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Understanding Tax Cost in Portfolio Transitions

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Understanding Tax Cost in Portfolio Transitions

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Many advisors still think of November and December as "tax-loss season," but tax management of client portfolios is better understood as a year-round opportunity to improve client outcomes. Systematic tax-loss harvesting is a key driver of the growing popularity of direct index separately managed accounts (SMAs) for clients with taxable accounts. The tax efficiency of funding SMA portfolios in kind can offer meaningful performance advantages over pooled vehicles, such as exchange-traded funds (ETFs) and mutual funds, for which cash is the only way in or out.

To help advisors compare the tax efficiency of similar investments, the CFA Institute's United States Investment Performance Committee (USIPC) has promulgated the USIPC After-Tax Reporting Standards of 2011 as a successor to the GIPS United States After-Tax Guidance of 2006.[1] These USIPC standards are commonly used for reporting historical after-tax performance and for illustrating the possible point-in-time tax advantages of transitions to direct index strategies. Illustrations for these transitions occasionally may show such advantages as a day-one net tax loss resulting from the transition.

Wealth managers should view such projections with caution because the Internal Revenue Service (IRS) uses a slightly different calculation method,[2] and a client's ultimate tax experience may differ substantially from the client's original expectation.

TWO CONFUSED CLIENTS

Because most investment advisors are not tax advisors, let's involve an accountant. Imagine two clients who have received tax-aware transition proposals to convert their existing portfolios of individual stocks, ETFs, and mutual funds into direct index SMAs tracking a major U.S. equity index. Their proposals both calculate "tax cost" according to USIPC guidelines. For mathematical simplicity, let's also imagine that both clients are subject to a short-term total tax rate of 40 percent and a long-term total tax rate of 20 percent. Neither expects to have any capital gains or losses other than those related to the transition proposal. And because it can get confusing to talk about positive and negative tax cost, let's use the words "tax impact."

Table 1

INVESTOR 1: TAX TRANSITION PROPOSAL

Security	Gain (Loss) Type	Gain (Loss) Amount	USIPC Tax Impact	IRS Tax Impact
A	Short-Term	($100,000)	($40,000)	0
B	Long-Term	$100,000	$20,000	0
C	Long-Term	$100,000	$20,000	$20,000
Net		$100,000	$0	$20,000

Investor 1 takes the tax transition proposal to an accountant to verify the tax impact of the chosen transition scenario. The proposal includes a detailed breakdown of the gains and losses that will be realized and the expected tax impact of realizing those gains and losses (see table 1).

The accountant says, "I have bad news," crosses out Security A's $40,000 tax impact and Security B's $20,000 tax impact, and changes the net tax impact from $0 to $20,000. The accountant reviews the disclosures on the proposal, tells the investor that they are very well written (see the suggestions below), and explains that the IRS does not account for gains and losses in the same way as USIPC-compliant investment proposals. In the view of the IRS, the scenario chosen by investor 1 is not tax-neutral; rather, investor 1 would owe $20,000 in capital gains tax if the proposal could be implemented exactly as proposed and the investor does not realize any additional capital losses.

Note that the accountant did not cross out any of the capital gains or losses. Altering the tax impact calculation does not alter the gains or losses themselves, and the net gain or loss does not change. The accountant also did not change the tax impact associated with Security C (the one that was not netted), so the tax impact of that sale remains the same.

Investor 2 takes a similar proposal to the same accountant (see table 2).

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This time the accountant says, "I have good news and I have bad news," crosses out Security X's $40,000 tax impact and Security Y's $20,000 tax impact, and changes the net tax impact from $0 to $20,000. Once again, the accountant reviews the disclosures on the proposal, tells the investor that they are very well written (again, they follow our forthcoming suggestions), and explains that the IRS does not account for gains and losses in the same way as USIPC-compliant investment proposals.

The IRS will allow only a portion of Security Z's $100,000 capital loss ($3,000 or $1,500, depending on the investor's filing status) to be used to offset ordinary income this year, resulting in a net tax loss this year of either $600 or $300. The remainder of the $100,000 long-term capital loss will be available to offset capital gains or a limited amount of income in subsequent years if the proposal could be implemented exactly as proposed and the investor does not realize any additional capital losses.

Once again, the accountant did not cross out any of the capital gains or losses or adjust the tax impact associated with Security Z.

ONE PORTFOLIO, TWO TAX COSTS

How can the USIPC and the IRS differ so widely on the tax impact of transition scenarios, and how can advisors explain the difference to clients?

The answer begins with an appreciation of the different objectives of both organizations. The USIPC standards exist to provide investors and advisors with accurate representation of the value that managers have provided during a particular period, allowing advisors and clients to compare the performance of investment choices facing identical market challenges. Such standards necessarily view an investment in isolation; they do not and cannot encompass whatever else might be happening in the rest of a client's portfolio.

Table 2

INVESTOR 2: TAX TRANSITION PROPOSAL

Security	Gain (Loss) Type	Gain (Loss) Amount	USIPC Tax Impact	IRS Tax Impact
X	Short-Term	$100,000	$40,000	0
Y	Long-Term	($100,000)	($20,000)	0
Z	Long-Term	($100,000)	($20,000)	($20,000)
Net		($100,000)	$0	($20,000)

In evaluating investment choices, advisors and investors want to know what each investment can contribute to an overall portfolio. Those contributions can take the form of investment growth, volatility reduction, tax reduction, current income, and other benefits. Because we want the most complete picture of the value added by a manager during a specific time period, the USIPC standards attribute all benefits (including tax advantages) to the period in which they were generated, not to the period in which they might ultimately be enjoyed by any particular investor.

Investors evaluating transition proposals have a similar interest in assessing the immediate tax impact of a change in strategy, which is why historical performance reporting standards are applied to forward-looking proposals. There is nothing intentionally misleading about this practice; it meets the test of describing what advisors and investors can expect from the proposed investment strategy in isolation from the rest of a portfolio. Such projections of tax impact do not and cannot consider whether other gains and losses in a client's portfolio might change the client's overall experience at tax time.

And that's the crucial distinction: The objective of the IRS is not to facilitate performance comparisons, but to assess taxable income accurately. Whereas the USIPC standards consider investments in isolation, the IRS considers investments in aggregate. The IRS (and, by extension, the accountant in the above examples) is able to see everything, which means that a client's total tax experience might be quite different from the expectation created by a specific proposal. Moreover, advisors and clients might justifiably be attracted to a proposal that purports to generate a net tax loss on day one; however, unused tax losses have no value (in the eyes of the IRS) until the year in which they actually are used.

The bottom line is that the tax impact a client expects after receiving a transition proposal might be substantially different from the tax impact the client experiences at tax time.

A SIDE-BY-SIDE COMPARISON

The USIPC standards (which optimization engines typically also follow) net short-term losses against short-term gains and "tax" the net at the short-term rate, then separately net long-term losses against long-term gains and "tax" the net at the long-term rate, and then sum the two tax impacts. Losses do not offset gains of a different type, and the ability to offset up to $3,000 of ordinary income is not considered.

IRS rules are a little more complicated:

1. If net long-term gain/loss AND net short-term gain/loss are both positive, each is taxed at the appropriate rate.
2. If one is positive, the other is zero/negative AND the sum of the nets is positive, that sum is taxed at the rate of the positive net gain.
3. If both are zero/negative OR the sum of the nets is zero/negative, the IRS tax impact is $0 and any remaining losses are eligible to offset some ordinary income and/or carry forward.

An exaggerated illustration comparing the calculations is shown in table 3.

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Table 3

COMPARISON OF USIPC AND IRS TAX IMPACTS

USIPC	Gain	(Loss)	Net LT or ST	Tax Rate	Tax Impact	
Long-Term	$100,000	$0	$100,000	23.8%	$23,800	
Short-Term	$0	($60,000)	($60,000)	40.8%	($24,480)	
					($680)	
IRS	**Gain**	**(Loss)**	**Net G or (L)**	**LT or ST?**	**Tax Rate**	**Tax Impact**
Long-Term	$100,000	$0				
Short-Term	$0	($60,000)				
	$100,000	($60,000)	$40,000	Long-Term	23.8%	$9,520

Figure 1

SAMPLE TAX COST CALCULATOR

Edit white cells only, and enter losses as negative numbers (preceded by a minus sign). ASSUMPTIONS: Gain and Loss values represent the only gains and losses available to the investor this year. A net loss under the USIPC tax calculation method may only be used (for IRS purposes) to offset some ordinary income this year or carried forward for use in future years. No other taxes are considered. For illustrative purposes only. This is not tax advice.

Capital Gain Tax Rates

	Federal	State	Total
Long-Term	20.00%	0.00%	20.00%
Short-Term	40.00%	0.00%	40.00%

Scenario Test: Realized Gain (Loss)

	Gain	(Loss)	NET LT/ST	Rate	Tax Calculation Methods: USIPC	Tax Calculation Methods: IRS
Long-Term	$100,000	$0	**$100,000**	20.00%	$20,000.00	B
Short-Term	$0	($60,000)	**($60,000)**	40.00%	($24,000.00)	
NET Gain (Loss)	**$100,000**	**($60,000)**	**$40,000**		**($4,000.00)**	**$8,000.00**

IRS Tests and Tax Costs (only one letter can apply)	Condition One?	Condition Two?	
IF ...			***THEN IRS Tax Cost is ...***
A) Net LT G/L > 0 AND Net ST G/L > 0	FALSE	N/A	(Net LT G/L × LT Rate) + (Net ST G/L × ST Rate)
B) Net LT G/L > 0 AND Net ST G/L <= 0 AND (Net LT G/L + Net ST G/L) > 0	TRUE	TRUE	(Net LT G/L + Net ST G/L) × LT Rate
C) Net LT G/L <= 0 AND Net ST G/L > 0 AND (Net LT G/L + Net ST G/L) > 0	FALSE	TRUE	(Net LT G/L + Net ST G/L) × ST Rate
D) Net LT G/L <= 0 AND Net ST G/L <= 0 (Also B & C if Cond Two = FALSE)	FALSE	N/A	$0.00

In this example, an investor who expected a net tax loss of $680 based on the transition proposal actually could be liable (absent any other relevant current losses or unused loss carryforwards from previous years) for tax due in the amount of $9,520. In a situation such as this, practitioners may wish to inform clients about potential tax surprises before they meet with their accountants. If advisors have this discussion after the tax year ends, they likely will have waited too long.

Advisors can use a simple Excel-based calculator to determine whether the IRS tax cost of a particular transition will differ materially from the USIPC tax cost (see figure 1). Although advisors may wish to create their own, our template with formulas can be provided upon request.

BEST PRACTICES FOR TAX IMPACT DISCUSSIONS

Advisors should understand (and direct index asset managers should take pains to disclose) the purpose and the limitations of tax impact calculations in transition proposals. This includes reminding investors that the estimated realized gains/losses and tax impact in a proposal are solely intended to help the investor compare the various scenarios described in that proposal. The investor's actual realized gains or losses, adjusted gross income, and total tax that eventually will be calculated for the tax year in which the proposal is implemented may differ significantly.

This is where well-written disclosures, such as those observed by our fictional accountant, can help. The conditions that can cause the actual values to be different from the proposal values include (but are not limited to) the following:

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1. The actual values will be calculated with full knowledge of all the investor's earned and unearned income, including any actual realized gains/losses not associated with the implementation of the proposal, whereas the proposal's estimated values have been calculated with very limited knowledge.
2. The actual realized gains/losses associated with the proposal will be calculated using the sales that were made to implement this proposal and the prices at the time those sales were made. The estimated gains/losses will be calculated using the sales that were expected to be made and the prices at the time the proposal was generated. The passage of time between proposal generation and proposal execution can result in short-term gains/losses becoming long-term gains/losses, and market volatility can result in differences in prices. These factors together can result in differences in both the set of securities sold and the sales prices received for those securities.
3. The USIPC tax impact methodology separately calculates the impact of short-term gains/losses and long-term gains/losses and then sums them to estimate a tax impact. In certain situations, the IRS methodology may require long-term gains to be netted with short-term losses, or short-term gains to be netted with long-term losses, either of which could result in a tax impact that is less favorable to the investor than was estimated in the proposal.
4. The USIPC tax impact methodology assumes that all realized losses can be used to lower the tax impact. The IRS methodology may disallow some losses in the tax year in which the proposal is implemented and require them to be used in subsequent tax years.

It seems reasonable to expect that, in most cases, IRS tax cost will not differ materially from USIPC tax cost. Discovering the difference in an accountant's office, however, may mean losing the opportunity to change a client's tax outcome for the better. In an effort to avoid such disappointments, our firm calculates transition tax impact both ways. Although our proposal documents conform to USIPC standards, our support team is equipped with the IRS tax impact of our proposals so that we can proactively discuss any significant potential differences with advisors using our direct indexing platform.

In addition, our gain budgeting methodology invites a client to identify a "tax reserve"—an amount that the client would be willing to pay in capital gains tax this year—and offers a transition option for which the calculated IRS tax cost aligns closely with the client's tax reserve. Although this approach is admittedly constrained by the number and quality of inputs, we believe it is preferable to a nasty surprise at tax time.

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ENDNOTES

1. USIPC After-Tax Reporting Standards, Revised Effective January 1, 2011, is an update of GIPS United States After-Tax Guidance, Effective January 1, 2006, https://www.cfainstitute.org/-/media/documents/corporate-record/usipc-after-tax-performance-standards.pdf.
2. See IRS Publication 544 (2021), Sales and Other Dispositions of Assets, Internal Revenue Service. https://www.irs.gov/forms-pubs/about-publication-544.

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