

*An Introduction to Tax Aspects of  
Investment Management*

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April 2008

# “Four Horsemen of the Investment Apocalypse”

1. Investment Expenses  
(Management fees, transaction, and custody costs)
2. Taxes  
(Income and estate taxes)
3. Inflation
4. Consumption

# “Four Horsemen of the Investment Apocalypse”

Example:

Gross R.O.R. (R)	R
<u>Less:</u>	
Expense Rate (E)	R-E
Tax Rate (T)	$(R-E) \times (1-T)$
Inflation (i)	$((R-E) \times (1-T)) / (1 - i)$
Consumption Rate (C)	$((R-E) \times (1-T)) / (1 - i) - C$

Note that some expenses will actually be “Below the Line” (E’) and some above, e.g., Knight Case.

$$(((R-E) \times (1-T)) - E') / (1 - i) - C$$

# “Four Horsemen of the Investment Apocalypse”

Vanguard Total Bond Fund on 2/13/08

Yield	4.39%
Fees	<u>-0.19%</u>
Yield After Expenses	4.20%
Taxes	<u>-1.47%</u> at 35% Federal Only
Yield After Taxes	2.73%
Inflation	<u>-4.50%</u> Estimated Headline Number
Net Real Increase	-1.77%
Consumption	<u>-5.00%</u> Endowment Spending Rule
Change in Real Net Worth	-6.77%

Sustainability is 14.8 Years

# “Four Horsemen of the Investment Apocalypse”

Example with Stocks:

Return Incl. Dividends	6.25%	Vanguard Ttl Stk Mkt Index 10Y
Fees	<u>-0.15%</u>	
Return After Expenses	6.10%	
Taxes	<u>-0.92%</u>	15% Federal
Return After Taxes	5.19%	
Inflation	<u>-4.50%</u>	Estimated Headline Number
Net Real Increase	0.69%	
Consumption	<u>-5.00%</u>	Endowment Spending Rule
Change in Real Net Worth	-4.31%	

Sustainability is 23.2 Years

# The Hedge Fund Problem

You have been offered an investment in the Achilles Fund, a top one-percentile fund.

It has made 17% per year for 12 years – gross.

It only charges a 2% management fee and a 20% carry.

Half its income is STCG + ordinary income and half is from 1256 contracts (60% LTCG/40%STCG) – for a blended federal + state rate of about 33%.

To achieve this return ALL your hedge funds have to be this good – not just one!

Notes: LTCG = long-term capital gains; STCG = short-term capital gains

# The Hedge Fund Problem

Gross	17%
Mgmt Fee	2%
<u>Carry</u>	<u>-3%</u>
Net pre-tax	12%
<u>Less tax</u>	<u>-4%</u>
Net	8%

# The Federal Income Tax System – Why Knowing the Rate is Not Enough

## Three Factors Determine the Amount of Tax

- Tax “Rate”
- “Character” of Income
- Applicable “Netting” Rules

# Tax Rates Vary Widely Across and Within Asset Classes

## Examples:

Interest 35%

Dividends 15%

LTCG 15%

STCG 35%

Real Estate Recapture 25%

Collectibles, Long Term 28%

Alternative Minimum Tax 28%

Effect of deduction limitations 2%-7%

Notes: LTCG = long-term capital gains; STCG = short-term capital gains

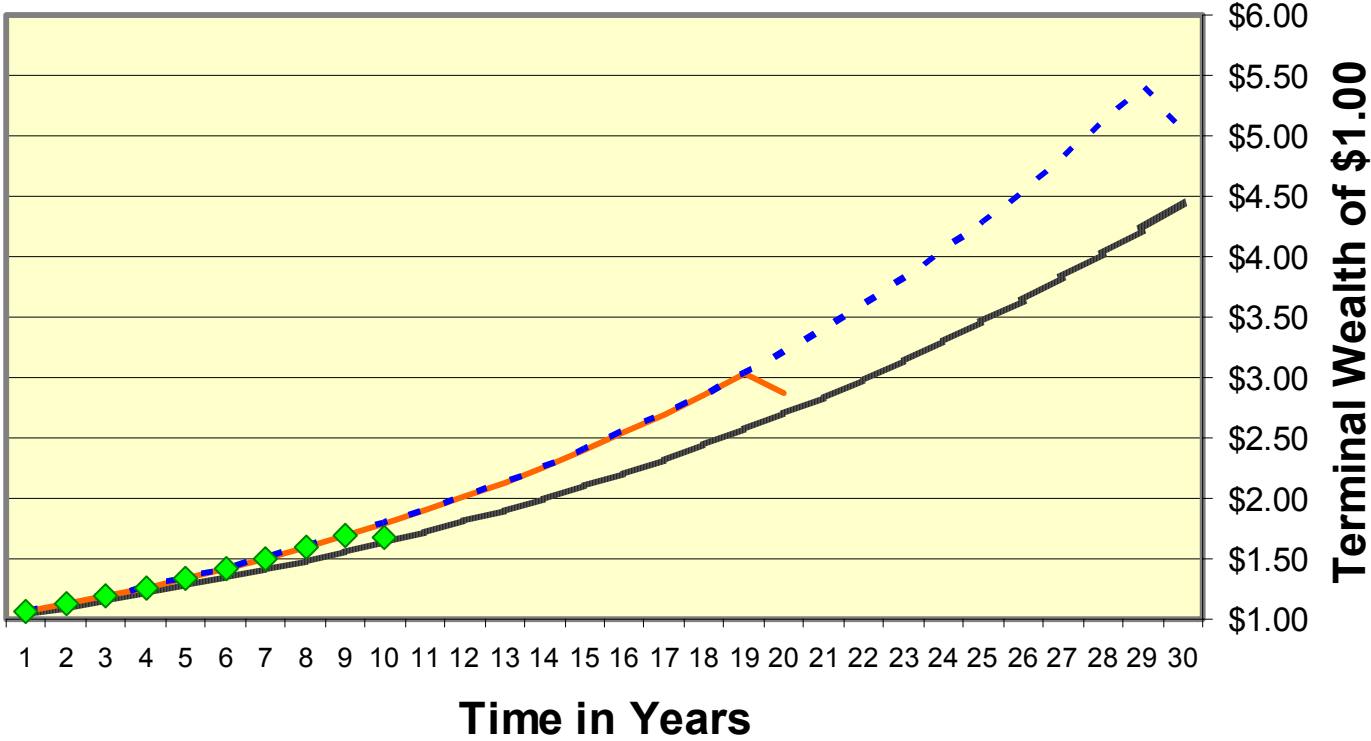
# Tax Deferral

# Terminal Wealth of \$10,000 Invested Under Different Tax Rates

	5 Years	10 Years	20 Years
<u>ROR=5%</u>			
15% LTCG tax	\$12,310	\$15,160	\$22,990
35% STCG tax	\$11,730	\$13,770	\$18,960
<u>ROR=10%</u>			
15% LTCG tax	\$15,040	\$22,610	\$51,120
35% STCG tax	\$13,700	\$18,770	\$35,240

Notes: LTCG = long-term capital gains; STCG = short-term capital gains

# After-Tax Price Change 6% Compounded Annually



# Terminal Wealth as a Percentage of Tax Exempt Investing

Price Change Only (ROR = 6.0%)

<u>Years to Liquidation</u>	<u>No tax</u>	<u>Tax deferred</u>	<u>Annual tax</u>
5	100.0%	96.2%	95.8%
10	100.0%	93.4%	91.8%
15	100.0%	91.3%	88.0%
20	100.0%	89.7%	84.3%
25	100.0%	88.5%	80.8%
30	100.0%	87.6%	77.4%

# Tax Loss Harvesting

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## Two core issues:

1. Present value of tax deduction must meaningfully exceed total transaction costs.
2. For each trade the amount of loss taken should be maximized.

# Tax Loss Harvesting

## Operational problems to be solved:

- A. How do you calculate NPV of tax deduction and transaction costs when recapture is uncertain?
- B. How do you know when to trigger a loss recognition?

# The Gift Tax and the Estate Tax – Why it Matters for Investment Decisions

The ultimate value of tax deferral depends on which of the following occurs:

1. Estate is below exemption
2. Estate left to charity
3. Estate subject to tax
4. Estate left to spouse

# Q: Why is it usually better to defer gain recognition until death?

If cost is \$1000, FMV is \$1500, LTCG rate is 15%, estate tax rate is 45%, then total tax paid is:

		<u>Is the estate exempt?</u>	
		<u>YES</u>	<u>NO</u>
<u>Gain recognized before death?</u>	<i>YES</i>	\$75.00	\$716.25
	<i>NO</i>	\$ -0-	\$675.00

A: You save the cap gain tax X (1 - the estate tax rate).

# *Contact Information*

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