

# Tax-Efficient Investing

*Fact or fantasy?*

**Ernst & Young LLP**

# Tax-Efficient Investing

*We Will Discuss...*

- Problems with today's approach
- A way to add up to 250 basis points of return to your clients' portfolios ?
- Decisions that *really* make a difference to your clients

# Tax-Efficient Investing

## *What's wrong with today's approach?*

- Popular press coverage of this issue focuses on after-tax performance reporting
- The real issue is much broader....
  - Recent Lipper study concludes that mutual fund investors pay 1.3% to 2.5% annually in taxes (more than the average expense ratio)
  - Their study also concluded that tax-managed funds outperformed non-tax managed funds (by about 3%) and kept more of that return (at least 77% versus 60% for non-tax managed funds)

# Tax-Efficient Investing

## *What's wrong with today's approach?*

- The tools are tax “ignorant”
  - An example
  - Asset allocation software is tax “ignorant”
  - Taxes incurred in rebalancing are ignored
  - After-tax optimization requires multiple time periods and complex input data
  - Standard deviation is lower when measured on an after-tax basis

# Tax-Efficient Investing

## *What's wrong with today's approach?*

- The tools are tax “ignorant”
  - Cannot integrate unique tax attributes – NOL, AMT, capital loss carry forwards
  - Cannot incorporate special tax status conferred by Sections 1202 and 1045, or tax-deferred structures like private placement life insurance

# Tax-Efficient Investing

## *What's wrong with today's approach?*

- Other issues
  - Different “taxpayer IDs” with different tax rates and attributes
  - Failure to distinguish manager and investor decisions
- Recommended portfolios are VERY different
- Should we discard the current tools for taxable investors?

# Tax-Efficient Investing

*What impact can taxes have on a portfolio?*

- For 2002, top federal marginal tax rate on interest and dividends = 38.6%
- Deduction phase-out can raise top federal marginal tax rate to about 40%
- State tax rates vary, but can add several percentage points

# Tax-Efficient Investing

*What impact can taxes have on a portfolio?*

- For 2002, short-term capital gains taxed at 38.6%
- Long-term capital gains – top rate 20%
- Beginning in 2006, special 18% rate for stock held longer than 5 years
- AMT and estate taxes confuse the picture

# Tax-Efficient Investing

## *What impact can taxes have on a portfolio?*

- Pre-Act income tax rates:
  - 15%, 28%, 31%, 36%, and 39.6%
- New law introduces the following reduced rates:

Tax Year	Tax Rates					
2000	-	15%	28%	31%	36%	39.6%
2001	10%	15%	27.5%	30.5%	35.5%	39.1%
2002-2003	10%	15%	27%	30%	35%	38.6%
2004-2005	10%	15%	26%	29%	34%	37.6%
2006 and later	10%	15%	25%	28%	33%	35%

# Tax-Efficient Investing

## *What impact can taxes have on a portfolio?*

- Example
  - \$1 invested, earning 2% income and 10% capital gains annually
  - All taxes paid annually

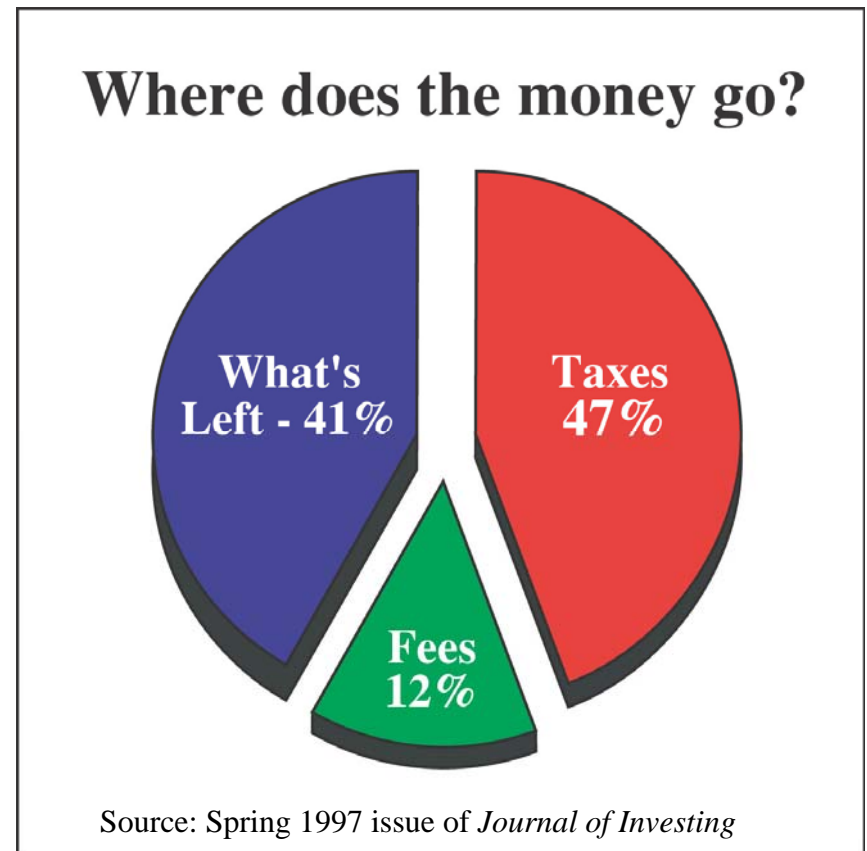
<b>Tax Rate</b>	<b>Capital gains tax</b>	<b>After-tax wealth, 10 years</b>	<b>After-tax wealth, 30 years</b>
0%	0%	\$3.11	\$29.96
28%	20%	\$2.29	\$12.01
39.6%	20%	\$2.01	\$ 8.16

Source: 5 Prescriptions for Tax-Efficient Investing, James M. Poterba, Journal of Investment Consulting, December 2000

# Tax-Efficient Investing

## *What impact can taxes have on a portfolio?*

- They destroy power of compounding! Example:
- Time period: 1971 – 95
- Assume:
  - Returns = S&P 500 actual
  - Expenses = 1.0%
  - Turnover = 80%
  - Capital gains = 28%
  - Income tax = 36%
- Total return = 1721%
  - “Net” return = 706%



# Tax-Efficient Investing

## *What does it mean?*

- Over time, a tax efficient portfolio generates the highest return, at an acceptable level of risk, with the lowest tax cost
- Maximizing after-tax return may not be the same as minimizing taxes on a portfolio in a given year

# Tax-Efficient Investing

## *What does it mean?*

- Lowering the tax rate - vs. - maximizing after-tax return:  
Portfolio 1
  - Pre-tax return 9% (3% dividends, 6% LT capital gains)
  - Effective tax rate: = 26% (efficiency 74%)
  - After tax return: 6.64%

# Tax-Efficient Investing

## *What does it mean?*

- Lowering the tax rate - vs. - maximizing after-tax return:  
Portfolio 2
  - Pre-tax return 8% (1% dividends, 7% LT capital gains)
  - Effective tax rate: = 22% (efficiency 78%)
  - After-tax return = 6.21%
  - Portfolio 2 is more tax efficient but generates a lower after-tax return

# Tax-Efficient Investing

*What does it take to be tax efficient?*

- Determinants of tax efficiency
  - *Money manager/fund level decisions:*
    - Portfolio turnover
    - Holding period of securities
    - Identification of tax lots
    - Character of income generated

# Tax-Efficient Investing

*What does it take to be tax efficient?*

- Determinants of tax efficiency
  - *Investor decisions:*
    - Screens for manager tax efficiency
    - Selection of implementation vehicles
    - Creation and implementation of an appropriate strategy

# Tax-Efficient Investing

## *What does it take to be tax efficient?*

- Determinants of tax efficiency
  - *A focus on more tax-efficient strategy:*
    - Optimal asset location decisions – putting the right assets in the right places for the long-term
    - Trust instruments which maximize tax efficiency for income and remainder beneficiaries
    - Effective use of minimum required distribution (MRD) rules for qualified plan assets
    - Integration of generations of beneficiary needs and the resulting estate and income tax consequences

# Tax-Efficient Investing

## *What does it take to be tax efficient?*

- Will new rules impact investment policy decisions for taxable investors?
  - Uniform Principal and Income Act (UPIA)
  - IRS Proposed Regulation 1.643(b) –1
  - New MRD Regulations for qualified plans
  - Proposed estate tax changes under EGTRRA

# Tax-Efficient Investing

## *The Impact of Tax Efficient Strategy*

- Husband and Wife – both about 50 years old, and W needs \$90,000 of income annually at H's death
- Assets are as follows:
  - H's separate assets \$2,250,000
  - W's separate assets \$500,000
  - Jointly-owned assets \$350,000
- Traditional estate plan uses the credit shelter trust and a marital (QTIP) trust to provide income for the spouse
- To generate enough income to meet W's needs at H's death, investments must be about 77% fixed income

# Tax-Efficient Investing

## *The Impact of Tax Efficient Strategy*

- As an alternative, suppose that the plan is revised to pay Wife 5% annually from the marital trust (regardless of income) and 2% from bypass trust
- If we assume:
  - Actual returns from 1960 to 1998, Wife lives to age 88
  - The bypass trust is invested entirely in equities, and the marital trust is 50/50 bonds and stocks
- The result:
  - Marital trust would have had \$5.8 million and bypass trust would have \$13.5 million (total \$19.3 million)

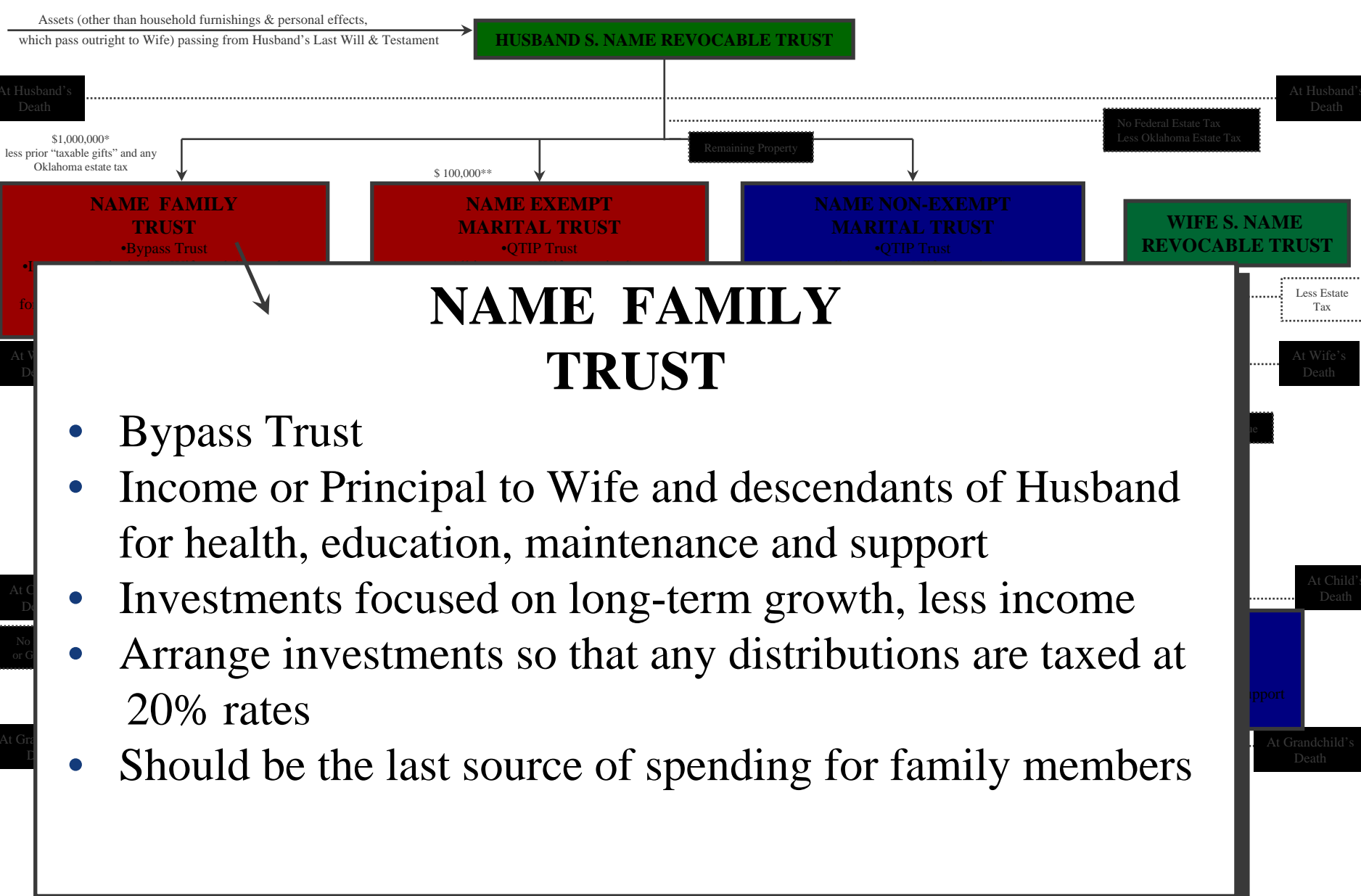
# Tax-Efficient Investing

## *The Impact of Tax Efficient Strategy*

- Over the same period, the “traditional” approach would have resulted in only \$3.7 million!
- Note, too that the bulk of the growth occurred where it will do the most good – the bypass trust
- For further improvement, raise payout on the marital trust to meet income needs and make distributions from credit shelter trust discretionary
- And this is only the beginning – think about the results over multiple generations!



# FLOW CHART OF THE PROPOSED HUSBAND S. NAME ESTATE PLAN (ASSUMES HUSBAND PREDECEASES WIFE)



## NAME FAMILY TRUST

- Bypass Trust
- Income or Principal to Wife and descendants of Husband for health, education, maintenance and support
- Investments focused on long-term growth, less income
- Arrange investments so that any distributions are taxed at 20% rates
- Should be the last source of spending for family members

\*\$3.5 million in 2009, repealed in 2010, and possibly reinstated to \$1 million in 2011.

\*\* Formula amount so that the net amount passing to the Family Trust plus this amount equals the GST exemption amount. By 2004, this amount will be reduced to zero because of the new tax law changes.

# Tax-Efficient Investing

## *Credit Shelter/Bypass Trust*

- Usually created to take maximum advantage of the unified credit amount available to all individuals
- Typically, this trust will be generation-skipping tax exempt
- If funded at death, assets will currently receive stepped-up basis
- If sufficient funds exist elsewhere, and if generation-skipping tax exempt, this should be one of the last sources of spending
- Invest assets to maximize long-term growth and to minimize income taxes

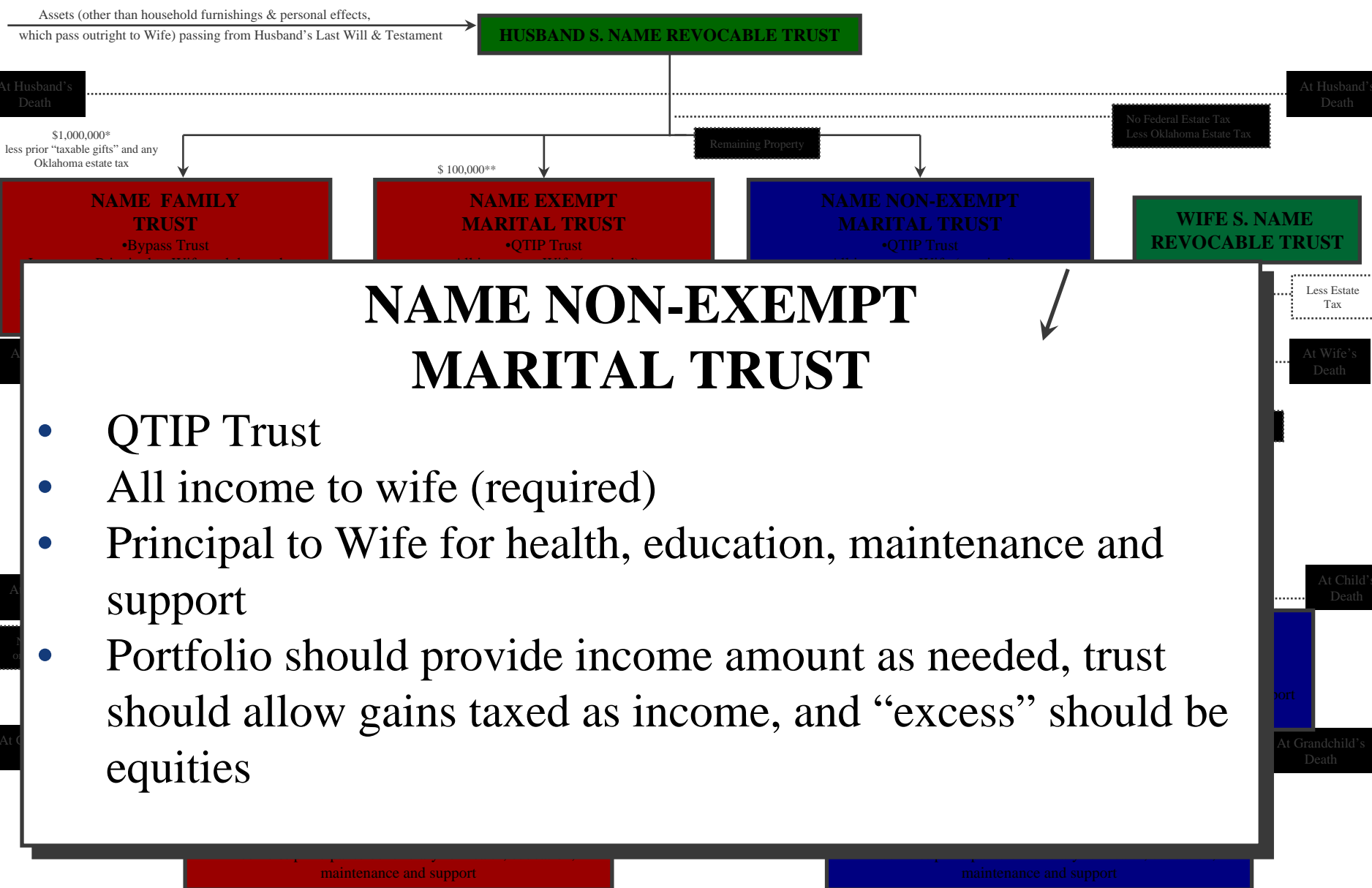
# Tax-Efficient Investing

## *Credit Shelter/Bypass Trust*

- If trust is funded during lifetime, assets may have basis carried over from previous owner
- If the trust is funded during lifetime, and there are opportunities to use the trust “seed capital” to leverage additional gifts to the trust
- Craft trust language to allow capital gains to be taxed as income
- Be careful about tax attributes that may be trapped in trust



# FLOW CHART OF THE PROPOSED HUSBAND S. NAME ESTATE PLAN (ASSUMES HUSBAND PREDECEASES WIFE)



\*Formula or specific amount—will not generate any federal estate tax. This will increase per new tax law to \$3.5 million in 2009, repealed in 2010, and possibly reinstated to \$1 million in 2011.

\*\* Formula amount so that the net amount passing to the Family Trust plus this amount equals the GST exemption amount. By 2004, this amount will be reduced to zero because of the new tax law changes.

# Tax-Efficient Investing

## *Qualified Terminable Interest (QTIP) Trust*

- Generally created for the benefit of a surviving spouse, and intended to qualify for the estate tax marital deduction
- Qualification requires that income from the trust be paid out no less than annually to the surviving spouse to maintain its qualified status
- This trust is generally subject to estate tax at the death of the surviving spouse, and is not generally exempt from generation-skipping taxes

# Tax-Efficient Investing

## *Qualified Terminable Interest (QTIP) Trust*

- Provisions of these trusts vary, but the survivor may be the initial trustee and distributions of principal will be allowed for the survivor at the discretion of the trustee
- There could be conflict between survivor and remainder beneficiaries over use and distribution of the funds (this trust tends to hold a significant portion of larger estates), especially with multiple marriages
- Income required to be distributed to the survivor will be taxed to the recipient
- Capital gains are generally taxable to the trust

# Tax-Efficient Investing

## *Qualified Terminable Interest (QTIP) Trust*

- Most spending for the survivor's lifetime should come from this trust and not from other sources
- If provisions do not allow for discretionary principal distributions, the survivor may be very interested in maximizing income produced by the trust – which will, in turn, drive the investment policy towards income-producing investments
- Consider a more growth-oriented approach and language which allows for capital gains to be considered income to the survivor

# Tax-Efficient Investing

## *Fact or fantasy?*

- *It's a reality* – taxes matter to your clients, their families, and their other “causes”
- *You can make a difference* – and create much better taxable portfolios
- *Educate your clients* – about why this is a better approach to managing their wealth