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7 All-Star Tax Experts: 7 Crisis-Tested Strategies

Martin Shenkman leads our top lineup of tax experts to help you get the most for your clients this April 15

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Photography by David Johnson

They call them experts for a reason. While tax changes are freaking out the average Joe, many advisors are calmly going about their business, lessening the tax burden on wealthy and high-net-worth clients. Strategies that were in place long in advance of the election, the fiscal cliff and the sequester are ticking along despite market booms and busts and worries over what might happen tomorrow. We spoke with a number of them who were willing to share their best and most effective tactics in protecting client assets as they grow.

Trust Strategies

Trusts are feeling the effects of tax law changes more than other planning stratagems. Martin Shenkman of Martin M. Shenkman PC in Paramus, N.J., said that trustees of non-grantor trusts may need to consider gathering information on trust beneficiaries to determine tax consequences of distributions from the trust. “Bear in mind that trusts face a very compressed tax rate structure so that a trust will bear the maximum income tax rate and the 3.8% Medicare tax on about $12,000 of income,” Shenkman explained. “If beneficiaries are in lower brackets, they may demand distributions justifying those demands by the tax savings.”

However, there’s considerably more to it than that. “Income tax status information on the beneficiaries, including federal tax bracket, adjusted gross income to ascertain the impact of a distribution, state of residence to ascertain state income tax consequences, and more” may be required to determine whether distributions are warranted, and if so, to whom—particularly if one beneficiary is in a substantially lower tax bracket than others. Some of the other factors that must be considered include everything from the detailed terms of the trust to its investment policy statement and the Prudent Investor Act in the state whose laws govern the trust.

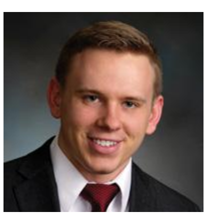
Bypass trusts may have been abandoned in some estate plans in the wake of the American Taxpayer Relief Act of 2012 (ATRA), with "some clients [… opting] for outright bequests or marital trusts so that the assets bequeathed will be included in the taxable estate of the surviving spouse to receive a step up in income tax basis on the second spouse's death," Shenkman said. "In contrast to the past, these clients will likely rely on portability to avoid federal estate tax on the death of the second spouse."

However, he pointed out, "Those opting for non-trust 'simple' distribution plans will expose assets to creditors, remarriage and other risks that could prove more devastating than the estate or income tax."

When all is said and done, changes in the tax laws will necessitate rethinking on trusts. "It might have been best in the past to pack equities into the bypass trust to maximize estate tax savings," said Shenkman. However, "under the new paradigm it might make more sense to have 100% bonds invested in a bypass trust to limit the potential for growth in the bypass trust. Locating equities in the marital trust (or surviving spouse's investments) should result in concentrating appreciation in the surviving spouse's estate where those assets can qualify for a step up in basis. This is quite the opposite of what was typically done in the past."

Shenkman concluded, "Investment planning and, in particular, asset location decisions have been affected by the new Medicare tax on passive income, the new relationship of income and estate tax, terms of the governing trust (which sometimes can be changed), the Prudent Investor Act and more."

Strategic Investing 101



Some tax-efficient planning begins when investments are chosen. While it's common to look at factors like equities versus bonds (more about that later), some parts of the puzzle are lesser known. Wealth manager Derek Tharp of Mote Wealth Management LLC in Cedar Rapids, Iowa, said that among the factors his firm considers is the tax cost ratio of a stock, since the lower the ratio, the less the asset's value falls annually due to taxes.

Specific identification of shares also offers more flexibility, said Tharp, by allowing investors "to identify the shares that best accomplish their tax objectives. They could be identifying highly appreciated securities for charitable gifting, […] securities with large losses to tax loss harvest, or even […] securities with large gains to tax gain harvest if they felt it was appropriate."

Asset Location, Location, Location

Tharp mentioned another strategy experts use: where to place a client's assets. He explained: "Many advisors make a location determination based on either expected return or tax efficiency of a fund. However, research suggests that optimal location is actually determined by a combination of both tax efficiency and expected return."

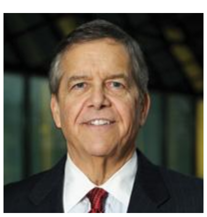
He pointed out that "when asset class returns are low, such as a bond fund," where the asset is located has less effect on overall wealth accumulation than the location of an asset class with high returns. "This stresses the importance of placing high-return, low-efficiency asset classes in qualified accounts first."

Planner Bobbie Munroe, owner of Fraser Financial in Atlanta, said of asset location, "It often surprises me when I work with new clients [that] all of their accounts hold exactly the same investments." It may make an advisor's job easier, she said, to "come up with a basic allocation and repeat it … [and w]hen it comes time to rebalance, all accounts may be rebalanced to the same percentages. But," she added, "it is NOT tax efficient" [emphasis hers]. She suggested putting a client's "riskiest investments"—those with the potential for the highest return, such as "tech, emerging markets or even high-yield bonds"—into Roths, where they can grow tax free.

Munroe added that while she does still use mutual funds, she does so largely within retirement accounts for dollar-cost averaging purposes. She prefers ETFs, which are usually more tax efficient than mutual funds thanks to their ability to do tax-free swaps.

An additional method of locating assets in a tax-efficient manner comes from Alan Clopine, CFO and director of tax planning for Pure Financial Advisors in San Diego. "We look at Roth conversion strategies in which our clients slowly move assets from IRAs/401(k)s to Roth IRAs," said Clopine. "You don't want to convert all of your assets to a Roth in one year because it will push you into too high of a tax bracket."

Instead, he said, his firm maximizes clients' current tax brackets, up to the 28% bracket, by converting to the top of that bracket. "The other tax brackets are often too expensive to justify a Roth conversion," he added, "particularly considering the AMT." The firm also considers a client's expected tax bracket in retirement and "combine[s] several other tax deduction strategies to reduce taxable income, thereby increasing our Roth conversion recommendations."



Mark Germain, founder and CEO of Beacon Wealth Management in Hackensack, N.J., pointed out that dividends coming out of a 401(k) account are "taxed at the current tax rate, not the capital gains rate" or any other rate. "So putting dividend payers into a 401(k) is not necessarily the best choice, because outside [of a 401(k)], the dividend is taxed at a lower rate."

CPA John Smartt, an RIA from Knoxville, Tenn., pointed out something that could escape the notice of some advisors. "Most 401(k) participants, and even the trustees of the plan, do not realize that you may be throwing away tax dollars if you own investments with foreign assets in your 401(k)," he cautioned.

The way it works is this: “If you own a mutual fund with foreign stock in your account, and if BP [for example] declares a dividend, then 10% to 20% of that dividend is routinely withheld at the source for the payment of foreign taxes. And with a 401(k) investment, that’s the end of the story,” he explained. However, “if that investment were sited (i.e., owned) in your regular, currently taxed account, then, after the end of the year, your 1099 form has a box [to indicate] foreign taxes withheld, and you get this as a dollar-for-dollar credit against individual income taxes on Form 1040.”

Tax Loss Harvesting

This is probably the most common tactic. Clopine recommended taking advantage of the volatility of higher-growth asset classes by harvesting losses when they occur; at the same time, he advised, “buy a ‘shadow’ position on the same day—so therefore you will enjoy the recovery, but you have harvested a capital loss on your tax return.”

Germain said such a tactic “will allow us to have losses to offset gains, which is very tax efficient.” It allows one to create a “reserve” of tax losses that can be harvested at need. While short-term gains are being “taxed at the highest income rate [and are …] inefficient where tax rates are going,” short-term losses can be used to offset both short- and long-term gains. Long-term losses, on the other hand, can only be used against long-term gains.

Income Shifting

Germain suggested that shifting income is another tax-efficient strategy. “One thing we use quite often in HNW management is a structure to put assets in for two purposes: one is asset protection, two is asset transfer.” He proposed a hypothetical situation of a father and daughter; the father forms a legal entity that allows him to direct who gets the income from the assets and who gets the losses. Then the father, who is, say, in a 40% tax bracket, can direct the income to his daughter, who may still be in school or just starting to build a career and is likely in a 15% tax bracket. That puts the taxes at a significantly lower level, even combined with the daughter’s earnings.

Another tactic, still using that entity holding the assets, is for the father to give the daughter a gift to pay her tax bill directly, “without ever taking money out of the investment pool.”

Creating a Business Entity

When an asset-holding entity is created, Germain said, which “exists like a human being—it has its own life, its own tax ID number, its own existence”—it can’t just be created and then ignored. “The IRS and regulatory authorities say you must have it as some kind of business concern” or make it a nonreversible gift. The business entity can have another advantage in that it can turn a hobby into a real business and provide tax advantages.

“We did that for a fairly wealthy client,” he recalled. “He had a beautiful farm in one of the northern states. We looked at it and said, ‘There’s a lot of hardwood on the farm. Did you think of selling any of that?'" By converting the wooded acres to a tree farm, Germain said, the client gained significant tax savings.

"We created a tree farm, had the state people come out and do a plot plan and [decide] what to harvest and what to replant," he related, "and this rather high-income earner was able to take what was his hobby, playing on the farm, and turn it into legal tax savings and do something for the economy." The farm had started out as a means of stress relief but was transformed into a tax-efficient entity.

Germain said advisors have to ask what the client's objective is. "Just doing a tax strategy is not what's driving the whole process. What is it that the HNW client, or any client, is looking to accomplish? Once you know that, you can come up with strategies, investment tools, tax-efficient planning to meet those objectives."

Stocks Versus Bonds

Advisor Brian Goodstadt of Paragon Capital Management in Denver said that his firm has not significantly changed what it does based on changes in the tax laws, either. Most of Paragon's clients are tax-sensitive, so "what's maybe a little bit unique is the way we look at expected returns of stocks and bonds."

The firm checks them out on both a before- and after-tax basis. While the equity risk premium may look at first glance to be about 4% over bonds, given Treasury yields projected to be about 2% over the next 10 years, Goodstadt reminded us that municipal bonds offer a higher return—more like 3%. That cuts the equity risk premium to 2%, and, "given the added risk of stocks, 2% is not a huge premium to justify risk. Conclusion? The higher the tax rate and the more assets you have in taxable accounts, the more attractive bonds get relative to stocks." Bearing that out is the fact that his firm's clients have shifted from at least 60% stocks and 40% bonds a decade ago, maybe even 70%–30%, to closer to 50%–50%, with some completely reversing to 30% stocks and 70% bonds.

Tax-efficient planning's many moving parts may not be new, but they are effective—something clients will be even more grateful for going forward.
