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summaries

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THE UPSIDE TO DOWNSIDE

The return of volatility in 2018 gave investors some interesting opportunities to harvest tax losses throughout the year across different asset classes all around the world.

Prudent tax management and planning is a year round activity. However, extra emphasis tends to be placed on the end of the year (end of calendar year review time, mutual fund distribution season, etc.) and also the beginning of the year (start of tax season, Form W-2s, 1098s & 1099s distribution).

CONSIDERATIONS FOR TAX PLANNING

Any move an investor makes to optimize their tax situation requires keeping a handful of things top of mind.

First off, don't let the tax tail wag the investment dog. The last thing you want is to create an unintended, self-inflicted negative event by not thinking things through or trying to be too clever. It is important to keep actions simple, direct and understandable.

For example, someone may hold a low cost basis, concentrated single equity position with large embedded gains. Some investors will hold off from liquidating such a position because of the large potential tax bill even though they could be taking on substantial risk with continuing to hold on to such a large concentrated holding.

Another example could be realizing gains. Realized gains would bump up your AGI and this could affect your eligibility for certain tax credits and deductions if not planned out accordingly.

Secondly, one needs to consider how the sale affects their overall asset allocation and plan.

The opportunity to harvest losses may not be appropriate if it substantially changes the risk profile of your investment portfolio. Keep your long term investment objectives in mind first and foremost, but keep your eyes peeled for well thought-out tax optimization opportunities.

Finally, ask yourself the question "what is my current tax situation and where do I think my tax rate will be in the future?"

Without knowing where you currently stand, you won't be able to figure out the proper plan of attack to reach your future goals. Some proper tax management techniques can take place over long periods of time as well.

For example, if you are trying to change your tax exposure through Roth conversions of tax deferred accounts there may be an opportunity to parse out your conversions across multiple years to manage your tax bracket. Or maybe you are in a low income year in comparison to what you extrapolated for your future income. Then it might make sense to convert more tax deferred assets to Roth assets in this low income year as opposed to sticking with your initial plan of parsing it out.

TAX LOSS HARVESTING

Opportunities to tax loss harvest occur throughout the entire year. To take advantage of the opportunities requires keeping a keen eye on the underlying holdings and cost

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basis in order to identify potential opportunities to harvest. Periods of volatility in both Q1 and Q4 in 2018 provided the backdrop for tax loss harvesting in both equities and bonds.

But when doing so, don't forget about wash sale rules. Any purchases in either the same security or a substantially identical security across all of your taxable accounts made 30 calendar days before and purchases made 30 calendar days after your tax loss trade date will nullify the loss. This requires an investor to understand the nuances involved in what is considered a substantially identical security. This applies to ETFs, stock (preferred and common), and options.

Any violation of these rules will result in the loss being disallowed.

MUTUAL FUND CAPITAL GAINS DISTRIBUTIONS

One end of year issue to consider are large mutual fund capital gain distributions in taxable accounts.

These distributions can be caused by different factors including portfolio turnover and investor redemptions. These factors coupled with the fact that mutual funds by law must distribute virtually all gains to shareholders in capital gain distributions can lead to some large distributions. This can be avoided through the use of different investment vehicles (ETFs, individual stocks and bonds) and by keeping tabs on distribution estimates released by mutual fund families prior to the actual distribution. If the estimated distribution is too much for an investor to bear, the security can be sold prior to the record date to avoid this distribution. However, the sale would be a taxable event.

Another approach would be take a closer look at data points like annual portfolio turnover, after-tax returns, distribution history and fund inflows/outflows before initiating a positon. This will provide a clearer understanding of a mutual fund's tax profile.

SUMMARY

Proper tax management can add to your investment portfolio and investment plan's bottom line. However, knowing the nuances involved and some of the potential obstacles is required to implement a smooth approach. Keep things simple and easy to understand to avoid potential pitfalls. Ask yourself how these tax management moves affect your overall plan and whether the benefits outweigh the costs. Lastly, know where you are currently at from a tax perspective and have an idea of where you are heading in the future to put forth an optimal plan of attack.

One last point to remember, proper tax management also requires coordination between a client's investment advisor, tax advisor and estate planning advisor.

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