THE TAX ADVISOR

By Karl Romero, CFP, CFS

Be Tax Sensitive, Not Tax Driven

When advisors are first building a portfolio, and then managing it, be careful not to let the tax tail wag the investment dog

MUCH HAS BEEN WRITTEN ABOUT THE new tax rates promulgated by last year's tax bill, but what impact have those rates had on investors, the markets, and financial advisors?

When Congress passed the Jobs and Growth Tax Relief Reconciliation Act, or JGTRRA (a stand-up comedian could not have dreamed up a more long-winded moniker), tax rates on long-term capital gains and qualified dividends were slashed to 15%. A snapshot of JGTRRA provisions shows that capital gains will be taxed at 15% for most investments held more than one year. Dividend income from domestic and qualified foreign companies will be taxed at the same 15% for most investors. Those in the 10-15% tax brackets will be taxed at 5% through 2007, dropping to zero in 2008. Coinciding with the economy awakening from a three-year hibernation, many expected the legislation to trigger a flurry of portfolio realignment activity.

But it appears there has been no stampede into higher dividend-paying stocks. Among the many financial planners and investment managers I know, few have experienced much client interest in converting to higher-dividend-yielding stocks. Of course, there is always the possibility of an upswing in activity now that tax season has passed and the realities of ordinary income versus capital gains rates have fully sunk in on investors.

Jeff Coons, the co-director of research at Manning and Napier Advisors in New York, reports that investors are beginning to display a desire for dividend yield, but he believes the renewed interest in yield may have as much to do with low bond and money market yields as the lowered tax rates on dividends. "Being able to realize some dividend yield in addition to a stock's growth potential," says Coons, "has become more attractive from an investment perspective."

Coons believes that, to some extent, the new rates will help investors avoid making decisions based solely on tax considerations, "which is how a lot of bad investment decisions are made." To the extent that dividend tax rates have declined somewhat, he thinks investors may be more willing to look at income and capital gains as a balanced tradeoff. "In the past, growth stocks held for a long time represented the larger portion of many individual investor portfolios because of tax treatment concerns. Anything that promotes a willingness to take gains and lower their overall portfolio risk is a positive development," he adds.

John Dickerson, president of Summit Global Management in San Diego, has not seen any objective or even anecdotal evidence that JGTRRA was having a discernible impact on the financial markets as of mid-March. "If pressure to convert assets existed even at the small investor retail level," says Dickerson, "it would be reflected in increased cash flows to higher-dividend-paying stocks, mutual funds, and the like." The only pressure that might have a meaningful impact on the markets in the aggregate, says Dickerson, "would probably be institutional pressure," which he notes is, for the most part, tax-free money, meaning "dividends and the tax rate thereupon are meaningless to them. With individual investors, far and away the most money held in the markets is in their IRAs and 401(k)s, where dividends are again superfluous."

The Capital Gain Impact

The impact of the legislation on capital gains, however, may be a different matter. In particular, owners of closely held companies who may have been contemplating the sale of their business now find themselves with an unusual, albeit relatively short-lived, opportunity to cash out and pay a significantly lower tax rate on the proceeds. Many of my own clients own small businesses, the value of which represent most of their net worth. Many small businesses have no cost basis, so when they are sold the entire profit is treated as capital gains. As such, the lower capital gains taxation will have a significant effect on their planning. While the favorable tax treatment is not scheduled to phase out until the end of 2008, time is still a consideration for those contemplating the sale of their business. While it’s true that taxes will always be a negotiating point between buyers and sellers, the seller who can hold out for his price will probably do better today than later as the leverage created by the four-year opportunity window closes.

Coons argues that the best way to manage **investment risk** is to **sell** a stock before it becomes **overvalued**

Mark Alban, a New York-based CPA, hasn’t seen much movement toward dividend-paying stocks among his clients, most of who are in their 30s and 40s. “For the most part, they seem hesitant to change their investment strategy based solely on tax considerations, which I think is wise for most people,” says Alban. He adds, “I generally advise my clients that choosing investments based on tax treatment is fine if you are convinced the investments won’t change, but that should not be your sole consideration. If your stocks are performing well, the appreciation over the long term will likely more than offset any tax savings you would gain by shifting into dividend-paying stocks.”

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Alban admits that basing investment strategy on tax considerations will guarantee a certain amount of savings, but notes that each person must evaluate whether the savings are worth it. “If an investor hangs on to an underperforming equity to take advantage of the long-term capital gains rate, that’s a guarantee,” he says. “But if in the meantime the stock continues to lose value, hanging on to it purely for tax savings makes no sense. There is the potential for investors to have their thinking clouded regarding performance if their investments are chosen mainly because of their preferential tax treatment.”

Remember Asset Allocation

For most clients, JGTRRA will apparently not have a huge impact on financial planning or asset allocation strategies. Advisors should make certain they have adequate systems in place to monitor and rebalance client portfolios in response to regulatory changes as well as market movements. Run-ups in equity values, such as we have experienced during the past 18 months, can skew portfolio balance. An equity component that previously represented 25% of a portfolio can quickly become 35%, so advisors may want to be especially vigilant in taking advantage of the new capital gains treatment before executing an automatic rebalancing response.

These tax considerations are not an issue if investments are held in a qualified plan, of course. If sectors within a qualified plan portfolio exceed set limits, automatic rebalancing is appropriate because the trades do not trigger a tax impact.

Kirk Michie, drector of client development at Osborne Partners Capital Management in San Francisco, says that while his firm has answered questions from clients about JGTRRA and the stimulus that preceded it, he has not seen pressure to restructure portfolios. “Investing for higher dividends has historically been a losing equity strategy (rising dividends excluded),” Michie notes. “In fact, I have seen some research from Merrill Lynch indicating dividend-focused investing may be among the worst performing styles over the past 15 years,” he says. Conceding that taxes should always be kept in mind for individual investors, Michie says the new revisions “merely highlight the fact that longer-term holding periods are preferable because they minimize tax impact and transaction costs; offsetting gains and losses always benefit the investor; and while it’s important to pay attention to tax policy, it’s more critical to adhere to a proven strategy for generating performance.” In short, Michie concludes, you shouldn’t “let the tax tail wag the investment dog.”

Tax considerations remain an integral aspect of financial planning discipline and asset allocation strategy, just as they did prior to JGTRRA. They continue to have an impact through all stages of a client’s life and are a crucial issue in both pre- and post-retirement planning. The desire on the part of some clients to reallocate assets based solely on tax considerations should not compel financial advisors to abandon long-term investment objectives or established financial planning principles.

Jeff Coons says that a tax-driven strategy can cause bad investment decision-making, and argues that the best way to manage investment risk is to sell a stock before it becomes overvalued. “The more important managing risk and avoiding sustained losses are to achieving investment objectives,” he says, “the less flexibility to pursue tax-sensitive approaches.” Traditional tax-driven strategies like buy and hold, he contends, only make sense if an investor can “withstand the inevitable downside of holding stocks beyond fair value. After a three-year bear market, we see more investors appreciate this tradeoff and are less willing to let tax treatment control investment risk.”

After all, Coons notes, “Selling a stock today produces a known impact, that is, a definable tax obligation.” The unknown impact is that of holding a given stock at least partially to avoid taxes. Recalling the investors who in the late 1990s held on to technology stocks to avoid taxes on their gains, Coons suggests that, in hindsight, “the 20% tax rate was the least of their problems.”

While the temptation exists to accommodate investors who wish to shift into strategies specifically designed to convert ordinary income into long-term capital gains, as financial advisors we should be wary not to overlook individual client investment objectives or sound asset allocation principles in the process. Investor portfolios should be tax sensitive, but not tax driven.

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