# Overlay tax management strategies[1]

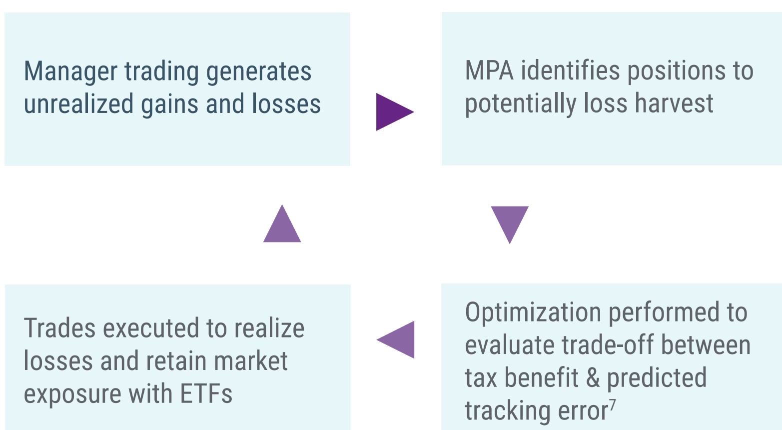
While views vary widely on tax policy, one thing everyone can agree on is that the US tax code is remarkably complex. Yet despite this complexity, there are some relatively straightforward techniques and strategies that can be employed to help manage the tax liability generated by clients' investment portfolios.

The importance of considering tax issues when managing client portfolios is significant. Research studies have found that taxes can cost clients as much as 2% or more in return on an annualized basis.[2] Lipper Analytics has observed that taxes are at least as important as fees in terms of their impact on investor returns.[3] But surprisingly, many clients, advisors and investment managers pay little attention to taxes when making investment decisions.

Over the past decade the discipline of overlay portfolio management has evolved and now often incorporates a number of tax management strategies to help manage clients' tax bills. Overlay managers coordinate the implementation of a range of different investment strategies, usually within a single account. This overarching perspective provides a unique opportunity to address tax issues by coordinating activity across the underlying components of the portfolio.

## Integrated Portfolio Implementation®

As an overlay manager, Managed Portfolio Advisors® (MPA) employs a process we call Integrated Portfolio Implementation®. This approach seeks to combine a disciplined yet flexible implementation process with robust tax management that preserves the integrity of the underlying investment strategies. Integrated Portfolio Implementation® incorporates a variety of specific tax management strategies, from tax loss harvesting[4] and short-term gain deferral[5] to optimal tax lot selection.[6]




**1** A management style that harmonizes an investor's separately managed account strategies, as well as other investment vehicles, preventing the formation of inefficiencies. Overlay management coordinates the implementation of multiple investment strategies or disciplines within a single account while ensuring the account remains aligned with a prescribed asset allocation. **2** Longmeier, G. and G. Wotherspoon, "The Value of Tax Efficient Investments: An Analysis of After-Tax Mutual Fund and Index Returns." The Journal of Wealth Management, Fall 2006. **3** Lipper Analytics 2010 Tax Study, Tom Roseen, Lipper, Refinitiv. **4** Selling securities at a loss to offset a capital gains tax liability. **5** The process of deferring the sales of securities that would result in the realization of short-term capital gains until those securities have been held for at least a year so that they qualify for treatment as long-term capital gains. For most taxpayers long-term capital gains tax rates are lower than the rate paid on short-term gains. **6** Tax lot selection involves choosing the optimal tax lot when selling off part of a security position so as to reduce the associated tax liability. **7** Predicted tracking error is only an estimate, and while it may be used to estimate this parameter, there is no guarantee that actual performance tracking differences realized will be in line with the levels predicted by the risk model.

## Tax loss harvesting

Of all the tax management techniques we employ, tax loss harvesting is likely to add the most potential benefit. The concept is fairly simple – identifying unrealized losses in an account and realizing them so they can be used to offset gains in that account or elsewhere. Any excess losses in a given year may be used to offset ordinary income[8] up to a limit and can then be carried over to be used in future years.

- MPA's tax loss harvesting is performed in a systematic manner throughout the year. Accounts go through the loss harvesting cycle illustrated above roughly every 31 days, timed to avoid potential wash sale[9] issues. This approach allows us to take advantage of opportunities to harvest losses that may not be available at year-end.
- The process incorporates sophisticated risk management tools to ensure the portfolio doesn't deviate excessively from the desired allocations.
- We replace loss harvested security exposures with exchange-traded funds,[10] which helps keep the overall portfolio in line with its asset class target weightings.

## Short-term gain deferral

For many investors, the difference between the tax rates that apply to long-term capital gains[11] and short-term capital gains[12] can be significant. When positions are being sold in portfolios, MPA may defer trades for certain accounts that have significant gains associated with those positions and are relatively close to reaching the one-year holding period that would qualify those gains for treatment as long-term.

## Optimal tax lot selection

Custodians typically resort to some kind of standardized accounting process (often First In First Out or FIFO)[13] when identifying which tax lot is being sold unless they are instructed otherwise. But in many cases there may be other tax lots that would generate less tax liability for the client. When implementing sales of securities in client accounts, MPA has the ability to look across a client's entire portfolio to find the optimal tax lot from a tax savings perspective.

## Avoiding wash sale rule violations

The IRS's wash sale rule prevents taxpayers from using a realized loss to offset gains if they purchase the same or a similar security within 30 days of the sale. Avoiding these occurrences can be difficult in a diversified portfolio when the different investment managers are acting independently. As an overlay manager coordinating activity across the entire portfolio, MPA can help prevent most of these types of situations.

## Other techniques

MPA also employs other techniques in tax-managed accounts to help mitigate the impact of taxes. Cash inflows into accounts can be used to true up allocations, reducing the likelihood that rebalancing[14] – and the associated trading and potential for realizing gains – will need to occur, to keep the portfolio aligned with its targets.

When the need for rebalancing does occur, the techniques discussed above come into play to help reduce the tax impact from that trading. Similarly, when clients must liquidate part of a portfolio, selecting the optimal tax lot and deferring some short-term gains may help reduce the associated tax liability. Transitioning a client's existing holdings can also be done in a more thoughtful manner when approached at the overall portfolio level.

Tax liabilities associated with investing have been rising in recent years. After over a decade of relatively low income and capital gain tax rates, low dividend and interest rates, and high levels of carry-over losses, 2013 saw the implementation of the Net Investment Income Tax, an additional 3.8% tax that may apply to investors in the top three tax brackets. Additionally, income and capital gains rates rose in the top tax bracket. As evidenced by mutual fund distribution trends, capital gains distributions have been increasing and dividend distributions have trended higher. Going forward, the outlook for tax rates is unclear, but even at the lower rates of recent years, the drag taxes impose on investment returns can be substantial.

MPA's approach to overlay management can help address this often neglected area of investment management. MPA seeks to strike the right balance between the investment considerations driving portfolio changes and the potentially significant tax benefits that can be gained from deviating temporarily from the recommended portfolio composition. By doing this in a thoughtful, risk-managed manner and customizing decisions at the individual client level, MPA strives to improve a client's after-tax investment results.

To learn more about how Managed Portfolio Advisors® can help mitigate tax liability in investment portfolios, please work with your financial advisor.

8 Income received that is taxed at the highest rates, or ordinary income rates. Ordinary income is composed mainly of wages, salaries, commissions and interest income (as from bonds). 9 A transaction where an investor sells a losing security to claim a capital loss, only to purchase the same or a similar security within 30 days. The IRS wash rule prevents taxpayers from using a realized loss to offset gains if they purchase the same or a similar security within 30 days of the sale. 10 An exchange-traded fund (ETF) is a type of fund that tracks an index, commodity or basket of assets and trades on an exchange. Exchange-traded funds trade like stocks and are subject to market volatility, liquidity risks and trading expenses. 11 A gain from a qualifying investment owned for longer than 12 months and then sold. The amount of an asset sale that counts toward a capital gain or loss is the difference between the sale value and the purchase value. Long-term capital gains are assigned a lower tax rate than short-term capital gains in the United States. 12 A capital gain realized by the sale or exchange of a capital asset that has been held for exactly one year or less. 13 An accounting method in which the assets produced or acquired first are sold, used or disposed of first. 14 Rebalancing may involve tax consequences.

Use of overlay management and tax management strategies does not guarantee a profit or protect against a loss in an investor's portfolio. Natixis Advisors, L.P. does not offer tax advice. Clients should always consult with their tax advisor to discuss their personal situation.



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