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Tax Alpha Isn't Just for the Superrich

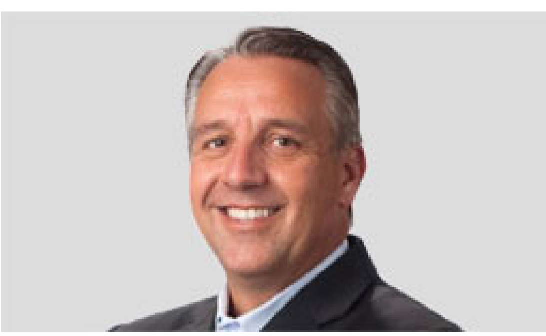
By Chris Latham December 30, 2014

"Don't let the tax tail wag the investment dog" is among the most ubiquitous warnings in wealth management. It also might be the most overhyped one. In fact, tax alpha is often the best alpha, experts say — if by "alpha" you mean retained earnings in excess of average expected performance. That's because tax strategy is far more predictable and controllable than investment strategy.

It also has a clear, measurable impact on a client's net worth. And even without an accounting or tax-law degree, advisors have plenty of techniques at their disposal for mitigating taxes on investment earnings. To be sure, it often helps to confer with a specialist.

Ultra-wealthy clients often benefit from strategies to generate tax alpha, but many of those strategies are also available to the mass affluent, according to **Clint Pelfrey**. He's president of **Prosperity Capital Advisors**, which manages $350 million in Westlake, Ohio. "The middle-class millionaire, with IRAs and 401(k)s, is often overlooked," he says. "I'm not a tax expert; but as an advisor, it is a key component of what I work on with clients."

For Pelfrey, this entails using passive or lower-turnover strategies in pretax and non-qualified accounts, and active strategies in tax-deferred accounts. His firm uses funds that incorporate tax-loss harvesting, as well as portfolios of funds ranging from all equity to all fixed income — including tax-exempt municipal bonds.


Clint Pelfrey

Tax-loss harvesting and holding-period strategies are perhaps the easiest ways for any advisor to keep earnings in the client's pocket and out of the **IRS**'s, says **Stephen Horan** of the **CFA Institute**. He's a managing director based in Charlottesville, Va.

Tax-loss harvesting, or selling underperforming shares in a client's portfolio to help offset capital gains, should be done throughout the year — not just in late December. And it works best over several years, according to Horan. Of course, an outperforming stock will eventually trigger capital gains taxes when sold; but if its winning streak holds, letting the returns compound over years benefits the investor.

Meanwhile, advisors can save clients taxes simply by holding securities for more than a year instead of one year or less. Waiting just two extra days to sell shares means the difference between a short-term and a long-term capital gain, Horan says — and short-term gains generally incur higher taxes.

Even so, many advisors downplay tax considerations. “Clients ask for it in much greater numbers than they actually get it,” Horan says. He believes advisors worry that fixating over taxes will lead to warped investment decisions. That’s a valid concern, up to a point, he admits: “You wouldn’t want to pick an investment product just because it’s tax-efficient, because the product could be an MLP with a risk-return profile that’s antithetical to the client’s core boundaries.”

The advantages of some tax moves so strongly outweigh their risks that advisors have an obligation to consider them, according to **Michael Delgass**, managing director of **Sontag Advisory**, which manages over $4 billion in New York.

Asset location, for example, can add 2% in after-tax returns, says Delgass, an attorney with expertise in tax law and estate planning. With tax-exempt municipal bonds, advisors can add 1% of fixed-income yield — based on the historic spread between munis and taxable bonds — and another 1% by putting munis in non-qualified accounts while putting taxable issues into IRAs. This requires being nimble, Delgass warns. For example, in recent years, sky-high yield-to-default ratios made junk munis far more attractive than junk corporates.

The AMT Deep End

No dive into investment-related tax strategy is complete without dipping into the alternative minimum tax, or AMT, says **Matthew Allain**. He’s CEO of the **Leo Group**, a Chatham, N.J., RIA that supervises almost $600 million.

The IRS defines AMT as “the excess of the tentative minimum tax over the regular tax.” Basically, it’s the federal government’s way of making sure wealthy people with heaps of exemptions and deductions pay taxes — usually at least 26% of gross earnings. Those deductions often stem from real estate, investment-management fees, tax-preparation fees and legal fees, Allain says.

Advisors can help clients avoid the AMT and mitigate overall taxes by accelerating realization of regular income, according to Allain. In effect, clients get taxed earlier on certain events instead of deferring them. After the IRS recognizes that clients are “out of the AMT,” clients can take their remaining deductions.

“That can be counterintuitive,” he says. “AMT planning requires intimate knowledge of clients’ current and future income items and tax exposure.”