Create a Lean, Mean, Tax-Efficient Portfolio

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Why should investors care about the tax efficiency of their investments?

- Many factors are outside of investors' control, including:
  - The health of the economy
  - The trajectory of the stock and bond markets
  - The direction of interest rates
  - The rate of inflation
  - The direction of the dollar (or euro or yen)

Why should investors care about the tax efficiency of their investments?

- Minding tax efficiency is on a very short list of factors that investors do exert at least some control over.
  - Their savings rates
  - Their asset allocations
  - The quality of the investments they choose
  - The fees they pay
  - The drag of taxes on their portfolios

In the course of this presentation, I'll cover:

- How to put tax-sheltered investment accounts to work for you
- How to decide between Roth and Traditional tax-sheltered vehicles
- How to maximize your aftertax returns from your taxable accounts
- Model tax-efficient portfolios
- Best practices for managing your taxable portfolio
- How to draw down your various accounts in retirement

Tax-sheltered vehicles: Definitely not perfect

- Limits on how much you can put in
- Money cannot usually be withdrawn prior to retirement without taxes and/or penalty
- But at some point, money has to come out on a predetermined schedule (unless it's a Roth IRA)
- There may be strictures on what you can invest in (especially in company plans)
- Company plans, especially, may feature layers of fees

But the tax benefits can boost take-home returns

- Example 1: Emily invests $15,000 of her salary in a 401(k) for 30 years
  - She contributes pretax dollars so her annual contribution is $15,000
  - She invests in a balanced portfolio that earns 6% per year; those earnings are not taxed as they are accrued
  - Balance after 30 years = $1,185,873
  - She'll owe income taxes on her balance when she pulls money out in retirement
  - Value upon withdrawal (assuming 25% income tax bracket) = $889,405
  - Employer matching contributions would further boost 401(k) advantage

Meanwhile, taxes drag on taxable accounts: in, out, along the way

- Example 2: Kathy invests $15,000 of her salary in a taxable account for 30 years
  - She must contribute aftertax dollars so her annual contribution declines to $11,250 if she's in the 25% tax bracket
  - She invests in a balanced portfolio that earns 6% per year
  - After income and capital gains taxes are taken into account, she earns 5.5% per year
  - Balance after 30 years = $814,899
  - She'll owe capital gains taxes on her appreciation when she pulls money out
  - Value upon withdrawal = $743,289 (assuming 15% capital gains rate on appreciation)

Employer-provided plans at a glance: 401(k), 457, 403(b)

- No income limits on contributions
- $18,000 contribution limit if under age 50 (2016); $24,000 for 50+
- Two major flavors of contributions:
    - Traditional (pretax contributions, balance taxed upon withdrawal in retirement)
    - Roth (aftertax contributions, balance not taxed upon withdrawal in retirement)
    - Roth contributions may not be available in every plan
- Participants must take mandatory distributions after age 70-1/2 (Roth, too)
- Matching contributions, automatic features add to the advantages

Aftertax 401(k) contributions may also be an option

- Total 401(k) contributions (conventional contributions plus aftertax) can go as high as $53,000 in 2016
- Aftertax contributions are not the same as Roth contributions; earnings still taxable
- BUT aftertax 401(k) monies can be converted to Roth provided employee:
  - Is retired
  - Has left employer ("separated from service")
  - Can take "in-service" distribution from the plan
- Virtue is that employee builds more assets eligible for Roth conversion

But there are limits to benefits of aftertax 401(k) contributions

- Only advisable if investor is already maxing out contributions to conventional 401(k) and IRA (and maybe health savings account, too)
- Investment earnings on aftertax contributions are still taxable upon conversion to Roth or withdrawal
- Aftertax 401(k) contributions could also face legislative scrutiny in the years ahead
- Obama FY2017 budget would bar aftertax dollars from conversion to Roth IRAs
- Aftertax 401(k) contributions not available in many plans

IRA: The other key retirement-savings vehicle

- Open to anyone with earned income
- 2016 contribution limit: $5,500 if under 50/$6,500 if 50+
- Can invest in almost anything inside of an IRA wrapper
- Two main varieties: Traditional and Roth
- Traditional IRA tax treatment: Contributions may be deductible, tax-deferred compounding, withdrawals in retirement taxed as ordinary income to the extent they consist of money that has never been taxed.
- Roth IRA tax treatment: Contributions not deductible, tax-free compounding, tax-free withdrawals in retirement

Roth IRA basics

- Income limits apply to contributions
  - Single filers with less than $132,000 in MAGI in 2016 can make at least a partial Roth IRA contribution
  - Married couples filing jointly with less than $194,00 in 2016 can make at least a partial Roth contribution
- No required minimum distributions post age 70-1/2 (at least not right now)
- Contributions can be withdrawn at any time and for any reason
- Perfect vehicle for multitaskers (e.g., building emergency fund, saving for retirement)

Traditional IRA basics: Deductible

- Traditional IRA contributions are deductible by anyone who cannot contribute to a company retirement plan, regardless of income
- Income limits apply if you can contribute to a company retirement plan and want to deduct your contribution
  - Single filers with less than $71,000 in MAGI can make at least a partially deductible contribution (2016)
  - Married couples filing jointly with less than $118,000 in MAGI can make at least a partially deductible contribution (2016)
- Required minimum distributions apply

Traditional IRA basics: Nondeductible

- Investors of any income level with earned income can make a nondeductible contribution to a Traditional IRA
- Sole tax benefit: Tax-deferred compounding (Money is taxed going in and coming out)
- Required minimum distributions apply
- Can also serve as a conduit to a "backdoor Roth IRA"
  - Popular among earners whose MAGI is too high to allow for a deductible Traditional IRA or Roth IRA contribution
  - The maneuver: Fund Traditional IRA, then convert to a Roth IRA later on. Voila! Roth IRA.
  - Assuming no other IRA assets, only amount that is taxable is investment earnings since contribution has already been taxed

When “backdoor Roth” is not advisable: You have other IRA assets

- Taxation of your conversion of Traditional IRA assets to Roth depends on the ratio of assets in your IRA that have never been taxed (pretax contributions and investment earnings) to those that have already been taxed (aftertax, nondeductible contributions)
- Example:
  - Rosa invests $5,000 in a Traditional IRA; she earns too much to deduct her contribution
  - She also has $45,000 in an IRA rolled over from a former employer; that money has never been taxed
  - 90% of her IRA assets are taxable ($45,000 rollover IRA/$50,000 her total IRA kitty)
  - Even if she converts only her new, $5,000 IRA to Roth via “the backdoor,” $4,500 (90%) would be subject to taxes

And days could be numbered for "backdoor Roth"

- Maneuver is a loophole created by Congress' lifting income limits on IRA conversions starting in 2010
- Obama budget has twice including proposals to end backdoor Roths by barring aftertax assets from being converted to Roth IRAs
- Change in the laws unlikely to affect assets already in Roths via "backdoor"
- But would affect the ability to make future conversions of aftertax dollars

Traditional or Roth: How to choose?

- For IRAs, there may be no choice: Income limits on contributions may make the decision for you
- For 401(k)s, income doesn't affect eligibility; everyone can contribute max
- Assuming you can contribute to either a Roth account or make a deductible IRA or 401(k) contribution, the right answer depends on when the tax break is most valuable:
  - Higher tax rate at time of contribution than in retirement? Make Traditional deductible
  - Lower tax rate at time of contribution than in retirement? Make Roth
- If you're not sure, you can split your contributions across the two account types
- Roth contributions also better if you have more money than you'll need in retirement, because Roth IRAs aren't (currently) subject to RMDs

A word about health savings accounts (HSAs)

- Can have one only if you participate in a high-deductible heathcare plan
- Current contribution limit: $3,350 (singles), $6,750 (families)
- Catchup contributions (age 55+): $1,000
- Triple tax-advantaged:
  - Pretax contributions
  - Tax-free compounding
  - Tax-free withdrawals for qualified healthcare expenses
- Can be used for anything post age 65, but you will pay ordinary income taxes on distributions for non-healthcare needs
- Great auxiliary savings vehicle for “healthy and wealthy” (save HSA, don’t spend it)

What if employer-provided HSA is lousy?

- HSAs can be larded with fees: account-balance fees, transaction fees, expensive fund costs
- If your company-provided HSA is lousy, consider using it to obtain a payroll deduction on your HSA contribution, then periodically transferring your balance to a different, better HSA
- If you're self-employed and participating in a high-deductible healthcare plan, you're free to select any HSA
- As long as you save your receipts, you can tap your HSA later on for non-healthcare expenses
  - Example: Tim incurred $2,500 in out-of-pocket healthcare costs in 2015. He used taxable assets rather than his HSA to cover them.
  - In 2016, he needs to pay for a new fence. He can tap his HSA for $2,500 in tax-free withdrawals.

Taxable accounts also belong in investors' toolkits

- Taxable accounts offer a huge amount of flexibility
  - No income limits
  - No strictures regarding investment types
  - No strictures regarding withdrawals
- Good assets to pass to heirs, charity
  - Allow investor to pass on highly appreciated securities without incurring tax cost
  - Heirs receive step-up in cost basis based on date of death
- Capital gains rates currently pretty low
  - Ability to tap assets with a 0% or 15% tax hit could come in handy in retirement

Tax treatment of taxable assets

- Income, short-term capital gains taxed at investors’ ordinary income tax rates (10%-39.6%)
  - Taxable bond income
  - Income from nonqualified dividends (like REITs)
  - Short-term capital gains from fast-trading strategies
- Long-term capital gains (for securities held more than 1 year) taxed as follows:
  - 0%: Investors in 10% and 15% tax brackets
  - 15%: Investors in 25% to 35% tax brackets
  - 20%: Investors in 39.6% tax bracket
- Qualified dividends have same tax treatment as long-term capital gains; most U.S. stocks pay qualified dividends

Mutual funds and capital gains

- When mutual funds sell securities at a profit, they must pass on those gains (to the extent they exceed realized losses) to shareholders
- Capital gains payouts:
  - Usually occur in December
  - Don't necessarily synch up with when an investor has profits
  - Can be exacerbated if a fund has had redemptions: fund forced to sell securities to pay departing shareholders, fund distributes capital gains across smaller shareholder base
- Broad-market index funds tend to have lower turnover, so fewer capital gains distributions
- ETFs also very tax-efficient; low turnover, plus they can use highly appreciated shares to pay off departing institutional shareholders "in kind"

What are tax-friendly investments for taxable accounts?

- Individual stocks (investor controls buying and selling)
- Equity exchange-traded funds (broad market)
- Equity index funds (broad market)
- Tax-managed funds
- Municipal bonds
- Master limited partnerships (rare income-producing security that is better in a taxable account than in an IRA)

Keep these out of your taxable account/inside your IRA/401(k)

- Securities that kick off high levels of ordinary income, such as:
  - High-yield bonds (or funds)
  - Multisector bond funds
  - Emerging-markets bonds (or funds)
  - Bank loans (or funds)
- Securities that pay nonqualified dividends, such as:
  - REITs
  - Some preferreds
- High-turnover mutual funds (rack up S/T capital gains)
- Commodities (gains taxed as 60% long-term, 40% short-term)

Think twice about putting any active equity fund in a taxable account

- Redemptions, manager changes can cause formerly tax-efficient equity funds to pay big capital gains
  - Selected American: Turnover: 26%; 1-year tax-cost ratio: 4.65%
  - T. Rowe Price Equity Income: Turnover: 27%; 1-year tax-cost ratio: 2.11%
  - AMG Yacktman: Turnover: 3%; 1-year tax-cost ratio: 3.15%
- Index funds, ETFs, tax-managed funds are more reliably tax-efficient
  - Vanguard Total Stock Market Index: 10-year tax-cost ratio: 0.41%
  - iShares Core S&P Total US Stock Market: 10-year tax-cost ratio: 0.39%
  - Vanguard Tax-Managed Capital Appreciation: 10-year tax-cost ratio: 0.38%

Model tax-efficient portfolio for accumulators

- 20%: Fidelity Intermediate Municipal Income FLTMX
- 25%: Vanguard FTSE All-World ex-US VFWAX
- 40%: Vanguard Tax-Managed Capital Appreciation VTCLX
- 15%: Vanguard Tax-Managed Small Cap VTMSX

- Assumptions
  - Time horizon to retirement: 20-plus years
  - Risk tolerance/capacity: Above average
  - Target stock/bond mix: 80% stock, 20% bond

Model tax-efficient portfolio for retirees

- 10%: Cash
- 15%: Fidelity Limited Term Municipal Income FSTFX
- 25%: Fidelity Intermediate Municipal Income FLTMX
- 10%: Vanguard FTSE All-World ex-US VFWAX
- 30%: Vanguard Tax-Managed Capital Appreciation VTCLX
- 10%: Vanguard Tax-Managed Small Cap VTMSX

- Assumptions
  - Time horizon/life expectancy: 15 years
  - Risk tolerance/capacity: Average
  - Target stock/bond/cash mix: 50% stock, 40% bond, 10% cash

Best practices for maintaining a taxable portfolio

- Trade as little as possible
- Concentrate rebalancing activity in tax-sheltered accounts
- Use specific share identification method for tracking cost basis
- Use market downturns, security-specific problems as an opportunity to harvest tax losses
  - Can buy similar security to maintain like-minded market exposure
  - Buying exact security triggers the "wash sale rule"
- Consider tax-gain harvesting if in the 10% or 15% tax brackets
  - Receive a step-up in cost basis
  - Can re-buy same security immediately
- Consider leaving highly appreciated assets to heirs or give them to charity during your lifetime (removes appreciation from your estate)

Withdrawal sequencing can also help reduce taxes in retirement

- Basic idea is to tap those assets with the biggest tax drag first; save most tax-friendly for last
  - Take required minimum distributions: 50% penalty plus taxes for any amount you don’t take
  - Tap taxable accounts
  - Tap traditional tax-deferred (IRAs and 401(k)s)
  - Save Roth assets for last

But there may be occasions to flout those rules

- Withdraw from tax-deferred accounts rather than taxable in an unusually low tax year
  - You have lots of healthcare and other deductions
  - Your income is low because you're post-retirement, pre-RMD; want to reduce future RMDs
- Withdraw from Roth accounts rather than tapping more heavily taxed accounts (tax-deferred, taxable) in particularly high tax year
  - You have fewer deductions than usual
  - RMDs bigger than usual due to market appreciation
- Withdraw from tax-deferred or even Roth accounts before taxable if selling taxable would trigger big capital gains bill
  - Those highly appreciated assets may be best left for heirs or given to charity during your lifetime

And what about those dreaded RMDs?

- You can and should reinvest them if they will take you over your planned withdrawal rate
- Cannot get back into a Traditional IRA but consider:
  - A Roth IRA if you or your spouse have earned income
  - A taxable account (open to anyone)
- Can use RMDs to help restore balance in your portfolio; withdraw from highly appreciated positions, for example
- Qualified charitable distributions (QCDs) can also be effective
  - Send RMD straight to charity so it never hits your income
  - Will tend to be more beneficial than withdrawing the money and then donating

The big takeaways

- Take advantage of all of the tax-sheltered wrappers you have available
  - Even ‘meh’ performers in tax-sheltered accounts will look better when their tax benefits are factored in
  - Highly taxed investments are a good fit here
- Stash additional assets in tax-efficient investments inside a simple taxable account
  - For cash: Cash!
  - For bonds: Municipal bond funds from Fidelity, Vanguard, T. Rowe Price
  - For stocks: Individual stocks, ETFs, index funds, tax-managed funds
- Practice good tax management: Harvest losses (or gains), limit trading
- Revisit withdrawal sequencing each year in retirement

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