Bridgeway Capital Management, Inc.
Andrew L. Berkin, Ph.D.
Director of Research

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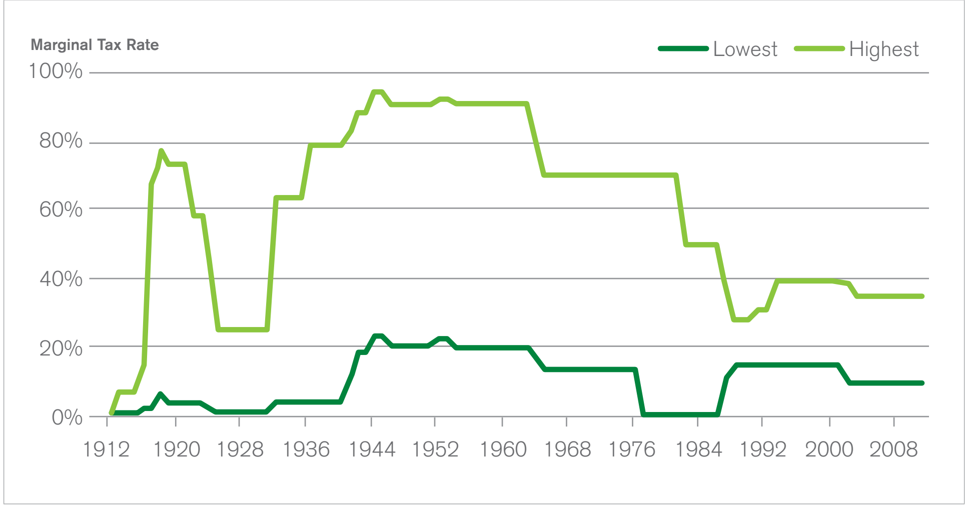
100 Years of Tax Efficiency

Now that 2013 has drawn to a close, those of us who care about tax efficiency (and that should be about everyone with a taxable account) should note an important anniversary. 2013 marked the 100th anniversary of the ratification of the Sixteenth Amendment, and with it the inauguration of regular income tax in the United States. This year also most assuredly marks the 100th anniversary of investors seeking greater tax efficiency.

The top tax rate in 1913 was 7% — low by today's standards but obviously a shock to those used to paying nothing. Before getting too nostalgic, however, that top tax rate rose to 77% in 1917 to help pay for World War I. As the chart below shows, top tax rates have fluctuated widely over the past 100 years from the initial low of 7% to a high of 94% in 1944–1945. By historical standards, today's tax rates are rather moderate.

Whether rates are high or low, people have always sought to reduce the taxes they pay. While some methods have been dubious or illegal, perfectly standard, well-established techniques exist to reduce tax payments. Judge Learned Hand, widely regarded as the most quoted judicial philosopher of the 20th century, once noted that "…there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible…" Indeed, one could argue that many of the provisions of the tax code are there to encourage people to make beneficial decisions. These include incentives to save for retirement, health care, and education and thus lessen poverty and reliance on the government; to own a home and create social stability; and to be a long-term investor and help grow business and the economy.

Historical Marginal Tax Rates for Highest and Lowest Income Earners



Source: Tax Foundation

To commemorate 100 years of tax efficiency, some of these common techniques are discussed below. Many of these are well known to both financial advisors and their clients, but listing them provides a reminder of their existence and importance. Much of investing is filled with uncertainty, but taxes are one aspect where an investor has greater control. Utilizing tax-efficient techniques helps keep the overall cost of investing down and leaves more wealth to grow and benefit from.

1. **Utilize tax-advantaged accounts.** As previously noted, the tax code provides for tax-advantaged accounts for purposes such as saving for retirement, health care, and education. Some of these, such as 401(k) retirement plans, are funded with pretax dollars and taxes are paid at withdrawal. Other plans are funded with after-tax dollars but no tax is paid upon withdrawal. Generally, the investments grow tax free.
2. **Implement asset location.** Investors will generally have money in different accounts, some taxable and others tax advantaged. Rather than holding the same allocation across accounts, locate assets in a tax-efficient manner. This often means placing less tax-efficient investments — such as fixed income where the coupon payments are taxed at ordinary income rates — in tax-advantaged accounts. More tax-efficient investments, such as low turnover equities, should be considered for taxable accounts. Tax rates now and in the future do matter. For example, placing those equities in a tax-deferred account, such as a regular IRA, can also mean they will be taxed at potentially higher income rates upon withdrawal, whereas they would be taxed at lower long-term capital gain rates if held in a taxable account.
3. **Consider Roth conversions.** The tax code now allows all investors to convert regular IRAs to Roth IRAs. Tax must be paid on the amount converted, but that money is then withdrawn tax free in retirement. Such conversions may make sense for investors who expect to be in a higher income bracket in retirement. By paying those taxes with money from outside the IRA, the amount of money growing tax free effectively increases. A big advantage can occur by doing the conversion at the beginning of the year and then waiting until taxes are filed to decide whether to keep the conversion or recharacterize it back to a regular IRA. Because taxes are due on the amount that was converted, if the account has appreciated notably, then taxes are being paid on a lower amount than the IRA is currently worth. If the IRA has declined in value or appreciated only modestly, then it should be recharacterized and the process repeated the following year.
4. **Avoid realizing gains.** One of the simplest ways to minimize taxes is to avoid realizing gains, as taxes aren't triggered until a position is sold. By waiting at least a year, short-term capital gains become long term and are taxed at a lower rate. But, delaying gains even longer effectively acts as an interest-free loan from the government. The money not being paid in taxes continues to remain invested. If a portfolio is held until death, then taxes may be avoided altogether as heirs receive a tax-free step up in cost basis. Gifting appreciated positions to charity can avoid realizing gains as well. It is important to not let tax considerations overwhelm other decisions, such as desired asset allocation. When positions do need to be trimmed, use tax lot accounting to identify the most tax-efficient lots to be sold.
5. **Actively harvest losses.** While investors don't want their holdings to go down, a well-diversified portfolio will typically have some positions that are at a loss. Realizing those losses by selling the positions enhances after-tax returns, as the losses can be offset against realized gains. Excess losses can even help reduce taxable income by up to $3,000 each year. Investors do need to be careful of wash sales, however, as repurchasing a substantially similar security within a 30-day window around the sale invalidates the loss. Opportunities for loss harvesting should be monitored year round, not just at year end, and should be considered on a lot-by-lot basis.

The aforementioned techniques are common but can contain some subtleties. Considerations such as the investor's specific current and future tax rates, retirement plans, and cash flows all matter. Tax-efficient investing is a critical part of an overall financial plan and needs to be considered in the context of the plan's other elements. Investor circumstances, portfolio positioning, and tax laws all can change and thus need to be monitored. By doing so, implementing tax-efficient solutions can be quite rewarding and should be an important element of every investment decision.

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