Destination: Tax-Smart Investing

Strategies to help you keep more of what you make

Taxes — especially when not managed properly — can erode investment gains and minimize progress towards your financial goals. Uncertainty around taxes can add to your psychological discomfort as well as increase the potential to make the wrong decisions.

In times like these, **every** investor needs to examine and possibly rethink investment tax management. This article will discuss:

- The evolving tax code and what it means to you,
- Why investors are likely paying more taxes than necessary
- Most importantly, the tools available to fight uncertainty and help you keep more of what you make — in any market environment.

Current federal income, estate and gift tax rates

- The top marginal income tax bracket is 39.6%.
- The top long-term capital gains rate is 20% (not including the 3.80% Medicare surtax).
- Qualifying dividends continue to have tax-favored treatment.
- The Medicare tax rate on households with an earned income of more than $250,000 increased from 1.45% to 2.35%. The same increase occurred for singles with earned income of more than $200,000. There is no income ceiling for the Medicare tax. The Social Security wage base for 2015 is $118,500.
  - A new Medicare tax was introduced for the same group earning investment income at a rate of 3.8%. The surtax applies to: taxable interest, dividends, capital gains, passive activity income, rents, royalties and annuities. The surtax does not apply to municipal bond interest.
- The estate and gift tax exclusion amount is $5,430,000 for 2015 indexed for inflation. The top tax rate is 40%. The annual gift exclusion amount is $14,000 for 2015.

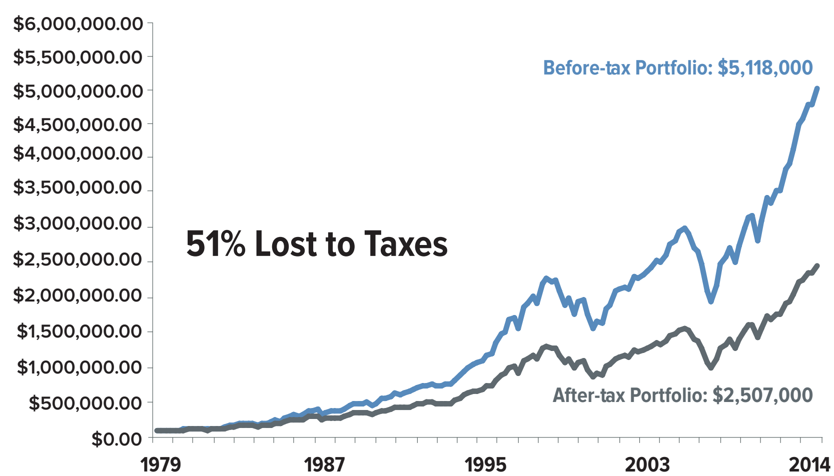
How much damage could be done?

It's important to keep in mind the impact of taxes on hard-won investment gains. According to the Investment Company Institute (ICI), at year-end 2008 more than 92 million shareholders (82% individuals, 18% institutions) owned the majority of the $9.6 trillion assets invested in mutual funds that year.[1] These investors paid approximately $736 million in 2009 due to short-term capital gains taxes, $149 million in long-term capital gains taxes and $12 billion because of taxes on dividends. Basically, these investors on average gave up almost 1% (0.98%) of earnings to taxes. And while those numbers are disturbing, they are from a year in which the tax burden had been relatively light. Finally, consider that those taxes covered little more than holding the fund and reinvesting gains, essentially a buy-and-hold strategy.

Here's another way to assess the damage of taxes. A hypothetical $100,000 portfolio invested in 60% stocks and 40% bonds in 1979 would have grown to $5.1 million before taxes by 2014. However, with no efforts to mitigate the tax effect, Uncle Sam would have eaten 51% of the gain, lowering the investor's wealth to just a little more than $2.5 million.[1]

It's Not What You Make, It's What You Keep

Taxes reduce performance over time ***(hypothetical growth of $100,000*)***



**Parametric Portfolio Associates: 60% Russell 3000; 40% Barclays Capital Aggregate; No Liquidation. Interest income and dividends are taxed annually at historical top marginal tax rates; capital gains are realized at 50% per year and are taxed at the historical long-term capital gains tax rate at the time. Past performance is no guarantee of future results. As of 12/31/14. Since inception 12/2002. There is no guarantee that distributions will not be made in the future.*

A hypothetical tax-free $100,000 portfolio (invested 60% in stocks and 40% in bonds) held for 35 years would have grown to about $5.1 million. If the portfolio was taxed like an average mutual fund, it would have lost 51% of its value, due to taxes paid and earnings lost on that money. Tax-managed investment strategies are designed to minimize capital gains distributions and maximize after-tax returns.

[1]ICI 2009 Mutual Fund Fact Book (Section 2, Figure 2.4).

Out with the old, in with the new

"Taxes take an enormous bite out of an investor's return — but the good news is that you can do something about it," said Brian Langstraat, President of Parametric Portfolio Associates, whose firm helps investment managers implement tax management strategies.

Historically, according to Langstraat, most investors and their financial advisors have focused only on cutting taxes in November and December or only in years in which investors have earned capital gains.

Firms like Parametric argue that there is a better way to help protect the investor's return throughout the market's ups and downs. It begins with the admission that tax management cannot be a part-time endeavor. Given the potential damage of overpayment, the management of taxes must be a cornerstone of an investor's planning process. It calls for employing new techniques and strategies from investment managers and more sensitivity to the tax consequences of portfolio implementation.

"Investment return is number one, tax management is 1A," said Steve Konopka, Director, Investment Services with SEI. Konopka admits to being frustrated when investors and their advisors ignore tax management until year-end, at which point options are limited.

"If the investor only does tax management at year-end and the market has gone up, there's not much that can be done at that point," he said. "But managing taxes throughout the year means the investor can take advantage of the ups and downs of the market and benefit from that volatility."

Parametric's Langstraat believes that "Investors need a consistent, systematic, year-round approach to tax management in their portfolios." However, there are minimal opportunities with traditional mutual funds because tax management is mostly limited to deferring capital gains or minimizing dividend distributions.

More to the point, the manager of a traditional mutual fund buys and sells securities with the interests of the fund in mind, and not necessarily the tax consequences of the investor. It's for this reason that we offer tax-managed funds and tax-efficient separate account strategies.

Tools to ease your uncertainty

The growing list of tools available to managers of tax-managed portfolios and other tax-advantaged investments reflects their growing popularity. Think of each as navigational tools to help you stay on course to your financial destination. While none of these tools is guaranteed, each can be very helpful in managing tax consequences:

Tax-lot accounting: A method of accounting for a securities portfolio in which the manager tracks the purchase, sale price and cost basis of each security. This allows the manager to "swap" a batch of stocks with long-term gains for a batch with smaller, short-term gains.

Loss harvesting: Allows the manager holding a stock at a loss to sell all or part of it to realize the loss and create an "asset" that may help offset some future gain.

Wider rebalancing ranges: A wider rebalancing range can help reduce the number of trades made to your portfolio within a range of the target allocation, say a 60% equity and 40% bond allocation, which may lead to lower realized capital gains and corresponding taxes.

Gain-loss offset: Involves selling securities at a loss that have dropped in price at year-end to help offset gains from selling securities that have increased in price.

There are other tools that fall within the category of "tax-aware" trading: delaying the sale of stocks that are about to become a long-term holding; identifying the most tax-advantaged stock sales for the purpose of making charitable donations; and identifying the most tax-advantaged (high-cost basis) stocks to sell for investors seeking regular income from their portfolios.

Techniques designed to produce higher after-tax returns

- Tax-lot Accounting
- Loss Harvesting
- Wider Rebalancing Ranges
- Tax-aware Trading
- Gain/Loss Offset
- Transition of Low Cost-basis Stocks

Knowledge is only power if you use it

Now that you know more about managing taxes on your investments — and the benefits you can reap from it — what can you do to take advantage of that knowledge?

- **Involve your advisor.** Set up an appointment to review your account's tax efficiency, the effects (good and bad) of your current tax management process, and what short- and long-term steps you need to take.
- **Keep taxes top of mind.** Unlike the holidays, successful tax management is not seasonal. If you wait until year-end to consider tactics, you'll never get the most benefit. You should be "tax-management-minded" on your investments year-round and in every market condition. Your advisor will make sure it happens so you don't have to worry.
- **Stay on top of changes.** The tax situation changes almost daily. Keep up (both directly and through your advisor) with changes — or potential changes — that could affect you. Plan accordingly. Again, your advisor can be of invaluable assistance.

An uncertain tax structure can cause significant harm. But different situations can be anticipated, and their harm minimized. Staying aware, and working with your advisor, will give you the best chance of sailing through uncertainty with minimal damage.

150433 C (02/15)