Investment Management for Taxable Private Investors

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Lifestyle,
Wealth Transfer
and Asset Classes

CATEGORIES OF SPENDING

1. BASIC NECESSITIES
   (food, basic housing, basic clothing, utilities, transportation, medical/insurance coverage)

2. LIFESTYLE MAINTENANCE
   (*education, entertainment, dining out, child care, family vacations*)

3. LUXURY CONSUMPTION
   (*luxury travel, luxury clothes, domestic staff, luxury furnishings*)

4. NON-INVESTMENT ASSETS
   (*primary home, second home, yacht, private airplane, art, antiques*)

5. SAVINGS AND INVESTMENTS
   (*bank accounts, employee stock and options, pensions, whole life insurance, stocks, bonds, alternative investments*)

A sixth category is the goal of making money as an end in itself, either for ego, prestige, or a sense of "winning."

"Four Horsemen of the Investment Apocalypse"

1. Investment Expenses
   (Management Fees, Transaction and Custody Costs),
2. Taxes
   (Income and Estate Taxes),
3. Inflation,
4. Consumption.

Annualized Compound Returns, 1925–2004
(net of taxes and inflation)

U.S. Asset Class Returns

Stocks 4.8%

Municipal bonds 1.3%

Government bonds 0.8%

Treasury bills 0.9%

Source: Ibbotson Associates (2005)

These results would be very different, and more attractive, if the analysis used today's tax rates, which are some of the lowest seen in the post–World War II era.

Overview of Federal Taxation of Investments

Three Factors Determine the Amount of Tax

- Tax "Rate"
- "Character" of Income
- Applicable "Netting" Rules

Key Tax Questions in Analyzing Investments

First, what is the *character* of the components of expected return, e.g., ordinary income; dividends; long-term capital gains; short-term capital gains; asset class–specific tax rates; federal tax exemptions; state/local tax exemptions; foreign income subject to withholding.

Key Tax Questions in Analyzing Investments

Second, given the character of the income, the AMT, and the limitation on deductions, what will be the effective marginal tax rate for the *n*th dollar of return?

Key Tax Questions in Analyzing Investments

Third, what deductions, expenses, or offsets are available to reduce the tax on the investment return? Does this investment make the most efficient use of those potential benefits? Will the taxpayer be subject to the AMT, and if so, how will being subject to the AMT affect the net treatment of taxable income?

Key Tax Questions in Analyzing Investments

Fourth, especially for periods of fewer than 12 months, what is the anticipated holding period of the investment?

Key Tax Questions in Analyzing Investments

Fifth, how will potential future changes in tax rates affect the after-tax risk and return attractiveness of the investment?

Key Tax Questions in Analyzing Investments

Sixth, how will the long-term attractiveness of the investment be affected by the application of the estate tax?

Techniques for Improving After-Tax Investment Performance

Wealth from $10,000 Invested after Different Tax Rates Applied

	5 Years	**10 Years**	**20 Years**
ROR=5%			
15% LTCG tax	$2,310	$5,160	$12,990
35% STCG tax	$1,730	$3,770	$8,960
ROR=10%			
15% LTCG tax	$5,040	$12,610	$41,120
35% STCG tax	$3,700	$8,770	$25,240

Notes: LTCG = long-term capital gains; STCG = short-term capital gains

Summary

Investment tax strategies fall into a few broad categories:

- Convert the character of taxable return from high-tax ordinary income or short-term capital gains into low-tax long-term capital gains.
- Delay the recognition of gain or income for long periods of time.
- Hold off the recognition of gain or income until death so that only the estate tax, if any, applies.
- Create voluntary losses to offset current gains.
- Use government-sanctioned tax-sheltering vehicles to defer or eliminate taxation of investment returns.