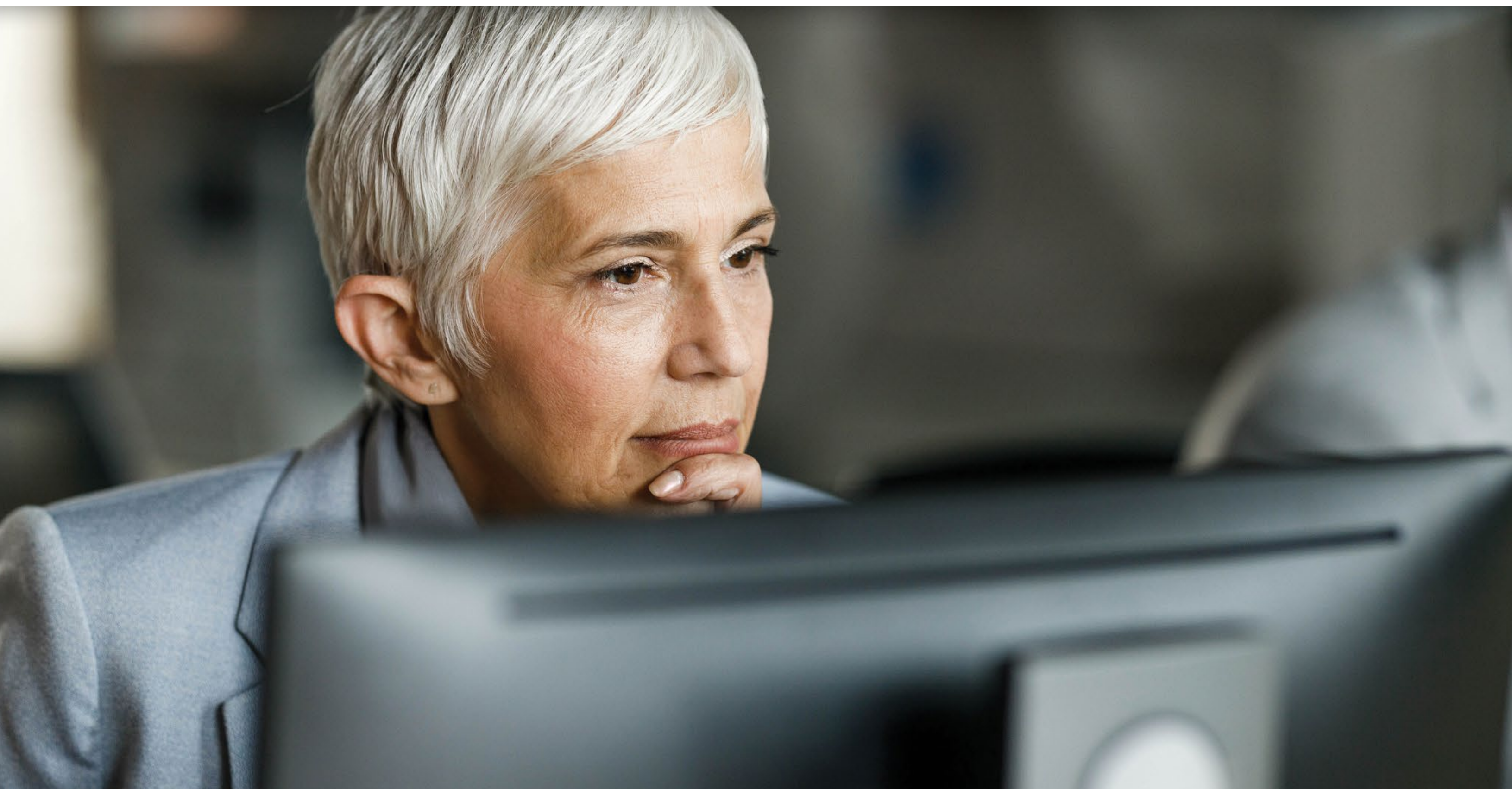
Vestmark | VAST®

Understanding Tax Cost in Portfolio Transitions

Systematic tax-loss harvesting is a key driver of the growing popularity of Direct Index SMAs for clients with taxable accounts. But many advisors may not be aware of the differences between after-tax reporting standards promulgated by the CFA Institute and the requirements of the IRS. Since a client's ultimate tax experience may differ substantially from their original expectation, this paper outlines key things that advisors should keep in mind when discussing such projections with clients.



For Financial Professional Use Only. Not For Use With The Public. Vestmark does not provide tax or legal advice. Prospective investors should consult with a tax or legal advisor before making any investment decision.

Vestmark®

While many advisors still think of November and December as "tax loss season," 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 SMAs for clients with taxable accounts, and the tax-efficiency of funding SMA portfolios in kind can offer meaningful performance advantages over pooled vehicles, such as 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. These USIPC reporting standards are commonly used not just for reporting historical after-tax performance, but also for illustrating the possible point-in-time tax advantages of transitions to Direct Index strategies. Illustrations for these transitions may occasionally show such advantages as a Day 1 Net Tax Loss resulting from the transition.

The IRS uses a slightly different calculation method from USIPC, and a client's ultimate tax experience may differ substantially from the client's original expectation. While VAST transition proposals conform to USIPC guidelines, there are some things to keep in mind when discussing such projections with clients. Examples are illustrated below.

Two confused clients

Since most investment advisors are not tax advisors, let's involve an accountant. Imagine that you have given two clients VAST 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 investors are subject to a short-term total tax rate of 40% and a long-term total tax rate of 20%. 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 costs", let's use the words "tax impact."

Investor #1 takes her VAST proposal to her accountant to verify the tax impact of the transition scenario she has chosen.

There are several investment-related risks associated with tax loss harvesting. There is potential that the tax loss harvesting may:(i) negatively affect the overall performance of an investor's portfolio; and (ii) result in a temporary overweight and/or underweight of certain sectors, securities, and/or cash in an investor's portfolio that influences performance, and VAS will not consider any other account that the investor may have. Tax-loss harvesting involves the risks that the new investment could perform worse than the original investment and that transaction costs could offset the tax benefit. VAS may repurchase securities after the end of the tax loss "wash sale" period at a price higher than that for which they were sold. Securities sold for the purpose of tax loss may or may not be repurchased by VAS following the 30-day wash sale period. VAS cannot prevent wash sales that may occur in other accounts besides the account to which the tax loss harvesting was applied. Furthermore, VAS cannot prevent wash sales that may occur due to investor or financial advisor requests that impact trading in the account.

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 (Table 1).

Table 1 – Gains, losses and Tax Impact for Investor #1

SECURITY	GAIN (LOSS) TYPE	GAIN (LOSS) AMOUNT	USIPC TAX IMPACT
A	Short	($100,000)	($40,000)
B	Long	$100,000	$20,000
C	Long	$100,000	$20,000
Net		**$100,000**	**$0**

For Illustrative Purposes Only.

Her 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 VAST proposal, tells the investor that they are very well written (see our disclosures later in this paper), 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.

Table 1 – Revised by the tax accountant

SECURITY	GAIN (LOSS) TYPE	GAIN (LOSS) AMOUNT	USIPC TAX IMPACT	IRS TAX IMPACT
A	Short	($100,000)	($40,000)	0
B	Long	$100,000	$20,000	0
C	Long	$100,000	$20,000	$20,000
Net		**$100,000**	**$0**	**$20,000**

For Illustrative Purposes Only.

Investor #2 takes a similar proposal to the same accountant (Table 2).

Table 2 – Gains, losses and Tax Impact for Investor #2

SECURITY	GAIN (LOSS) TYPE	GAIN (LOSS) AMOUNT	USIPC TAX IMPACT
X	Short	$100,000	$40,000
Y	Long	($100,000)	($20,000)
Z	Long	($100,000)	($20,000)
Net		**($100,000)**	**$0**

For Illustrative Purposes Only.

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 are VAST disclosures), 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 the 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.

Table 2 – Revised by the tax accountant

SECURITY	GAIN (LOSS) TYPE	GAIN (LOSS) AMOUNT	USIPC TAX IMPACT	IRS TAX IMPACT
X	Short	$100,000	$40,000	0
Y	Long	($100,000)	($20,000)	0
Z	Long	($100,000)	($20,000)	($20,000)
Net		**($100,000)**	**$0**	**($20,000)**

For Illustrative Purposes Only.

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 practitioners explain the difference to clients?

The answer begins with an appreciation of the different objectives of both organizations. The USIPC After-Tax Reporting 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.

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.

The USIPC Standards (which optimization engines also typically 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 LT Gain/Loss **AND** Net ST 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.

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, while advisors and clients might justifiably be attracted to a

proposal that purports to generate a Net Tax Loss on Day 1, unused tax losses have no value (in the eyes of the IRS) until the year in which they are actually 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 actually experiences at tax time. An example is illustrated below.

A side-by-side comparison

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

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)

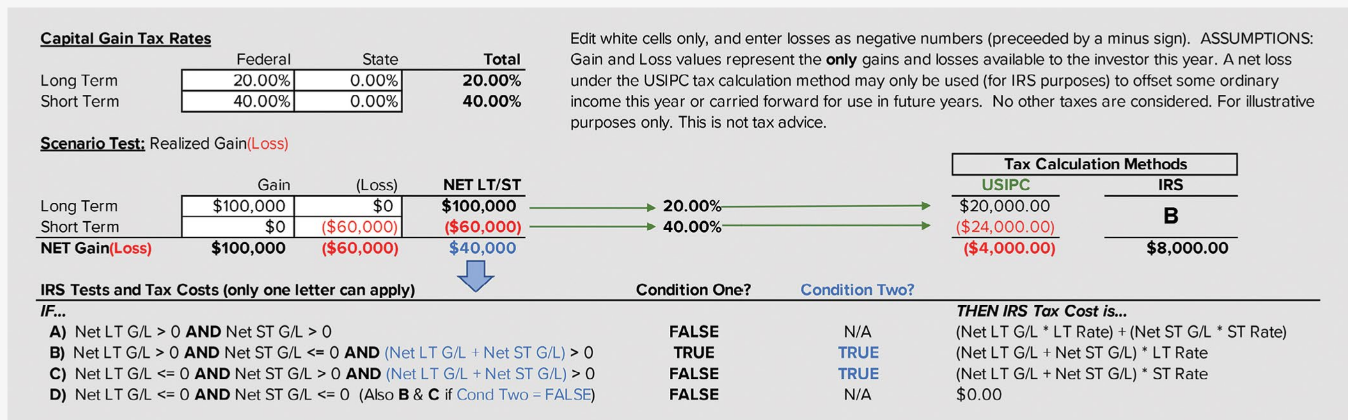
IRS	GAIN	(LOSS)	NET G OR (L)	LT OR ST?	TAX RATE	TAX IMPACT
Long-Term	$100,000	$0				
Short-Term	$0	($60,000)				
	$100,000	**($60,000)**	**$40,000**	Long-Term	23.8%	**$9,520**

For Illustrative Purposes Only.

In this example, an investor who expected a net tax ***loss*** of $680 based on her transition proposal could actually 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 like this, practitioners may wish to inform clients about potential tax surprises before they meet with their accountants. If you have this discussion after the tax year ends, you will likely have waited too long.

We have created a fairly simple Excel calculator to determine whether the IRS tax impact of a particular transition will differ materially from the USIPC tax cost (Figure 1). While practitioners may wish to create their own, we are happy to provide this simple template (with formulas) upon request.

Figure 1 – Sample tax cost calculator



Capital Gain Tax Rates

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

Edit white cells only, and enter losses as negative numbers (preceeded 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.

Scenario Test: Realized Gain(Loss)

	Gain	(Loss)	NET LT/ST		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) *IF...*	**Condition One?**	Condition Two?	***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

For Illustrative Purposes Only.

Best practices for tax impact discussions

Advisors should understand (and Vestmark takes 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/losses, adjusted gross income and total tax that will eventually be calculated for the tax year in which the proposal is implemented may differ significantly.

This is where VAST's 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:

1. The actual values will be calculated with full knowledge of all of the investor's earned and unearned income, including any actual realized gains/losses (in this portfolio and related to any other investments being managed by you or held elsewhere) 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 market 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 the 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 than 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 impact 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, Vestmark actually calculates transition tax impact both ways. While our proposal documents conform to USIPC reporting 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 the VAST platform.

In addition, our gain budgeting methodology invites a client to identify a Tax Reserve™ – what the client would be willing to pay in capital gains tax this year – and offers a transition option for which the calculated IRS tax impact 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.

SOURCES:

IRS Publication 544, Sales and Other Dispositions of Assets, Internal Revenue Service, Feb. 7, 2023

USIPC After-Tax Reporting Standards, Revised Effective 1 January 2011, is an update of GIPS United States After-Tax Guidance, Effective 1 January 2006

See what Vestmark can do for you

Learn more about how Vestmark VAST can help you provide personalized investing and tax management at scale.

Contact Us:

Email: vast@vestmark.com

www.VestmarkVAST.com

For Financial Professional Use Only. Not For Use With The Public.

There is no assurance that a separately managed account ("SMA") will achieve its investment objective. SMAs are subject to market risk, which is the possibility that the market values of the securities in an account will decline and that the value of the securities may therefore be less than what you paid for them.

This document does not constitute advice or a recommendation or offer to sell or a solicitation to deal in any security or financial product. It is provided for information purposes only and on the understanding that the recipient has sufficient knowledge and experience to be able to understand and make their own evaluation of the proposals and services described.

Vestmark Advisory Solutions, Inc. ("VAS"), a wholly-owned subsidiary of Vestmark, Inc., is an investment advisor registered with the U.S. Securities and Exchange Commission ("SEC"). VAS acts as a paid sub-advisor and/or overlay portfolio manager offering VAST and tax optimization services. Registration does not imply a certain level of skill or training. VAS has its principal place of business in Wakefield, MA. Investing involves risk. The value of an investment will fluctuate over time, and an investor may gain or lose money. Past performance is no guarantee of future returns and individual investor results will vary. Please consult our full disclosure document for a discussion of risks related to the services provided by VAS.

©2024 Vestmark, Inc. All Rights Reserved. Reproduction in whole or in part in any form or medium without express written permission is prohibited. Vestmark, VAST, and the Vestmark icon are registered trademarks. Other trademarks contained herein are the property of their respective owners. Vestmark believes that the information in this publication is accurate as of its publication date; such information is subject to change without notice.

VMK-VAST-WP/DIGI/UNDERSTANDING TAX COST/V5-3/24