FINANCIAL ADVISOR FA

This copy is for your personal, non-commercial use only. Reproductions and distribution of this news story are strictly prohibited.

- View reprint options • Order a reprint article now • Print

Using The Tax Protection Triangle To Help Clients Limit The Impact Of Taxes

JULY 10, 2019 • JEFF MAGSON

The old adage about investing remains the gold standard for portfolio management—“it’s not what you make, it’s what you keep.” Each year, as clients receive 1099s for their investment accounts, the issue of taxes from investment holdings—capital gains, income, mutual fund distributions, etc.—generate a discussion with their advisor.

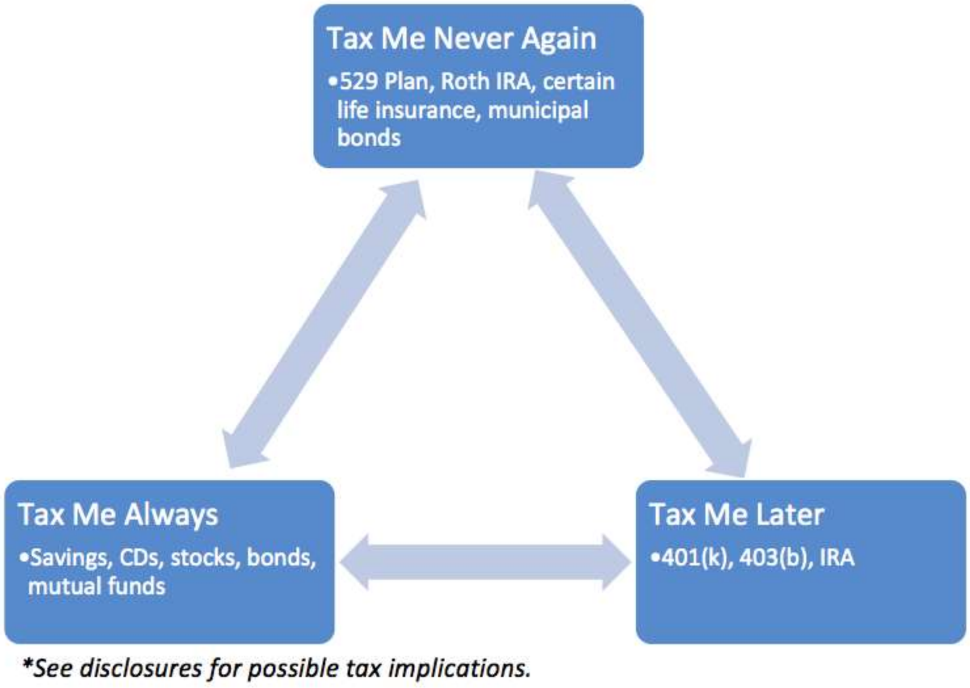
While asset allocation and explaining return dynamics and risk mitigation have long played a central role in advisor/client relationships, a significant portion of the “what you keep” comes down to taxes. Not all clients receive a truly comprehensive tax impact discussion, but it’s become essential and when it’s combined with portfolio planning, it’s an invaluable part of the partnership.

More wealth managers are recognizing that advising clients on another layer of diversification, called asset location, adds such value, that it’s become a differentiator for advisors who have that expertise. This is why a growing number of CPAs and tax professionals see an opportunity to move into providing wealth management, both to existing clients and new ones.

For financial advisors, effectively navigating clients through tax-consideration conversations can add a substantial amount to the advisor/client relationship. While tax considerations can oftentimes be very complex, there are some devices advisors can use to help clients visualize their options.

The Tax Protection Triangle

The easiest way to explain how taxes impact a client’s portfolio is to look at the various strategies in three separate buckets based on how they are taxed. Each is taxed very differently, and how much a client actually keeps over time is not inconsequential, particularly as the portfolio grows. It’s the greatest proof point that investing is not just about what you invest in, but also very much about which bucket the holdings go—and that’s where the benefit of having a CPA trained financial advisor truly becomes apparent.


Tax Me Never Again
•529 Plan, Roth IRA, certain life insurance, municipal bonds
Tax Me Always
•Savings, CDs, stocks, bonds, mutual funds
Tax Me Later
•401(k), 403(b), IRA
*See disclosures for possible tax implications.

Bucket 1 (Tax Me Always):

Investments made in this area are made with after-tax dollars, meaning federal and state taxes have been collected on earnings before remaining funds can be invested. Over time, this is where a client sees the most frequent ongoing tax liability, as interest, dividends and short- and long-term capital gains are all taxed annually as recognized. This is the area of the account that should be managed with prudence and close calculation from a tax-efficient standpoint. Minimizing short-term trading, tax-loss harvesting, etc. can all be part of the strategy. The benefits to investing in this arena include maximum product availability as well as liquidity.

Bucket 2 (Tax Me Later):

Investments made in this area are funded with pre-tax money, meaning more of each dollar earned can go to work. Investments reside in tax-deferred accounts, such as traditional IRAs, 401(k)s or 403(b)s, and provide some of the best opportunities to invest for the future while deferring tax implications for a very long time. During the period of investment, gains are not subject to taxation, leaving again more capital available to grow. Ultimately, when these funds are withdrawn, they are 100 percent subject to ordinary income tax rates. Additionally, there are IRS restrictions on funding and withdrawals.

Bucket 3: (Tax Me Never Again):

Similarly to the first bucket, investments made in the area are made with after-tax dollars, and like bucket 2, assets can grow annually without incurring tax liability. Finally, and most critically, funds can be withdrawn in the future with no further tax implications. Clients who can fund this segment of their portfolios can see the most benefit, as municipal bonds, 529 plans, Roth IRAs and specially designed life insurance plans all offer tax-advantaged investing.

To best illustrate the power of creating a diversified portfolio that takes into account the detrimental effect of taxation now and in the future, let’s compare the outcome for two hypothetical clients of identical means and saving capability. The only difference between the two is that the first client relies heavily on qualified plan savings (bucket two) for the future, and invests the rest in traditional non-qualified accounts (bucket one). The second considers asset location, saving the same amount of money over time while intentionally diversifying how that money will be taxed now and in the future.

For simplicity, let's assume each client needs to supplement retirement income by accessing $100,000 from their overall savings. This is a hypothetical example used for illustrative purposes only, and does not represent the return of any specific investment. Actual rates of return will vary over time, particularly for long-term investments. Tax deferred accounts: Withdrawals of taxable amounts will be subject to ordinary income tax and if made prior to age 59½ may be subject to a 10 percent IRS tax penalty.

Client #1 –Like the majority of Americans, their investments are concentrated in the "tax me always" and "tax me later" buckets. This means that the first $19,000 they take out is taxed at 10 percent (so $1,900 tax liability), the next $58,000 is taxed at 12 percent ($7,000 liability) and the last $23,000 is taxed at 22 percent ($5,000 tax liability). Collectively, their tax liability is $13,900, so of the $100,000 they need annually, they're only getting $86,100.

Client #2 – By incorporating the "tax me never again" bucket as part of their savings strategy for years, they now have options. The first $19,000 they take out is still taxed at 10 percent (so $1,900 tax liability), and the next $58,000 is still taxed at 12 percent ($7,000 liability). However, they now have the option not to access the final $23,000 from a "tax me never again" account, such as a Roth IRA or specially designed life insurance policy. This means zero additional tax, for a total tax liability of $8,900. Compared to Client 1, they have a total tax savings of $5,000 for that year. Multiply that over a 30-year retirement, and they are able to avoid $150,000 in tax liability.

Intentionally building tax control into portfolio design clearly gives clients options in retirement. For example, if we assume client #2 will avoid paying $150,000 in unnecessary tax over the course of a 30-year retirement, they can choose to retire sooner or retire better, perhaps enjoying an annual trip with grandchildren. Some clients may choose to take less risk as they save for retirement knowing that they can meet their needs easier by avoiding taxation.

Incorporating asset location with asset allocation clearly adds value over a long-term investment experience. Using this tax protection model is one way financial advisors can better serve their clients.

Jeff Magson, CRPC, is an executive vice president and the client experience officer at 1st Global, where he is responsible for national sales and revenue results as well as all product platforms, including those in capital markets, insurance, investment advisory and retirement solutions.

This copy is for your personal, non-commercial use only. Reproductions and distribution of this news story are strictly prohibited.

• **View reprint options** • **Order a reprint article now** • **Print**