire fund balance at your retirement date). Your ending wealth after all taxes would be:

Investment Horizon	Cumulative Investment	Ending Wealth Adjusted for Taxes During Retirement
$6,000 invested each year in a taxable investment account, 20 years to retirement, current tax bracket 22%	**$120.000 (20 years at $6,000 per year)**	**$181,579 (If half of investment earnings are taxed each year and the balance is deferred until retirement)**

Non-Deductible IRA Account

In the case of a non-deductible IRA account, you would also invest the full $6,000 per year. Your wealth would accumulate tax deferred until withdrawn. For comparative purposes simplicity we will reduce the taxes at year 20 as above, although they would be spread out over your retirement period. Note that your cumulative contributions are withdrawn tax free in the case of a non-deductible IRA   Your ending wealth at the end of your investment horizon would be:

Investment Horizon	Cumulative Investment	Ending Wealth Pre Tax	Ending Wealth Adjusted for Taxes During Retirement
$6,000 invested each year in a non-deductible IRA, 20 years to retirement, current tax bracket 22%	**$120.000 (20 years at $6,000 per year)**	**$198,396**	**$188,988**

Ending wealth after taxes is higher for the non-deductible IRA than for a taxable investment account. This will be true whenever your future expected tax rate is lower than your current rate. Let's assume your future tax rate upon withdrawals is the same as today rather than lower. How would your ending wealth change if your tax rate was still 22% during retirement? Your ending wealth would be a little less after taxes but still at $181,149. This is higher than the regular investment account assuming taxes are paid fully annually but about the same as the regular investment account assuming a deferral of capital gains which are taxed later at a favorable rate. The non-deductible IRA is the better choice for your investment dollars than a taxable account if you are currently in a high tax bracket and expect a lower tax rate in retirement. A taxable account generating deferred long-term gains would be preferable if you expect a higher tax rate during retirement.

<u>Deductible IRA</u>

If you invest $6,000 each in a deductible IRA while you are in a 22% tax bracket you would save $1,320 in taxes so your after-tax investment is only $4,680 per year. In order to compare your wealth accumulation to the other choices, we will assume that the tax savings are invested in a regular taxable account (making your total out of pocket investment $6,000 per year or $120,000 over 20 years as in the prior examples). Before considering taxes your ending wealth would be:

Investment Horizon	Ending Wealth Pre-Tax – IRA	Ending Wealth Regular Investment Account (taxes paid each year)	Total Ending Wealth Pre-Tax on IRA
$6,000 invested each year in a deductible IRA, $1,320 of tax	**$198,396**	**$38.902**	**$237,298**

savings invested in a taxable investment account, 20 years to retirement, current tax bracket 22%			

After taxes these would equate to:

Investment Horizon	Ending Wealth After-Tax – IRA	Ending Wealth Regular Investment Account (taxed paid each year)	Total Ending Wealth After-Tax
20 years $6,000 each year in a deductible IRA, $1,320 of savings invested in a taxable account, 20 years, tax bracket 22%	**$174,588**	**$38.902**	**$213,490**

The deductible IRA accumulates more wealth than either a non-deductible IRA or a taxable investment account. This is true even if you end up in a 22% tax bracket in retirement.   In that case ending wealth after tax would be $193,651. The deductible IRA is almost always the preferred choice if it is available. The only way for it to not beat a taxable retirement account is if you tax rate is higher during retirement than it is when contributions are made.

<u>Roth IRA</u>

For the Roth IRA we once again assume $6,000 of contributions each year for a cumulative total of $120,000. Your wealth accumulation would be:

Investment Horizon	Ending Wealth Pre-Tax	Ending Wealth Adjusted for Taxes During Retirement
$6,000 invested each year in a Roth IRA, 20 years to retirement, current tax bracket 22%	**$198,396**	**$198,396**

Note that your pre-tax and after-tax wealth are the same as Roth Distributions are tax free assuming you have had the Roth account at least 5 years and the distribution is after age 59 ½ or due to disability. The Roth IRA is always better than the regular investment account and the non-deductible IRA. The deductible IRA is still the better choice when taxes are lower in retirement, and you invest the annual tax savings resulting from the deductible IRA.

The Bottom Line

To summarize and answer the question to IRA or not to IRA, the answer is almost always yes to making an IRA contribution. Except in rare circumstances where you are in a lower tax bracket today than at retirement, you will accumulate more wealth in an IRA. So, if you have earned income and expect to be in the same or lower tax bracket during retirement you should contribute as much as allowable to an IRA with your first choice being a deductible IRA. If not possible, the next best choice is a Roth IRA. If you cannot make either, then a non-deductible IRA is likely your next best choice. In this case work with your financial planner or tax advisor to determine your current tax rate and expected rate during retirement. If you expect to be in a higher tax bracket during retirement that you are today, then a taxable investment account with significant deferred income may be better than a non-deductible IRA. We will explore this further under asset location below.

Note that the same analysis above applies to workplace pensions and other plans such as 401ks and 403bs. Most workplace plans function like traditional IRAs where the contribution is effectively deductible and income is deferred until withdrawn from the plan. Limits are higher than for IRAs with most workplace plans. Some also allow for a ROTH provision. Generally, if a client is eligible for a workplace plan they should be taken advantage of especially to the extent that contributions are matched by the employer.

Asset Location/Asset Choice for Different Types of Accounts

Once a strategic asset allocation has been designed for a client, we need to determine how much of the overall portfolio should be invested in each asset class and sub-asset class. An important consideration is which accounts should hold which assets (assuming there are multiple available accounts including taxable accounts, IRAs workplace pension or similar accounts).

As noted above, different types of accounts have differing tax treatments. A typical regular investment account is taxed annually, whereas retirement accounts are either tax deferred or tax exempt. An employer retirement plan or traditional IRA is tax deferred until funds are withdrawn. Roth type accounts are both tax deferred and withdrawals are not taxed in most cases. Investment income in a regular account is taxed at either ordinary income tax rates (interest, dividends, and short-term gains) or capital gains (long term gains) tax rates which are lower. Distributions from traditional retirement accounts and IRAs are taxed as ordinary income even if they were generated by capital gains. As a result, if multiples types of accounts are available you may not want to have the same allocation across accounts. Instead, you should determine each investment optimal location to maximize the after-tax return. Here are some general guidelines:

- Low total return assets should generally be in taxable accounts whereas high total return assets should generally be in tax deferred or tax-exempt accounts.
- Assets generating mainly ordinary income and short-term gains taxable as ordinary income should generally be in tax deferred or tax-exempt accounts.
- Assets generating mainly long-term capital gains should generally be in taxable accounts depending upon the expected holding period (the longer the planned holding period the longer the tax deferral and more likely it should be in a taxable account).

Some accounts such as trusts may render these guidelines null and void as the trust instrument must be adhered to. These general guidelines can also conflict with each other and asset location can be an art. For example, at the time this article was written long term bonds have very low expected returns but are taxed currently as ordinary income in taxable accounts. The first guideline would suggest a taxable account is fine while the second would lean towards a deferred account. In these circumstances you should also consider liquidity needs and place in taxable accounts more assets that have lower volatility that could be sold when liquidity needs present themselves. The size of an allocation to a particular asset class can also prevent placement in the optimal account type. Client needs or preferences may also be to have a more uniform return and risk profile across accounts (for example when the accounts are in different family member names, are designed to fund specific goals or have different beneficiaries). When it is not optimal to place assets is the preferred account type you can engage in tax lost harvesting or other strategies to manage tax costs.

Using asset location, you can mimic a tax deferred non-deductible IRA through asset location. Let’s say you set up a regular investment account and within this account you invest $6,000 per year as in the IRA examples above but you use a very low yielding market capitalization weighted ETF. This generates very low annual taxable income. For example, you invest 100% in SCHG – Schwab U.S. Large-Cap Growth ETF. This fund has a 12 month yield of only 0.48% (interest, dividends and realized capital gains). So using the same data above for a non-deductible IRA:

- 5% total annual return with 0.5% taxed each year and 4.5% deferred.
- 20 year time horizon
- $6,000 total investment.
- 22% current tax bracket

Your accumulated wealth in 20 years would be:

Tax Rate During Withdrawals	Ending Wealth Pre-Tax on Withdrawals	Ending Wealth Post-Tax on Withdrawals
0% Capital Gains Tax	$196,105	$196,105

15% Capital Gains Tax	$196,105	$185,600

Note that in all cases this taxable investment account would yield wealth of $196,105 before taxes on withdrawals which is almost as much as would be accumulated with a non-deductible IRA. The difference being the small annual tax on low current investment income. Since the gain on liquidation of the account will be a long term capital gain it would be taxed at favorable rates relative to ordinary income. Without inflation adjustments this would be 0% for those individuals married filing a joint return with income up to $83,350 and 15% for those with income $83,350 to 517,200. For those able to pay the 0% capital gains rate, this investment account would generate more after tax wealth than a non-deductible IRA. For those in the 15% capital gains bracket you would accumulate a little less than the non-deductible IRA. However, there are no limitations on when you can or must take distributions from such an account (there are limitations in the case of IRAs). So, with good asset location choices you can get much of the benefit of non-deductible IRAs with a bit more flexibility.

In summary, where possible you should allocate the desired investments to the accounts where you will maximize the after-tax returns. Investment strategies for investment assets should also be placed appropriately. For example, a popular strategy is a covered call strategy where you buy stocks but sell slightly out of the money calls. This can be done directly with individual stocks or ETFs or through investing in a fund that uses a covered call strategy. Overall, this tends to have a modest reduction in long term returns relative to just owning the stocks but greatly reduces volatility. However, this strategy results in more short-term gains and should be implemented in tax free or tax deferred accounts. Asset location choices must be balanced by the need for returns in different types of accounts (for example a desire for a higher return in retirement accounts) and liquidity needs (for example, the need for keeping some liquid assets in non-retirement accounts to be used in a time of need).

Concluding Remarks

As can be seen above, taxes can have a significant impact on the accumulation of wealth from investments. Proper tax management can significantly improve after tax investment returns and wealth accumulation. With typical investment management fees ranging from 0.5% to 1.0% of assets under management it is possible to provide more than that in value through tax management techniques.

