Tax Alpha: How to Fix a Client Portfolio

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If you have recently taken over a portfolio for a new client and chances are you have, if you have a growing business then you've got an immediate opportunity to prove your value. Good financial planners can be worth their weight in gold in helping clients build a tax-efficient portfolio.

And for the wealthiest clients, achieving tax alpha can yield a small fortune annually.

Giving a portfolio a tax-oriented makeover is basically a three-step process: taking over the new portfolio and deciding what to sell, building the new portfolio and, finally, helping the client with recognizing income and withdrawal strategies.

When new clients come to me, I often find myself wanting to sell all their investments in order to build a lower-cost and more tax-efficient portfolio which, theoretically, would be more likely to outperform the existing portfolio on a risk-adjusted basis.

But reality trumps theory: After all, selling everything at once would usually present a client with unacceptable tax consequences, unless the majority of the portfolio is in qualified accounts.

Even if the gains are long-term capital gains, total marginal rates can easily be more than twice the normal 15% rate. That's because recognizing large gains can have a number of unintended consequences:

- triggering high state taxes or the alternative minimum tax.
- pushing a client into the 20% long-term capital gains tax rate (if income is more than $413,200 for single filers in 2015, or $464,850 for joint filers).
- prompting the 3.8% Medicare tax on passive income when total income tops $200,000 for single filers or $250,000 for joint filers.
- phasing down the amount of allowable deductions.

While I don't think tax consequences should drive the portfolio, it's critical that planners help clients move over time to a lower-cost, more tax-efficient portfolio.

WHAT TO SELL

To determine what to sell, start by determining where the marginal tax breakpoints are.

That is, understand how much gain can be recognized before any of the triggers above would create more dire tax consequences. It's critical to do this up front; the IRS doesn't allow do-overs.

Next, pick the low-hanging fruit. Some of the no-brainers include current holdings that have tax losses or minimal gains although, with stocks near an all-time high, these are getting more difficult to find in any client portfolio.

Finally, you'll need to make a judgment call in comparing the taxes from a sale against the benefit to the client. The benefit to the client comes from building a more appropriate asset allocation, lowering costs and having more diversification.

Just understand that it may take years to get the client to a better portfolio while keeping taxes more reasonable.

REBUILD THE PORTFOLIO

Once the positions are sold, you can start building the new portfolio, taking into account any legacy assets that aren't sold. Select the assets based on an agreed-upon asset allocation target. The two critical components here are selecting tax-efficient products and locating the right products in the tax wrappers that maximize after-tax return.

Pick investment products for the long run and avoid turnover. Whenever you sell an asset in a taxable account, it generates a gain or loss that creates taxable implications for clients. Holding on to assets with gains defers those taxes think of it as getting an interest-free loan from the government.

Bear in mind that mutual funds or ETFs that turn over their holdings generate taxable gains passed on to clients. According to Morningstar, the median turnover of U.S. active equity mutual funds is 67%, meaning the average holding period is about a year and a half. This creates both short-term and long-term taxable gains.

The broadest stock index funds, such as total U.S. or total international stock funds, have the lowest turnover and are the most tax efficient.

(Higher turnover also, by the way, tends to result in lower returns even before taking into account these taxable consequences.)

Next comes asset location. Tax- efficient vehicles belong in taxable accounts, while tax-inefficient vehicles belong in tax-deferred accounts, such as 401(k)s and IRAs. Roth wrappers are much more complex as I'll touch on in a bit. See the Where to Put the Assets chart below for a general guideline for asset location.

Even CPAs tend to get asset location wrong because everyone gets taught that stocks are for the long run and we think of our IRAs and 401(k)s as long-run wrappers. Yet placing stocks in an IRA converts what would have been a lower long-term capital gain rate into a higher ordinary income rate when it
comes time for the client to take withdrawals.

It also creates more taxes when clients reach age 70 ½ and must begin taking required minimum distributions which would likely be higher, since stocks typically outperform bonds in the long run.

INCOME STRATEGIES

Recognizing income and deductions particularly in retirement is even more complex, offering both minefields and opportunity. Mike Piper, a CPA and author of Taxes Made Simple, suggests several ways of helping a client manage taking in income. (He has also written about some of these techniques on his blog at ObliviousInvestor.com.)

For example, if a client retires before Medicare eligibility and would otherwise qualify for health care insurance subsidies under the Affordable Care Act, taking in a single marginal dollar of income could cost a client thousands of dollars as a result of a reduced or an eliminated government subsidy.

Piper suggests a few strategies, starting with what he calls income bunching.

If a client needs to recognize income to live on by taking funds from a qualified account, that income may reduce or eliminate credits or cost-sharing subsidies the client would otherwise be entitled to. The client could, for example, take a larger taxable distribution every other year to balance the benefits of cost sharing and credits against the costs from being in a higher marginal tax rate.

Another one is deduction bunching: bundling the client's deductions every other year. For example, a client can pay property taxes twice in one year, for the current year and the following year. This is helpful if the client can alternate by using the standard deduction and then itemize every other year, maximizing the value of the deduction.

Tax-gain harvesting is another strategy. Let's say a client is at 0% long-term capital gains rate, which applies to people in the 15% marginal tax bracket (making no more than $37,450 if single and $74,900 for joint filers for 2015). The client may be able to recognize a gain and pay no taxes.

ROTH CONVERSIONS

Even if a client doesn't need the money to live on, multiple Roth conversions can be helpful particularly if the client has retired and deferred taking Social Security. The goal here is to pay taxes sooner at a lower rate rather than later at a higher rate, when the client is taking Social Security and has higher income.

Roth conversions are especially attractive because they qualify for the one do-over the IRS does allow: recharacterization. Since a conversion requires paying taxes now, it's the equivalent of buying the government's share out.

I recommend making multiple conversions into different asset classes, so that any investment that performs poorly can be recharacterized later essentially making the government buy back its share at the original price.

These are only a few of the areas in which a good planner can restructure a client's portfolio to create tax alpha. Coordinating with clients CPAs is critical, as they typically have more information regarding the client's current and future income or any other relevant information (such as tax-loss carryforwards).

Tax alpha may not be as much fun as portfolio construction but it's a clear way to help your clients immensely.

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