THE NORTHERN TRUST INSTITUTE

THE TAX EFFICIENT INVESTOR

PREPARING PORTFOLIOS FOR CHANGE

In a low expected return environment, the prospect of changing tax rates has investors rightfully concerned about their bottom line. New research from The Northern Trust Institute sheds light on the potential impact of higher taxes on portfolios and offers tax-efficient strategies for current and expected tax environments.

Typically, in the wake of a presidential election, the question is not if there will be tax reform, but when and to what degree. Historically, new administrations, regardless of party affiliation, propose tax policy changes for Congress to enact. President Biden is no exception and his tax plan has caught investors' attention, especially among high net worth investors. Investors' top concerns center on a few key elements of the proposed plan, including:

INCREASING THE TOP INCOME BRACKET

37% → 39.6%

for those earning more than $400,000 per year

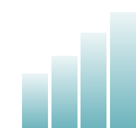
LOWERING THE ESTATE TAX EXEMPTION

INCREASING THE TAX RATE ON LONG-TERM CAPITAL GAINS AND QUALIFIED DIVIDENDS

20% → 39.6%

on incomes above $1 million

ELIMINATING THE STEP-UP IN TAX BASIS UPON DEATH



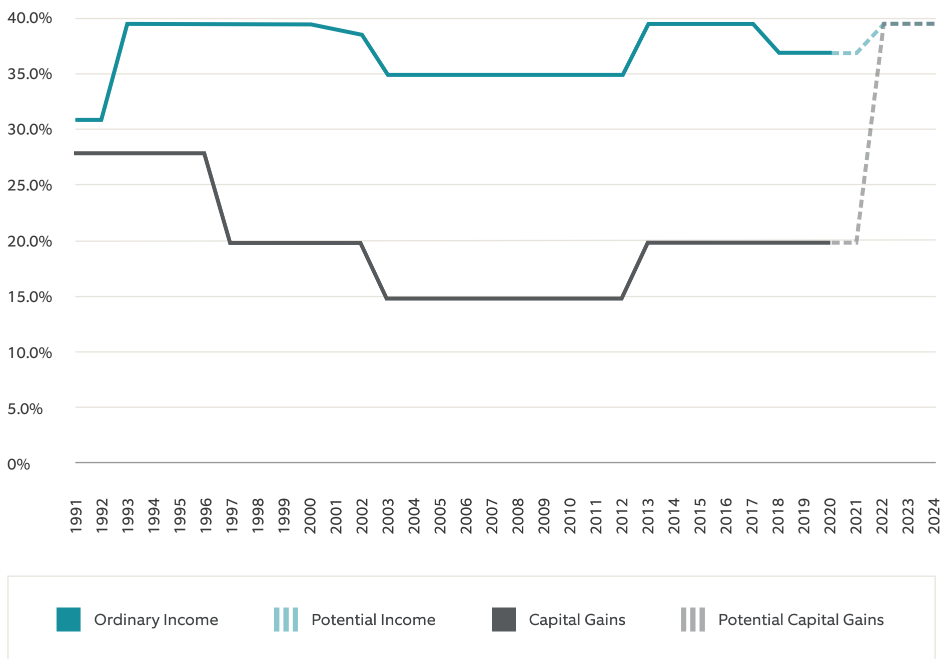
These changes almost always come slowly, as Congress debates the needs, costs, and specifics of the new administration's proposals. Rarely are the resulting tax law changes applied retroactively. In fact, over the past four administrations, changes took place on average 502 days after inauguration. And while a few provisions of the 2001 tax law were applied retroactively under the Bush administration, the only time comprehensive changes were applied retroactively was in 1993 when President Clinton was in office.

While history is not obliged to repeat itself, it does suggest that any changes to tax law are likely to provide ample time to understand the implications and adjust your investment strategy in alignment with your goals. As of the time of this writing, Congressional debates have not yet begun. But once they do, it is unlikely, given Congress' budget reconciliation process, that any change would take effect until 2022.

PUTTING THE PROPOSED CHANGES IN PERSPECTIVE

Recent history provides a helpful guide for interpreting the potential magnitude of President Biden's proposed tax changes. Exhibit 1 shows the highest marginal tax rates on ordinary income and long-term capital gains over the last 20 years. (Note that a beneficial tax rate on qualified dividends was introduced under the Tax Relief Reconciliation Act of 2003, with an applicable tax rate equal to that on long-term capital gains.) As the chart indicates, the proposed income tax increase is relatively small and would return it to 2013-2017 levels. In contrast, for investors in the highest tax bracket, the proposed tax increase on qualified dividends and long-term capital gains is more significant — and represents a material departure from recent history.

EXHIBIT 1 – HISTORICAL U.S. TAX RATES

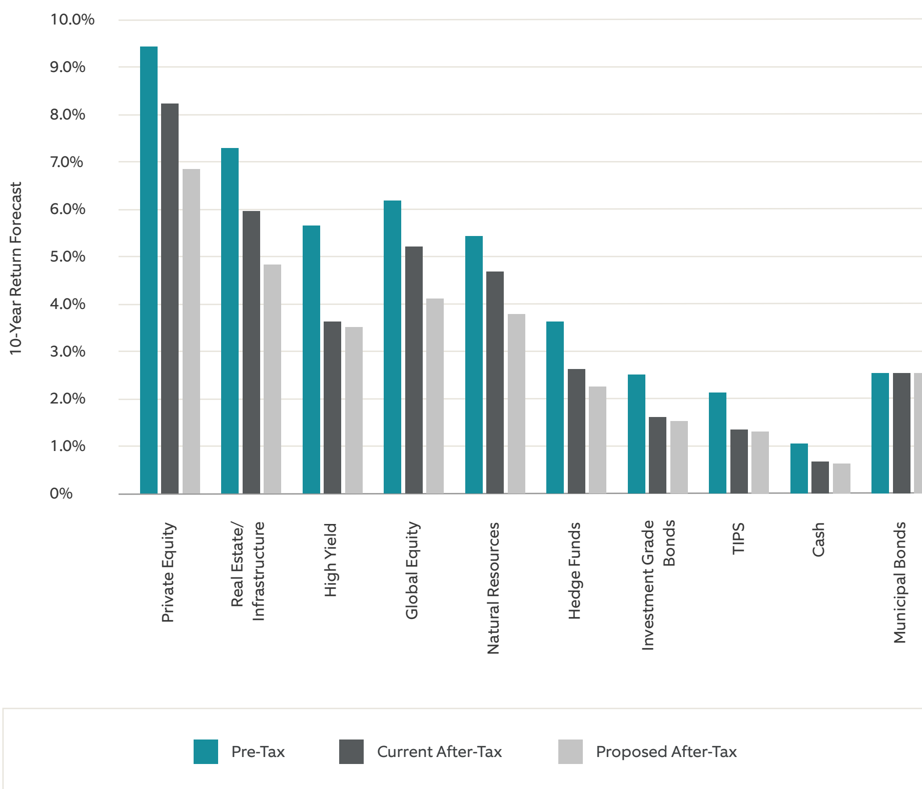


Source: The Northern Trust Institute

PORTFOLIO IMPLICATIONS OF THE PROPOSED TAX PLAN

At Northern Trust, we have long considered taxes in our annual Capital Market Assumptions (CMAs) and use after-tax portfolio optimizations to determine our recommended Strategic Asset Allocation (SAA). Exhibit 2 shows return expectations for strategic asset classes based on current tax policy and 2020-2021 CMAs:

EXHIBIT 2 - NORTHERN TRUST'S CAPITAL MARKET ASSUMPTIONS (CURRENT)



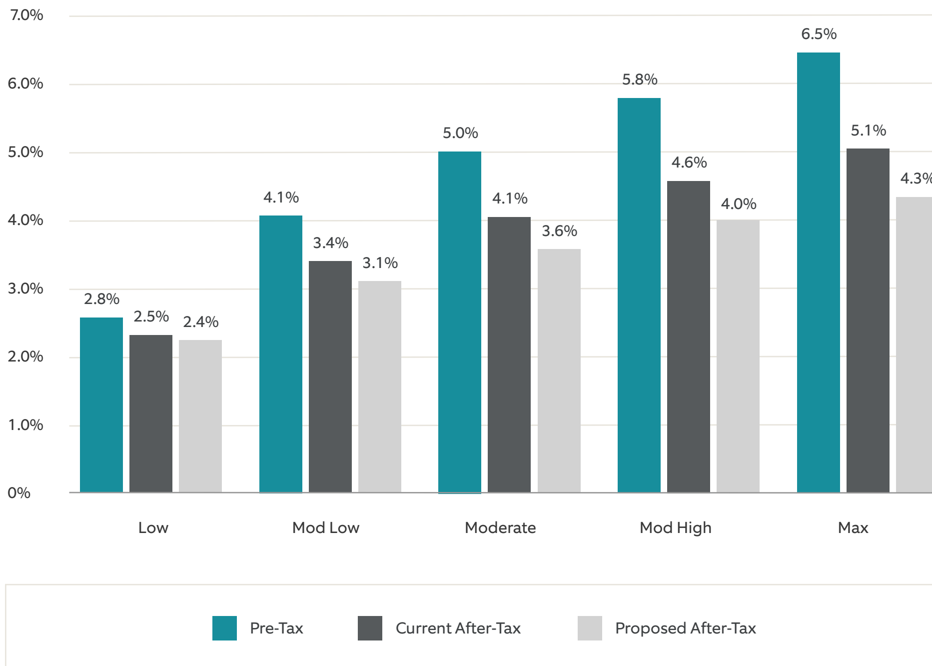
Source: Northern Trust Investment Policy Committee and The Northern Trust Institute

Based on current tax rates, our return expectations come down 0.9% on average after-tax across asset classes from their pre-tax forecasts. Under the proposed plan, those same return expectations decrease 1.4% on average. Risk-control assets (cash, TIPS, and investment-grade bonds) see a modest decrease in expected after-tax return because their return is dominated by income, and the increase in the ordinary income tax rate is modest. The after-tax return profile of municipal bonds remains unchanged given their income exemption from federal tax.

The proposed tax change on long-term capital gains and qualified dividends, however, is more impactful for after-tax returns. For example, the expected after-tax return for global equity investments that typically dominate Risk Asset portfolios would be reduced by an additional 1.1%, for a total reduction of 2.0% relative to our pre-tax forecast. Asset classes with particularly favorable capital market assumptions like private equity (-2.6%) and real estate/infrastructure (-2.5%) are even more impacted.

Exhibit 3 shows how the relative weighting to risk assets, like global equity, largely influences just how impactful the tax proposals could be for total portfolio returns:

EXHIBIT 3 – EXPECTED RETURNS BY RISK-BASED INVESTMENT OBJECTIVE



Source: The Northern Trust Institute Research of tax-optimized strategic asset allocation models

Under current tax policy, we forecast a tax-driven reduction in our Moderate Risk portfolio of 0.9% on its 5.0% pre-tax return, while our Maximum Risk portfolio would realize a 1.4% reduction on its 6.5% pre-tax return. If the administration's tax proposals were enacted as is, expected after-tax returns for the same Moderate Risk portfolio would be further reduced by 0.5% (1.4% total), while the Maximum Risk portfolio would see a further reduction of 0.8% in expected return (2.2% total).

FIVE CORE PRINCIPLES FOR TAX-EFFICIENT INVESTING

We believe assets serve a purpose — to fund goals. Therefore, a personal investor's overriding investment objective should be to fund lifetime goals efficiently. While taxes are one of many factors to consider in achieving that objective, the tax "tail" should not be allowed to wag the "dog" when developing an investment strategy.

Instead, we advise employing five core principles for tax-efficient investing should tax reform be enacted as currently proposed.

REALIZE CAPITAL GAINS WHEN NECESSARY TO FUND GOALS OR MANAGE RISK

Financial goals – whether funding one's lifestyle, securing wealth transfer goals, or philanthropic gifting – should be the primary driver of your investment strategy and wealth plan. Efficient goal funding considers the timing, magnitude and priority-level of each individual goal. The overall goal profile provides a roadmap of necessary liquidity events, with implications for optimal asset-goal alignment through time. For example, if the step up in tax basis is eliminated, low-basis assets may be better suited to fund philanthropic goals than wealth transfer goals. Similarly, occasional gains may need to be taken to fund your lifestyle goals efficiently over time and to keep your portfolio aligned with your risk preferences. Periodic rebalancing may be necessary to manage risk and maintain robust diversification across and within asset classes even though it may incur capital gains tax.

AVOID REALIZING CAPITAL GAINS UNNECESSARILY

Although short-term and long-term capital gains would be taxed at the same rate under the proposed plan, your after-tax return would still benefit from longer holding periods due to deferral of the capital gains tax. In fact, the difference in after-tax returns over time is even greater with higher capital gains tax rates. Longer holding periods also preserve optionality should future tax changes revert to a lower long-term capital gains tax rate, as has happened in the past.

MINIMIZE TAXABLE INCOME WITHOUT UNDERMINING DIVERSIFICATION

Interest income tax is no less onerous than dividend income tax under the proposed plan, making interest income relatively more attractive than it is under current tax rules. However, despite gains being taxed at the same rate, long-term capital gains would still benefit from a lower overall tax burden than interest or dividend income due to the after-tax return compounding benefit of the tax deferral. We caution, however, that tax strategies focused blindly on minimizing dividend or interest income can undermine portfolio efficiency by producing undesired concentrations and risk exposures.

EMPLOY ASSET LOCATION TO MAXIMIZE RETURN CONTRIBUTION AND DIVERSIFICATION BENEFITS

Interest income, dividend income, and realized capital gains are not taxed in tax-favored accounts, such as IRAs. Place less tax-efficient assets, such as high-yield and other taxable bonds, real estate investment trusts, high-dividend equity and high-turnover active strategies, in tax-favored accounts. However, when using asset location to mitigate taxes, it is important to do so within a broader framework that considers overall portfolio diversification across taxable and tax-favored accounts, and goal-funding liquidity needs over time.

USE AFTER-TAX PORTFOLIO OPTIMIZATION

Find the optimal after-tax mix of asset classes across taxable and tax-favored accounts. After-tax portfolio optimization can show whether an asset's diversification benefit outweighs an otherwise less-efficient tax profile. After-tax portfolio optimization is the gold standard, as it simultaneously solves the asset allocation and asset location problem. And it can sometimes override the other principles detailed above.

HOW TO ADDRESS UNREALIZED GAINS

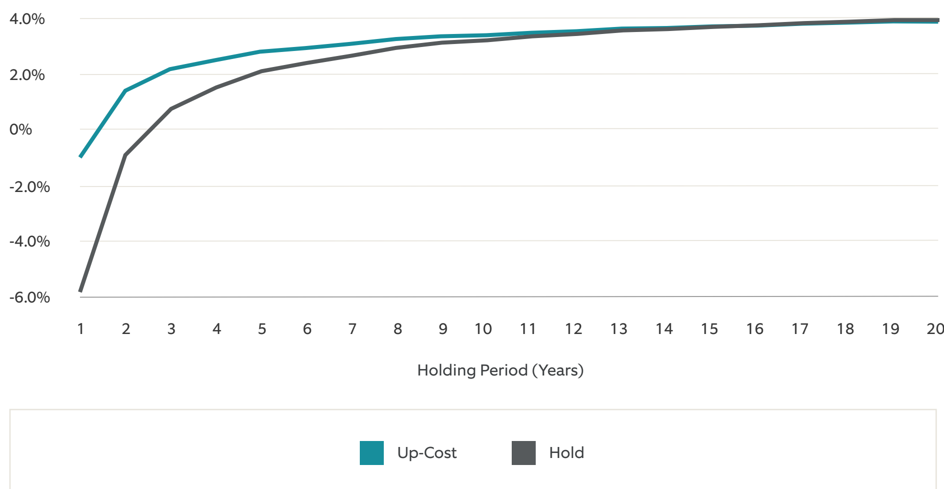
Given the significant possible increase in long-term capital gains tax rates, a natural question is whether it makes sense to realize capital gains in 2021 (i.e. to "up-cost" the tax basis) at the current lower long-term capital gains tax rate — assuming any tax changes are not retroactive to 2021. A goals-based perspective can help inform this decision.

In Exhibit 4, we illustrate the impact the proposed changes would have if legislated as they have been proposed. For this example, we assume an average unrealized gain of 35% and use Northern Trust's capital market assumptions for global equity.[1]

The "Hold" scenario assumes the investor maintains their unrealized gain position while the administration's plan for dividend and capital gains tax rates goes into effect in 2022. The "Up-Cost" scenario assumes the investor sells to realize capital gains in 2021 at the current 20% long-term capital gains tax rate, then reinvests the proceeds back into equity to up-cost the tax basis. In both scenarios, the investor ultimately realizes capital gains at the end of the remaining holding period (which is also consistent with the proposed elimination of the step-up in tax basis).

The exhibit below shows the after-tax return over the remaining holding periods for both scenarios. The after-tax return is calculated from the same initial pre-tax market value in 2021.

EXHIBIT 4 – UP-COST ILLUSTRATION



Source: The Northern Trust Institute

1. Expected return (6.15%), income return (2.60%), and standard deviation (15.4%) are based on IPC capital market assumptions for global equity. Tax analysis is based on the expected (50th percentile) outcome of a Monte Carlo simulation using the method documented in the appendix of Mladina, P., "Refining After-Tax Return and Risk Parameters," The Journal of Wealth Management (2020).

The up-cost scenario outperforms over holding periods of one to about ten years. At ten years, the difference in annualized after-tax return decreases to about 0.20%. After ten years, the difference is immaterial until it slightly benefits the Hold scenario over long holding periods.

These results suggest that up-costing equity may be prudent for investors funding near and intermediate-term (1-10 year) goals. For longer-term goals, the up-cost benefit dissipates, and investors may choose to retain optionality in the event that future tax reform lowers the capital gains tax rate.

TAX EFFICIENT INVESTING

The final form of any future tax law change is uncertain, and history tells us any changes may not endure as economic and political environments shift. The key to successfully maneuvering through the unknown is to have an investment strategy and wealth plan that can easily adapt to changing circumstances and evolving goals. That is what Goals-Driven Wealth Management at Northern Trust is all about.

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